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FROM THE SCIENTIFIC COUNCIL

Ladies and Gentlemen,

It is with great pleasure that we present the fourth edition of our „Journal of Management and Financial Sciences". It contains articles from authors of different countries. Because of this we recognise the fact that our articles are of increasing interest on the world markets.

The article written by Professor Bankinata Mishra is a record of what took place during the conference held by the Collegium of Management and Finance, at the Warsaw School of Economics in June of this year. It was dedicated to economic science after the subprime crisis.

Janusz Ostaszewski,
Chairman of the Scientific Council and Dean of the Faculty

Ryszard Bartkowiak,
Vice-Chairman of the Scientific Council and Vice-Dean of the Faculty

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Xavier Institute of Management – Bhubaneswar

The Global Meltdown of the Late 2000s and *The Day After Tomorrow*: A Futuresque Analysis

1. Introduction

Financial-market crises are not always much different from financial scams. A financial scam usually leads to wealth-transfer from a system to some persons or entities. The system may be a government, a group of people or firms, or, simply, investors-at-large. A typical example may involve dishonesty on the part of the sellers of an asset, for which the buyers suffer losses. A financial crisis, on the other hand, may involve stupidity on the part of the marketing-agents (like, say, the investment bankers or brokers), which also leads to loss for the buyers. The recent scam that started in 2007 involved both: dishonesty as well as foolishness on the part of the sellers (if not the buyers too).

Moreover, financial-market crises are not even new. But, to the generation that faces one of them – God save those who face more than one – it is a shock of a lifetime, more so when investors do not understand the *real monetary* world. Investment is risky – every investor knows this, but pretends not to accept it. Investors are excited when market is doing well, not that unhappy when market is not doing too well, unhappy when market is doing poorly, but very upset and angry at the capital-market when it does quite poorly. That shows a lack of appreciation of risk. In fact, every investor should engrave in his or her mind the following famous words of Socrates: *Remember that there is nothing stable in human affairs; therefore, avoid undue elation in prosperity, or undue depression in adversity*.

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* Professor of Finance, Xavier Institute of Management – Bhubaneswar (XIMB), Bhubaneswar 751013, India (banikant@ximb.ac.in); opinions expressed here are personal. The author thanks Sagarika Mishra for her assistance in the preparation of this article. The author also acknowledges helpful comments from Asit Mohanty and DV Ramana of XIMB as well as Ryszard S. Domański and Marek Gruchelski of SGH (Szkola Glowna Handlowa w Warszawie: Warsaw School of Economics) and other participants at the conference on *Economic Sciences in the Light of New Economic Challenges*, organized by Kolegium Zarządzania i Finansów (Collegium of Management and Finance) of SGH. The author dedicates this article to the memory of his great friend, Professor (Dr) Sakti Padhi, a *guru* in Marxism and econometrics, who died on 2 April 2010, and who always kept stressing that "economists have to be humane".

2. "All that Glisters ain't Gold"

Investing is a bit like betting and gambling, albeit in an *informed* way. In the former you are somewhat aware of the risk you are taking, in the latter, you have more faith in your luck than your knowledge (or analysis). As a popular story goes, a person who lost money over three consecutive days "betting", respectively, on football games, polo games, and basketball games, refused to bet on baseball games on the fourth day, saying "What do I know about baseball?" He was a true investor, engaging *only* in informed betting.

The capital-market, however, does not always attract informed investing. To that extent, anyone putting his or her money in the financial-market must understand that everyone else playing the "game in town" is not an informed better. Things are worse when the "market" is the "global village" and more so when stupid investors join the above-cited uninformed gamblers. "Globalization opened up the whole world of fools, … ignorance did little to stop them snapping up these securities though" (Stiglitz 2010).

What makes things more complex is that a myriad of factors can affect the price of a firm's share, some justifiably and some incomprehensibly. Every investor has to live with it. Even Sir Isaac Newton, who lost thousands of pounds in the South Sea Company debacle in the UK in the early eighteenth century, had exclaimed, "I can calculate the motions of heavenly bodies, but not the madness of people" (Malkiel 2007).

3. Too Big to Fail?

Perhaps many investors perceive many big firms "too big to fail" and panic when they indeed do. This *beautiful* concept of "too big to fail" was actually implicit in the story of "the Weaver and the Chariot Maker" by an Indian pundit, Vishnu Sharma, the author of the famous *Panchatantra*, who himself must not have realized this subtle import of his story. This is how our version of the story – perhaps a little different from the original one (Sarma 2007) – goes.

A weaver sees a princess during a festival and falls in love with her. As a weaver, he has no chance of marrying her; so he sinks into depression. His friend, a chariot-maker, decides to help him out. He designs a flying chariot in the shape of the one used by the Lord (actually the Lord flies around on the back of a mythological big bird named Garuda), dresses the weaver up as the Lord (Vishnu as Hindus call Him), and tells the weaver to fly the chariot into the princess's room. The weaver does that, tells the princess that he is the Lord and that he wants to marry her. But he pleads that the wedding be kept a secret.

The princess agrees, and the weaver comes back every night to consummate the marriage. Eventually, the maids notice that the princess is spending her days in total bliss, suspect that she is in love, and tell her father, the king, about it. The king asks her what is going on, and she tells him that she's married to none other than the Lord himself. The king is absolutely delighted, and decides that – now that the Lord himself is on the kingdom's side – there is no point in paying tax and tribute to Chakravarti, the emperor (the big king who rules over smaller kings). The next night, the king catches the weaver as he enters the princess's room and persuades him to fight the emperor's army. The weaver is horrified at the thought of having to face single-handedly an imperial army. But, if he confesses to the king that he is not actually the Lord, the king would have his head chopped off. So he decides to get on to the battlefield and do the best he can, while the king whips up enthusiasm among his people by telling them that the Lord is going to do all the fighting. By this time, Garuda, the real one, has tipped off the Lord (and – if one may add – also His wife, Lakshmi, the goddess of wealth), about what is going on. Garuda also alerts the Lord that if the weaver, who is impersonating the Lord, does not win the battle, the people of the kingdom will think that the Lord himself has lost and lose all faith in Him. That is something the Lord does not want to see happen. So, on the battlefield, he enters the weaver's body and annihilates the emperor's army; the entire army, every single soldier. The victorious weaver then confesses everything before the king, who is too thrilled at the just-achieved victory to mind such "small" things. So, the king – who becomes the new emperor – marries his daughter off to the princess, and people go on worshipping the omnipotent Lord with greater fervor.

There have been a lot of attempts by the governments of USA and other large countries to demonstrate to the whole world that they are concerned about the recent crisis – in which many big firms failed and had to be bailed out – and want to fix the problem. But, not everyone is convinced or impressed about the genuineness of the efforts and intentions behind these actions. "Sackings and show trials of bankers in front of the United States (US) Congress, United Kingdom (UK) parliamentary committee or elsewhere provide some schadenfreude, but are unlikely to change much for long. …The attack on offshore centres is a politically seductive distraction from the thorny task of making regulation better in large developed countries and will end up being a discriminatory attack on small developing countries with little voice. … Everyone is now getting into the game of blaming 'complex derivative instruments' on the crisis. …(But) financial instruments do not have original sin. It all depends on how they are used" (Persaud 2009b).

4. A *Stern* View of the Crisis

Faculty-members at the Stern School of New York University (NYU) came up with a publication documenting their views on the financial crisis and the solutions to avoid such catastrophes in the future (Acharya and Richardson 2009a). Though they agree, as most do, that the combination of the credit boom and the housing bubble was the root cause of the crisis, it is not as clear why this combination led to the level of severity experienced and particularly its ramification for the *real* economy. In fact, a "disproportionately large financial sector in relation to the real sector is what resides at the root of the present crisis in the American economy" (Ghosh 2010). If society finds that the financial system is not only unable to enhance social welfare, but, instead, is also undermining the same, it can legitimately ask: why is it that the institutions set up over time to oversee the financial system have failed to deliver?" (*ibid*).

Now-a-days, it is investment losses and not bank runs that have become the main source of systematic risk. But, the "transmission mechanism from investment losses to economic losses is not straightforward" (Persaud 2007). The examples of the world markets, however, make it amply clear that "large and widespread investment losses will lead to significant reduction in consumption and investment" (*ibid*). We can look at examples of the property-market collapse in the UK and Sweden in the mid-1980s, the stock-market-bubble burst in Japan in the late-1980s, and the Asian financial crisis in the late-1990s. The current crisis emanating from US amplifies that concern.

5. The Insecurity in Securitisation

It is also felt that, securitisation process depended on the greater fool theory – that there were fools who could be sold the toxic mortgages and the dangerous pieces of paper that were based on them (Stiglitz 2010). In fact, securitisation – whose basic purpose *should be* to transfer risk off the balance sheet of financial institutions – was achieved during 2003-2007 in a faulty way: "more for arbitraging regulation than for sharing risks with markets" (Acharya and Richardson 2009b).

As they highlight, banks set up SIVs (special investment vehicles) which were fully funded by ABSs (asset-backed-securities) like asset-backed-CP (commercial paper), and guaranteed these ABSs – fully or partially – through credit-enhancements and other means. But, these guarantees were off-balance-sheet contingent-liabilities and never reflected in the risk that was slowly and surely going up the ladder.

It is argued that the lack of risk-transfer – the "leverage game" as it is sometimes called – was the ultimate reason for the crisis. It is recommended that booking current profits against future losses should be penalised and regulatory arbitrage should be forestalled, while the contribution of the large, complex financial institutions to systematic risk should be taxed through capital-requirement or deposit-insurance-fee (*ibid*). Here is a summary of the suggestions from the Stern Faculty for restoring financial stability, especially in the USA (Acharya and Richardson 2009a).

- Identify predatory pricing and standardise mortgage loans.
- Focus on the aggregate-risk of the banking system.
- Discontinue the investor – not the guarantor – function of Government Sponsored Enterprises.
- Set up a dedicated regulator for large, complex financial institutions.
- Design compensation structures to make managers maximise the value of enterprise – not equity.
- Make ROA to be benchmarked against the cost of capital in the worst times, not the best.
- Regulate the OTC derivatives the same way as exchange-traded ones.
- Centralise the clearing of derivatives like credit-default-swaps and collateralised-debtobligations.
- Require central banks to ascertain that their loans are used properly.

Regulation should strive to make the financial system less sensitive to the error in the estimate of risk (Persaud 2010). One way to do this is to "limit the flow of risks to institutions with a structural capacity for holding that risk, and not a statistical capacity" (*ibid*). For instance, "banks with short-term funding and many branches originating different loans" would have a good capacity for holding credit-risk but low capacity for liquidity risks, whereas insurance firms and pension funds have the reverse capacity (*ibid*). Recognizing that crashes typically follow booms and are not as random as they are believed to be, it is recommended that a countercyclical capital charge on financial-institutions be imposed (thus requiring them to put aside during booms a higher level of capital than can be used when recession sets in and asset prices fall) and a capital cost be levied on short-term funding of long-term assets by these institutions (Persaud 2009a).

6. Basle(ss) Hopes of Reorientation?

Should one hope for a reorientation of the financial-system, given that the "men who ran the financial system and brought it to a disaster and the men who subsequently took charge to rescue the system were virtually the same" (Ghsoh

2010)? "It would require the profit motive – summum bonum for the market participant – to be made subordinate to the polity motive (so to speak), one that counts the welfare of ordinary citizens as the highest good" (*ibid*). The larger danger lies at the super-macro level of the US's world domination. "In its ambition to continue to remain the global hegemonic power, the US has assumed for itself far-reaching political commitments. There has developed a disturbing asymmetry between the political ambition of the hegemonic power and its capacity to continue financing it without creating a potential threat to global financial stability" (*ibid*).

There are many examples of US hegemony, but two are worth quoting here, since it suggests how the broader economy of smaller countries may be affected in a globalised world. Lawrence Summers, as the chief-economist of the World Bank, had sent a private memorandum in December 1991 to some of his colleagues stating that, "Just between you and me, shouldn't the World Bank be encouraging more migration of the dirty industries to the LDCs? … I think the economic logic behind dumping a load of toxic waste in the lowest-wage country is impeccable and we should face up to that…" (Foster 1993). Shocking, but true!

The second one is a more recent one in some sense, though based on the old 1984 tragedy at Bhopal in the state of Madhya Pradesh, India, where around 15,000 people died due to leakage of gas from the plant of Union Carbide, a US company. Strong reactions have emerged after some recent legal verdict on the case. What has really pushed up emotion is that the Carbide CEO Anderson, a main accused who had been "arrested" was "allowed" to escape from India and, therefore, has not been sentenced. Referring to Arjun Singh, a columnist said, "He was the Chief Minister of Madhya Pradesh when the Bhopal gas tragedy happened on the night of 2–3 December, 1984. Unless he had given specific instructions, how could Anderson have got a plane to flee to Delhi and then to the US" (Shankar 2010a). He wonders what would have happened if an Indian company had done the same on the US soil. USA's first choice, he thinks, would have been as follows. "Arrested the chairman and directors of the Union Carbide of India, try them as expeditiously as possible and give them the toughest punishment. If they were not available in the US, the government would have put pressure on the Indian government and seen to it that the culprits are extradited, even if there was no policy to speak of" (Shankar 2010b).

There is indeed a serious economic danger of remaining subservient to the big powers. Unless a country belongs to the Big Boys' Clubs like G-7, G-30, or G-N – most small and developing countries would not – it would forever remain only at the periphery, while the US or the G-N countries would remain at the centre. Since “the rate of exploitation is and always has been vastly higher in the periphery than in the centre” (Sweezy 1981: 76), this would make the populace of these countries – and, thus, especially their real sectors – quite susceptible to all kinds of shocks, including financial-market tremors.

Is the Basle Consensus the way out of potential future crises? No, believes some authors (Persaud 2008). He urges the India’s central bank, the Reserve Bank of India, not to allow market-prices to be at the centre-stage of regulatory measures. Instead, economic-cycle should be the focal point driving policy measures. Based on recent experiences, he suggests that regulators also look quite closely at the maturity mismatches and leverage inherent in the asset-liability position of financial-institutions. An important and interesting requirement that he pushes for is to make banks either adequately insure themselves or pay taxpayers an insurance-premium (or, rather, a “potential bailout premium”) because of the *possibility* that taxpayers may need to *actually* bail them out later (*ibid*). Similar sentiments have been sounded elsewhere. “Bailout funds would then go into rescuing the hapless borrowers who had been the victims of predatory lending, and stimulus packages would then be designed to directly encourage spending and thereby, enhance employment” (Ghosh 2010).

Technically, however, risk-premium on any financial-asset (including a deposit with a bank or non-banking financial-institution) should have been appropriately determined by the market, taking into account *all* non-diversifiable risks that the holding or ownership of the asset exposes the owner to. But, as we have seen all too often, the market can never fathom the “games banks play”. So, it is a real challenge to *quantify* the above-mentioned default (or bail-out) risk. Based on an analysis of the “financial stability reports” of the UK, Sweden, the Netherlands, and Spain, researchers argue that, whether or not these reports reduced damages, publishing these reports seemed to be “a worthwhile exercise that encourages central banks and international authorities to identify and monitor important financial trends and emerging risks …” (Wilkinson, Spong, and Christensson 2010).

7. “Everything is either good or bad, but you got to think hard to make it so.”

Many think that the recent meltdown would also usher in some realignment in global perspectives and attitudes. “The economic crisis will mean a welcome change to the totally unsustainable increase of carbon dioxide emissions. … Indeed, an economic crisis affords an opportunity to put the economy of the rich countries on a different trajectory as regards material and energy flows. Now is the time in rich countries for a socio-ecological transition to lower levels of energy and materials use. The crisis might also give an opportunity for a restructuring of social institutions. The objective in rich countries should be to live well without the imperative of economic growth" (Martinez-Alier 2008). As the author rightly points out, rich-countries should now look at and adopt a model of "sustainable degrowth".

What does not pass through a "market" does not get priced, and what does not get priced does not enter GDP. But, strangely, a "society rich in 'relational goods and services' would have a lower GDP than an (impossible) society where personal relations would be exclusively mediated by the market" (*ibid*). In fact, the Sustainable Degrowth Model stresses upon "the non-chrematistic value of local, reciprocal services" (*ibid*). It does not require too much of an expertise in economics (or, for that matter, psychology) to realise that "above a certain threshold, GDP growth does not lead necessarily to greater happiness" (*ibid*). The advice, therefore, is to "converge to an acceptable level of material consumption, b) take energy use to lower levels, and c) realize that, beyond a point, higher GDP can indeed lead to lower total welfare" (*ibid*). And also that the "world conservation movement should … push for the introduction of an economic language that reflects better our relations with nature, while not forgetting the legitimacy of other languages: territorial rights, environmental and social justice, livelihood, sacredness" (*ibid*). A world where every person gets at least basic food, health, housing, and education is a happy and sustainable world, the author reiterates. We have to ensure that the prices of these basic necessities are not left to the vagaries of the market. One should not be starve because one's "bonuses" have vanished; should not be sick because one cannot afford to pay the high, unregulated insurance premiums; should not be homeless because one cannot afford to pay the floating mortgage payment anymore; and should not be deprived of studies due to the inability of paying for costly private education.

But, the affluent and even the (temporarily) successful people are often not too generous in helping the underprivileged. "We want the dynamism and flexibility that a capitalist economy uniquely provides. But we want protection too – a safety net for ourselves and our families when markets fail. Lucky, prosperous people disdain this human need for protection when times are good and relief is going to the destitute and unlucky" (Ignatius 2008).

8. "If Spring Comes, Can *Fall* be Far Behind?"

Some have noted that the force behind international capital flow, more for investment than speculation, has revered (Chomsky 1999). Therefore, countries that have not been caught in its cross-current have been lucky many times.

Though India escaped the earlier Asian Financial Crisis, the recent crisis has hit it hard, since it is much more globally-integrated now; this has meant huge price-reductions in the equity-market and a depreciation in the exchange-rate. Anyway, this experience should awaken Indian to the need for cautiousness through self-insurance. "If self-insurance becomes an important policy objective, the government will need to revisit its macroeconomic policy, including exchange rate management and capital account convertibility" (Subramanian 2009). This would involve many things. Some overall measures – which should be, of course, common sense – suggested are as follows (*ibid*).

- Keep debt-to-GDP ratio in rein.
- Manage – even check – capital inflows.
- Have a flexi fiscal policy that can be tightened fast.
- Differentiate between different forms of capital flows.
- Keep an eye on sharp asset-price-increases.
- Keep leverage under control.

But, the same author, in collaboration with another had suggested that the World Trade Organization be empowered to intervene against exchange-rate undervaluation (Mattoo and Subramanian 2008), which was sharply criticized (Goyal 2009), with the critique ascribing this inconsistency to "the authors' preference for India to follow the United States' interests in international negotiations" (*ibid*).

A section, of course, believes that the collapse of the Indian market has nothing much to do directly with the subprime-mortgage crisis *per se*. The real culprit, it claims, is the participatory-note (PN). While PNs accounted for around 46% of the assets managed by the foreign-institutional-investors (FIIs) in 2007 and plummeted to a paltry 16% by the end of 2009 (Sivakumar 2010), it peaked to 60% by September 2008 (Swamy 2010). PN is a derivative instrument that is issued against an underlying asset, such that the holder of the PN receives a part of the income from the underlying security. Indian brokerage-houses buy Indian securities and issue PNs against these to FIIs, who, in turn, sell these to their overseas clients. The PNs are quite attractive to buyers as they do not have to disclose their detailed identities nor the sources of their funds. Not only were the PNs exempt from capital-gains-tax as they came through Mauritius, they were outside the purview of any control, be it by India's security-market-regulator (Securities Exchange Board of India), its central bank (Reserve Bank of India), its premier investigating police agency (Central Bureau of Investigation), or its agency preventing money-laundering and enforcing exchange-control regulations (Enforcement Directorate).

Anyway, the crisis did impact India's real economy adversely. Not only was there a brake on its high growth-rate – which anyway had not helped its poor much during the recent past – employment did suffer, despite many other macroeconomic variables being not too different from the previous years. The Labour Bureau of the Ministry of Labour and Employment estimated that there has been a loss of a half-a-million jobs during September-December 2008. The decline in total employment was higher in the export sector than that in the non-export sector, though, however, the reduction in the employment level of different industries within the export sector was not correlated to the export-intensity of the industries (Kannan 2009). During January-September 2009, however, there was a net addition of around 6.45 lakh – a lakh is 1,00,000 (or 0.10 million) – jobs (Government of India 2010). In 2009-10 financial-year, 4.34 crore – a crore is 1,00,00,000 (or 10 million) – households were provided employment under the National Rural Employment Guarantee Act (*ibid*). The Appendix provides some detailed information on performance of various important sectors of India during the FY 2009-2010, with special highlighting of its last quarter, and also gives some idea about the expectations for this FY 2010-2011.

But, India's usual problems far surpass this unusual crisis. Hunger, poverty, starvation deaths, farmers' suicides, and – yes, of course, one tends to forget this *unusually* usual thing – corruption. The world knows this well. "Europeans believe that Indian leaders in politics and business are so blissfully blinded by the new, sometimes ill-gotten, wealth and deceit that they are living in defiance, insolence and denial to comprehend that the day will come, sooner than later, when the have-nots would hit the streets" (Murti 2010). That Maoism violence is on the increase in India in the wake of liberalisation-induced-income-inequality is perhaps a scary alert – which one hopes is a false alarm – that that day may not be too far. The neglect of the lifeline, agriculture, in minerally-rich but economically-poor states like Orissa (Mishra 2010) where mining – be it in production or exports – has flourished in recent times bears a worrisome testimony to the denial. And, the attempt by big corporations – especially mining based ones – in Orissa and other mining states of India to forcefully displace tribals and underprivileged masses from their land to set up large and capital-intensive factories reveal the defiance (*ibid*).

Something like Kautilya's *Arthashastra*, which gave sagacious advices like "*Road to Wealth Goes by the Countryside*", should be the guide of the hour for Indian firms and governments. This famous epic also sheds light on many issues of administration like Civic Rules, Foreign Trade, Politics, Accounting & Taxation, Legal System, Business Ethics, and Strategy.

9. "If Ignorance is No Bliss, 'Tis Not Folly to be Wise"

Would the economic crisis change economic science? The answer is not that straightforward, more so because the term "change" here is quite difficult to define. Let us analyse the way we go about building a finance theory – say one pertaining to the capital market – and testing it against the real world data. We can break it down to a series of steps.

- Conceive of some objectives of the capital-market participants.
- In the light of that, choose some issue(s) to focus on.
- Make some assumptions about the (environment of the) capital market.
- Build a theoretical model based on the above set-up.
- Test the suitability and efficiency of the above model against real-world data.
- If the model does not satisfy completely, strive to come up with another model.
- Repeat the above steps for the new model.

Let us take the case of the famous CAPM (Capital Asset Pricing Model) that we use to come up with the RRR (Required rate of Return) for discounting cash flows from a risky asset.

- We assume that investors minimize risk for a given return and *vice versa*.
- We want to find out how investors build the risk-premium into pricing of securities.
- We make some assumptions about the capital-market (like, say, it is perfect).
- We come up with the CAPM, which gives us the RRR (to be used to price securities).
- We empirically test CAPM against actual capital-market data.
- We are not fully happy with the way CAPM performs in the real world.
- We come up with an alternative model like APT and test it against real-world data.
- We compare APT to CAPM.
- And the exploration continues...

Assuming that we found CAPM to be the best model and that we have been using it to price financial assets, should the meltdown make us question the model? If yes, question what? The issues that we focused on (like, say, determining the RRR)? The variables that entered our model (like RRR, the risk-free rate, the market return, the beta)? The assumptions behind the model? The model *per se*? Or would one instead argue that the meltdown was due to the failure of one or more group of participants? Academicians? Practitioners? Investors? Companies? Regulators? Government?

There is also a tension between book-value, market-value, and fair-value of assets. Open-ended models make the tension all the more palpable. For example, in CAPM, which Rf do we use? Which market-index and Rm do we use? What frequency of data (daily, weekly, monthly, annual) do we use? How many periods of historical data do we take – 250 days, 50 weeks, 60 months, or 30 years, to cite an example? We ought to consider whether putting more constraints can reduce the above-cited tension. For instance, we can require Rf to be the return on, say, one-year treasury-bill, Rm to be the return on the most broad-based value-weighted index available in the context, and frequency to be monthly (with 60 data-points taken). But, if RRR is a small part of the predicament in valuation of securities, then the problem may get only marginally reduced but not eliminated.

So, we do not think that one can hold economic science responsible for the crisis; economic art possibly was. Thus, the science may not call for alterations, the art may. Here, the role of assumptions is perhaps important. For example, the severe recent recession makes some wonder whether the period of low-volatility that the US economy experienced during most of the three pro-crisis decades is over; but a study concludes that, it is not, though macroeconomic volatility would "undergo occasional shifts between high and low levels, with low volatility the norm" (Clark 2009). Two researchers who have developed a framework to show how "coordination of expectations" was instrumental in the recent crisis point out as follows (Cooper and Willis 2010).

The economic choices individuals make are often based on their expectations of what other people will do – in what economists call "coordination games". In such situations, changes in the beliefs of what others may do can affect the actions of individuals. A key element in such situations is that, as collective beliefs change and individuals respond to these altered expectations, the outcome in the marketplace can change. In the recent crisis, the coordination of expectations played a key role in areas such as financial markets, the housing market, and the automobile sector.

10. Parting Shot

One thing that business-schools all over the world should do is to introduce finance students to scams and financial-crises. Dr Birendra Nayak, a Professor of Mathematics at Utkal University, and I plan to offer a course titled – à la

Ig-Nobel Prize – *Ig-finance: How to Create a Scam*. The purpose of the course is to enlighten the students about how scams are created both through dishonesty and foolishness. We also plan to *prove* to the students that there does not exist a level of "sustainable greed"; any level of greed is simply unsustainable. If we may paraphrase Mahatma Gandhi, "The earth provides enough to satisfy every man's need, *but not enough foreven one man's greed*".

But, going beyond finance, we also need a macro attitude and approach to avoid economic or financial crises. We ought to resist the *Fatal Attraction* of the pure capitalist models. Sustainability – economic, social, or whatever – requires some kind of what one may call *approximate* socialism. Those who romanticize capitalism as the emblem of "efficiency" would do well to understand that "efficiency" has nothing to do with people's welfare. The evolution and development of the much-hyped highway-system in the USA is a classic example. In one case, the "state-corporate programs, which included massive projects of suburbanization along with destruction and then gentrification of inner cities, began with a conspiracy by General Motors, Firestone, and Standard Oil of California to buy up and destroy efficient electric public transportation systems in Los Angeles and dozens of other cities; they were convicted of criminal conspiracy and given a slap on the wrist" (Chomsky 2009).

We must not, however, get caught in the war of isms, which is often a ploy by political parties to make people take attention away from the *real* issues – pun intended. Many a government – irrespective of its *ism* – have always tried to engage in "media control" so that the truth does not come out. Their philosophies may differ only at some subtle – and possibly irrelevant – levels. Some may, however, be relevant. If we consider the history of political democracy and economic democracy (see, for example, Padhi 2010) in communist and capitalist countries, we would possibly reckon that the capitalist system focuses on political democracy, while economic democracy goes for a toss there, but, a communist system perhaps gives higher weight to economic democracy, though political democracy (which would involve, for example, freedom of speech too) is not honoured there in its true spirit.

The right *ism* is people-ism (a new *ism* proposed by us), based on people-centric policies that strive to achieve the highest total welfare for the largest mass (thus, naturally, with as low income and consumption inequalities as possible). This *ism* should give people the right to safeguard their land & livelihood as well as flora & fauna. And, it is only this *ism* that would make the world a better place – nay, a good place – to live in.

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Appendix

India: Yesterday, Today, and Tomorrow

As India's Economic Survey 2009–10 (Government of India 2010) points out, 2009–10 was a difficult year for many countries, and India was *not* an exception. Yet, the manufacturing sector, which had been declining for almost two years (eight quarters), showed signs of recovery and its growth rate in 2009–10 was in fact more than double of its 2007–08 figure. Merchandise export also picked up towards the end of 2009. Food items continued to exhibit an upward price trend, and so did fuel and power (*ibid*). Not surprisingly, there was a decline in the growth-rate of per-capita income and consumption. The monsoon did not provide enough rainfall, and water-storage was inadequate. Due to poor rainfall and perhaps also the neglect of agriculture, area under foodgrains decreased, and the foodgrains output in FY 2009–10 was lower by around 20% (CMIE 2010).

The Index of Industrial Production (IIP) reveals that this sector got back on the track. The honours, however, were not evenly shared. Automobiles, rubber & plastic products, wool & silk textiles, wood products, chemicals exhibited strong growth, while non-metallic mineral-products posted a modest increase. But, paper, leather, and food & jute textiles remained flat, while beverages & tobacco products showed a downward trend (Government of India 2010).

Telecom services – with the telecom sector opening up – showed robust growth and led power, coal, and other infrastructure business like port, civil aviation, and roads on a path of recovery. Despite constraints in coal supply and hydel generation, electricity generation came back to its satisfactory historical levels. The domestic supply of crude-oil and natural-gas was significantly higher than those in previous years. Railways was somewhat like a fairy-tale story, and launching of fast, long-distance trains did their bit to add to this story. National Highways development remains a challenge, but one that the central and state governments would not like to refuse (*ibid*).

The country saw in 2009-10 a surge in coal production. Domestic oil output remained almost flat with a 0.5% increase, but natural-gas output went to an all-time-high. Consumption of petro products also went up by 3.6% in 2009–10 against the previous year. Electricity generation – especially nuclear and thermal – was up by 6.6%. Cargo traffic at major ports grew by 5.7% last FY, while passenger-traffic at airports fell by 7.7%. The telecom sector continued on a dream run, adding over 20 million subscribers in the last month of the last FY (CMIE 2010).

The service-sector continued to grow rapidly though the rate dipped slightly compared to the previous year thanks to a significant decline in community, social, and personal services. But, other sub-sectors like trade, hotels, transport & communications, financing, insurance, real estate & business services retained their growth or did better (Government of India 2010).

A welcome-back of investment that took place in the agricultural sector was what the doctor had ordered, but, the industrial sector has gone through ups and downs in its investment in the recent years. Investment in the service-sector grew as a whole (*ibid*).

In the first half of FY 2009–10, exports and imports exhibited decreases, though BoP situation during this time was better than it was in the previous year. Merchandise exports declined and so did imports – perhaps due to a fall in oil prices – both of which had shown appreciable increases during the corresponding period the previous year. Interestingly, net-capital-flows to the country – in fact, each of its components, except loans and banking capital – grew in this period and touched US$30 billion, almost 2.5 times its level during the same period in the previous year. The foreign-exchange reserve also went up by around US$30 billion to over US$280 billion (*ibid*).

Coming to the most recent time, three factors contributed to the good corporate earnings in the third quarter of the 2009–2010 Financial Year (India's FY goes from the 1st April to 31st March). Fall in interest costs, decrease in electricity and fuel bills, and less than usual growth in salaries helped companies in cost-control, thus leading to an increase in both net and operating profits vis-à-vis their levels in the same quarter the previous year (ET Intelligence Group 2010). Service-sector benefited the most from low interest-rate regime, while the non-financial service-sector also exhibited signs of revival with a decent growth rate (*ibid*). The gains were not even. The manufacturing sector was the leader in growth, while banking and financial services showed only a modest upward-trend in net-profit (*ibid*).

"Yesterday, Once More"

The first quarter of 2010 (which is the last quarter of the FY 2009–2010) as well as the first month of FY 2010–2011 (April 2010) gives an overall mixed-positive picture. Mining and manufacturing GDP at factor-cost at 2004-2005 prices grew year-over-year by more than 10% each, while agriculture's growth was a meagre 0.2% (Business Line 2010). Financing, insurance, real-estate, hotels, transport, and communications grew by more than 9%, while electricity, gas, and water supply as well as construction grew up by 6.5%. The overall GDP at 2004–05 prices went up by 7.4% (*ibid*).

The Indian currency, rupee, which had appreciated against the US$ during 1 December 2009 and 31 March 2010, appreciated further in April 2010. But, India's central bank did not have to trade in the foreign-exchange market during the last quarter of the FY 2009–10 (CMIE 2010). Merchandise exports were very high in March 2010, but imports also went up, paving the way for a current –account deficit. Those expecting a boost in the capital inflows, however, remain quite upbeat. Reversing the "grim" scene in the recent months, FIIs brought in over US$5 billion in March 2010; NRIs also brought in half a billion dollar during that time, reversing the trend in preceding months (*ibid*).

IIP went up by over 15% in February 2010, which should make the growth during the last FY close to 10%. Growth in textiles was also quite satisfactory last year. Chemicals saw a decline in production in February 2010. Production of capital goods last year was up by more than 15%. Equipment like cutting tools, power driven pumps, insulated cables, industrial machinery, tractors and turbines went up, while that of printing machinery, cranes, dumpers, lifts, and telecommunication cables went down (CMIE 2010).

Consumer durables sales grew last year, propelled by an improvement in consumer spending. Automobile sales grew by around 24% in 2009–10 due to healthy domestic demand – perhaps due to an increase in disposable income of the working. Corporate sales grew heftily in the last quarter of the last FY. The non-financial-services sector witnessed a big jump in sales during the first quarter of 2010 (*ibid*).

Moreover, despite the increase in the Cash Reserve Ratio (the statutory liquidity ratio) effected by the country's central bank, leading to a squeezing out of one-eighth million rupees, banks' comfortable liquidity position made short-term interest-rates fall (*ibid*).

Through the Looking Glass: FY 2010–11

In this FY 2010–11, both export and imports are expected to go up by around 15%, but trade-deficit is expected to be 13% higher than the last year. In addition, Indian firms – which raised an aggregate amount of more than 150 billion rupees (roughly US$3 billion) in the first month of this FY – are expected to spend a huge amount on capital-expenditure and, therefore, resort to external-commercial-borrowing of a high magnitude (CMIE 2010).

Output of different foodgrains, along with production of major crops, is expected to rebound in 2010–11 by growing by more than 10% each. More specifically, production of rice, pulses, cotton, oilseeds as well as minor crops such as straws & stalks are expected to go up, while that of wheat is expected to remain somewhat unchanged (*ibid*).

IIP is expected to go up by 10% in the FY 2010–11. Electricity, steel, aluminium, construction & road infrastructures, cement, fertilizer, and automobiles sectors have grandiose plans for expansion, but a lot would depend on the capacity of many of these projects to secure the permission of people who would be affected adversely by those. Growth in textiles is expected to be quite satisfactory this year, but, given the expected appreciation in rupee, apparel exports would perhaps fall. Chemicals may remain stable during this year. Coal production is expected to go up. (*ibid*)

Consumer durables sales is expected to continue growing. Automobile sales would possibly grow in 2010–11 too. Corporate profits would grow by around 10%. On the other hand, manufacturing-sector is expected to see an increase in sales of more than 20%. The non-financial-services sector may see a continuation of last year's trend, leading to a growth of more than 20% in after-tax profits. (*ibid*)

Overall, for the country, some macroeconomic indicators *look* brighter than they have been in the recent difficult times, but the grassroots problems of the "common (hu)man" do not look like going away.

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European Financial Integration and Economic Growth

1. Introduction

It has recently become very clear to what extent well-developed and accessible credit markets and institutions may be an important condition to economic growth. Unfortunately, it also became evident that they may be the cause of serious troubles and how a financial crisis may contribute to an economic crisis and unbalances in different markets and regions.

Banks and other financial institutions are supposed to guarantee the financing of productive investments and activities, as they mobilise and allocate financial resources and also by their specific money-creation processes through bank credit. At the same time, well-functioning markets and financial institutions may decrease the transaction costs and asymmetric information problems. They also play an increasingly important role in identifying investment opportunities, selecting the most profitable projects, mobilising savings, facilitating trading and by the diversification of risk, as well as improving corporate governance mechanisms. More efficient credit sectors may also represent a necessary and important condition for the transmission mechanism of monetary policy.

The introduction of the single currency accelerated the process of consolidation and financial integration not only in the European Monetary Union, but in the European Union as a whole, in which the newest 10 member-states also have a voice.

This paper is a contribution to the study of the link between financial intermediation and economic growth in the context of the European Union and particularly in the context of the integration of new member-states and their specific financial systems, just before the last financial and economic crisis.

This paper is developed following two main concerns:

1) the first one considers the role that financial systems play in economic growth, taking into account some historically important theoretical contributions and empirical studies which, using different financial

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variables, different estimations techniques and different sets of countries, confirm the linkage between financial systems and economic growth;
2) the second one analyses how financial integration may affect financial structure. In the context of the European Union, the focus is on the role that financial and credit sectors play today under the conditions of the European Monetary Union, and particularly after the recent and future enlargements embracing countries with specific financial systems, some of which present many limitations in financial-sector intermediation.

Our main contribution is an empirical data analysis of the influence of the financial systems in the economic growth of the European Union countries. More specifically, we use IMF and Eurostat quarterly data to analyse the possible influence of the financial intermediation, (here represented by the growth of three ratios: deposits/GDP, bonds and money market instruments/GDP, foreign assets/GDP as well as the discount rate) in the growth of the real GDP per capita.

For the estimations, we consider two sub-sets of EU countries:

- the 11 "old" EU member-countries (more precisely, Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom) for the period between Q1 1980 and Q3 2006,
- 26 EU countries (excluding only Luxembourg and including the future EU members, Bulgaria and Romania) for the period between Q1 1999 and Q3 2006.

The results obtained allow us to draw conclusions not only on the importance of bank-sector performance to economic growth, but also on the different level of integration in the two considered sub-sets.

The remainder of the paper is organised as follows: Section 2 presents relevant literature on the link between financial systems and growth; Section 3 underlines some specific questions arising from financial integration within the European Union; Section 4 reports the results of the empirical estimations and Section 5 concludes.

2. Financial Systems and Economic Growth

The link between economic growth and the quality of financial systems dates back at least as far as Schumpeter (1911), who maintained that the services provided by financial intermediaries are essential for economic innovation, productive investment and economic growth.

During the Great Depression, there was a collapse of the financial systems along with other economic sectors. Fisher (1933) analyzed the possible connection between the performance of the financial markets and the 1929 crisis and subsequent depression that ravaged the real economic activity, linked both directly and indirectly through the slowdown of the redistribution of wealth from debtors to creditors, while authors like Hicks (1937) and Modigliani (1944) underlined the role of the credit markets and the real interest rate in the context of the Keynesian liquidity theory.

A few decades later, Mishkin (1978) used data from the Great Depression to study the interaction between output, consumer balance sheets and consumer spending, concluding that during the crisis, the increase in consumer real indebtedness, resulting mainly from the decline in incomes, induced consumers to lower spending, particularly on durable goods and housing investment, which further contributed to a lowering of output.

The connection between real economic output and the characteristics and quality of the financial structure, in particular in the process of financial intermediation, was also emphasised by Gurley and Shaw (1955) who focused in addition on the differentiation of the financial systems of the more developed and less developed countries.

More recently, the link between economic growth and the quality of financial systems has been studied by more or less sophisticated analysis and empirical studies. According to most of these studies, financial development may be an important condition to economic growth, since well-functioning markets and financial institutions may decrease the transaction costs and asymmetric information problems. At the same time, financial institutions play an increasingly important role in identifying investment opportunities, selecting the most profitable projects, mobilizing savings, facilitating trading and diversification of risk, as well as improving corporate governance mechanisms.

However, other authors, for example, Stiglitz (1985), Bhide (1993), Bencivenga et al. (1995), stress that there may exist some costs associated with the role of financial intermediaries and that sometimes these intermediaries may be subject to adverse selection and moral hazard problems which may constrain real economic growth enhancing resource allocation, exaggerating the increase in interest rates, or contributing to the decrease in the saving rates.

Particularly since the renowned King and Levine (1993 and 1997) papers, there has been an increase of empirical studies at the aggregate level which explain output variables with financial ratios and variables such as liquid liabilities, bank loans to the private-sector, or stock market capitalization, which may be representative of the performance of the financial systems and institutions.

In one such study, Levine and Zervos (1998), using data from 49 countries for the period 1976-1990, conclude that there is a strong correlation between the rates of real per-capita output growth and stock market liquidity.

The influence of financial variables (particularly the liquid liabilities and the private credit from deposit banks in relation to GDP) in the real per-capita output growth is also demonstrated by Leahy et al. (2001), using data for 19 OECD countries for the years between 1970 and 1997. Similar variables (more precisely, liquid liabilities, private credit from deposit banks and stock market capitalisation, all in relation to GDP) are used by Bassanini et al. (2001), who use data for 24 OECD countries (1971-1998) obtaining better results for stock markets than for bank variables.

Examining 9 OECD countries and the available series with different starts between 1960 and 1986 and ending in 1998, Shan et al. (2001) explain real per-capita GDP by bank credit to GDP and conclude that the causality varies among countries.

Demirguç-Kunt and Levine (1999), with data from 150 countries during the 1990s, conclude that the rich countries have more developed financial systems, characterising this development by the size and efficiency of the financial sector, measured by the assets, liabilities, overhead costs and interest margins.

Comparing financial systems of different countries and regions, Allen and Gale (2001) conclude that there is an inherent inefficiency within the monopolistic power of banks, which may also adopt an excessively conservative approach while the competitive nature of markets tends to encourage innovation and growth-enhancing activities.

Beck et al. (2004) have used the ratio of the value of the credit by financial intermediaries to the private sector divided by GDP as a proxy to capture the depth and breath of the financial intermediation in a panel of 52 countries over the period 1960 to 1999 and conclude that financial development is not only clearly pro-growth but also pro-poor, that is, in countries with better-developed financial intermediation, income inequality declines more rapidly.

Summarising many of these studies, we must agree with Khan and Senhadji (2000), who in providing a review of the literature and empirical evidence of the relationship between financial development and economic growth, already concluded that the results indicate that while the general effects of financial development on the outputs are positive, the size of these effects varies with the different variables considered, with indicators of financial development and with the estimation method, data frequency or the defined functional form of the relationship.

3. Financial Integration in the EU

The link between financial integration and economic growth is currently emphasised by authors like Obstfeld and Taylor (2003). This link has particular relevance in the new European Union, which is still adapting to the conditions of the European Monetary Union (EMU) and to the new universe of 27 members.

Financial institutions play a unique role particularly in the context of the Single Market Programme and the European Monetary Union, although the EU banking sector has been considered as one of the sectors least affected by the SMP (Monti, 1996, Gardener et al., 2002). The introduction of the EMU may reduce some of the competitive advantages of local and national banks (advantages which were based on factors like currency risk, lack of price transparency and greater knowledge of national monetary policy), but it also increases competition in all the financial-product market segments.

The structural changes due to the adoption of the single currency and a common monetary policy are exerting a profound impact on the Euro area finance sector and intensifying competition for banking services.

Some authors have already analysed the degrees of integration through the common trends which may be identified in the context of the pressures of globalisation and which affect all the EU countries (not only the EMU members) with particular intensity, due to the process of disintermediation, new technologies and increased competition (Belaisch et al., 2001; ECB, 2002; Gardener et al., 2002; Guiso et al., 2004, Melnik and Nissim, 2006; Romero-Ávila, 2007).

Despite all the changes and disintermediation, the EU's bank asset structure reflects the rapid increase of lending since the advent of the EMU. It is a process which started before the implementation of the single currency and reflects the growing demand for credit provoked by the downward path of interest-rate levels.

At the present time, it remains true that the Euro area's financial and credit systems continue to be bank dominated; the ECB (more precisely, the European System of Central Banks and its Banking Supervision Committee) is obliged to monitor and supervise closely the banking activity and structural developments within the EU banking sector.

The inadequacy of the present extent of financial regulation in the context of the EMU was already emphasised by authors like Vives (2001), who defended a reform to establish clear procedures for confronting hypothetical crises in lending and moreover, to prepare the implementation of more centralised supervisory arrangements in the whole financial system, with specific regard to the banking sector. Measures are also required in order to increase the competition and to prevent and limit the national power of the "too big to fail" institutions.

So, in spite of all the remaining limitations in the supervision process, in addition to the profound structural changes due to the implementation of the single currency and the common monetary policy, and despite all the recent political shocks, the EU has diversified its activities and financial innovations, against a background of increasing competition, under continuing pressure not only to increase their income and profits, but also to guarantee most of the transmission mechanisms of the monetary policy and to maintain the financial stability of the whole system.

It is generally recognised that special attention must be paid to the EU banking sector following the most recent enlargements mentioned above, particularly regarding those countries under the former Soviet Union's sphere of influence, given that in a quite short period of time, the banks in these countries moved away from the socialist structure of banking, in which the financial organisations were used to support the central banking system, to a market economy and the concomitant decentralisation and liberalisation of the banking systems.

In most of these Eastern and Central European countries, forms and programmes were introduced to amend property rights, together with processes of privatisations of part of the State property. As a result, the importance of the private sector and firms increased in these countries, as did the particularly relevant role of their financial intermediaries and banking institutions. There is a fairly strong consensus on the increased performance and efficiency of the banks under the new market conditions in these countries. Several studies (Holscher, 2000; Hanousek and Kocenda, 2003; Stephen and Backhaus, 2003; Dimitrova, 2004; Bonin and Watchel, 2004; Bonin et al, 2005; Freis and Taci, 2005; Fries et al., 2006) confirm the relevant improvements in the efficiency of the banking systems of the new EU members and the effects of ownership, concluding that foreign-owned banks are usually more cost-efficient.

Other studies examine how, and to what extent, the banking sectors of the new member-states have integrated with those of the older EU members and the process of nominal and real convergence of these countries to EU standards (ECB, 2004 and 2005; Kocenda et al., 2006). The transmission of monetary policy to the non-monetary economic sectors also requires more efficient banking and the way that banks adapt lending in response to monetary policy decisions varies according to their specific political and economic environment. Some contributions analyse the transmission channels of monetary policy in different EU countries, including the new member-states in Central and Eastern Europe (Gambacorta and Mistrulli, 2004; Golinelli and Rovelli, 2005; Elbourne and de Haan, 2006; Ferreira, 2008). However, in spite of all the theoretical and empirical advances in this area, there is still no agreement about the precise specification of the ways in which monetary policy and credit lending influences the economy (Goddart et al. 2007).

During the last decade, three essential pillars were in place to assist the financial-sector development of the new member-states and to assure the conditions propitious to an increasing integration in the EU (and possibly also in the EMU) financial systems. These pillars are (Winkler, 2002, pp. 35):

1) internal and external government structures;
2) domestic and international competition;
3) prudential regulation supervision.

All three could also be accepted as strong and necessary pillars for the development of the financial systems, particularly the banking sectors, of the older EU member-states and above all, of the EMU members.

4. Empirical Estimations

The methods used in the different aggregate estimations which look for empirical evidence of the relationship between financial development and economic growth are mainly co-integration analysis, correlations, cross-country regressions and panel regressions.

One of the most common problems of these estimations is the difficulty in harmonising and making compatible the available data as, in spite of all the efforts of the ECB, Eurostat, IMF and other international institutions, the study of financial structures and financial developments in the context of the EU remains a difficult task. This is due not only to the lack of data, but also to the inherent complexity of the financial structures as well as the constant changes, besides the specificities of the financial structures in the different EU countries.

Using the quarterly data from Eurostat and IMF statistics, we contribute to the existing empirical evidence of the influence of financial systems and EU integration on economic growth in two ways:

Firstly – We use panel fixed effects estimates to explain the real per-capita GDP growth rate, admitting four variables to represent the role of financial systems:

- the logarithm of the ratio deposits to GDP as the total deposits in the banking institutions is still an important source of resources for credit lending and it may contribute to economic growth,
- the logarithm of the ratio bonds and money market instruments to GDP as a proxy of the development of the financial markets in the EU countries, which are mostly bank-dominated. Accepting that healthy financial markets and developed financial institutions are a guarantee for the direct and indirect financing of the bank clients' activities, we may expect that this

ratio will exert a positive influence not only on bank activities but also on the support of productive investments and economic growth,

- the logarithm of the ratio of foreign assets to GDP introducing the influence of the other countries, more specifically, the financial resources obtained from foreign partners, represented by the entry of assets, in particular to pay their debts and financial obligations and consequently, more resources to be applied in domestic bank lending and to support economic growth,
- the discount rate (end of the period) which is the monetary policy interest rate and influences the levels of the interest rates in the different countries.

Secondly – In order to analyse the degree of integration of the EU countries, we compare the results obtained for two different sub-sets:

- one balanced panel with 1177 observations, with data for the period between Q1 1980 and Q3 2006 for the 11 "old" countries (Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom),
- a second balanced panel for 26 EU countries (excluding only Luxembourg) for the period between Q1 1999 and Q3 2006, with 806 observations.

In Appendix I, we present the summary statistics of these series.

4.1. Unit Root Tests

The number of observations of the collected data to build our three panels does not lend itself to the application of single time series unit root tests. Therefore, we opt to use panel unit root tests, which are more adequate in this case. These tests do not only increase the power of unit root tests due to the span of the observations, but also minimise the risks of structural breaks due to deep changes during the considered time period.

From among the available panel unit root tests, we choose the Levin, Lin and Chu (2002) test, which may be viewed as a pooled Dickey-Fuller test or as an augmented Dickey-Fuller test when lags are included, the null hypothesis being the existence of non-stationary. This test is adequate for heterogeneous panels of moderate size, such as the present cases and it assumes that there is a common unit root process.

The results obtained are reported in Appendix II and clearly allow us to reject the existence of the null hypothesis for almost all the variables included in the two considered panels. The only exception is, in the second panel, the logarithm of the ratio bonds and money market instruments to GDP, but it is stationary in the first differences.

4.2. Panel estimations

In order to examine the relation between the four variables presented above and the real per-capita GDP growth and to compare the results for the two considered panels, we use a panel data approach (following Wooldridge 2002 and 2003) which provides more observations for estimations and reduces the possibility of multi-colinearity among the different variables.

We specify a linear model and control for individual country-specific effects using panel fixed-effects (within) estimates, which assume that slopes (b_1 to b_4) are common to all the countries, whilst intercepts (a_i) vary across the i countries[1]:

$$\ln\,(\text{real GDP } \textit{per capita})_{it} = a_i + b_1 \ln\,(\text{deposits/GDP}) + b_2 \ln\,(\text{bonds and money market instruments/GDP}) + b_3 \ln\,(\text{foreign assets/GDP}) + + b_4\,\text{discount rate} + u_{it}$$

Table 1 reports the obtained results for the first panel, including the 11 "old" EU countries (more precisely, Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom) for the time period between the first quarter of 1980 and the third quarter of 2006. The results confirm that the system responds well to the within (fixed-effects) estimations, which are more adequate and in all situations, they demonstrate consistency.

Simultaneously, the values obtained with the F-tests, allow us to conclude that there are common slopes, meaning that within these 11 EU countries, there are clear signs of integration, since the growth rates of the real GDP per-capita have similar reactions to the behaviour of the considered variables.

Nevertheless, each country has a different intercept, that is, it had a specific initial condition before embarking on the process of integration (and particularly of financial integration). And the relative hetetogeneity of the whole panel is confirmed by the obtained low R-squared overall (0.0838). Furthermore, and still according to the reported R-squared values, it is also possible to conclude that, in general, there is a stronger influence of the time interval (the R-squared within is 0.6522) than the cross-country approximation (the R-squared between is 0.1594).

The obtained results also confirm the expected positive influence of the growth of the three ratios (deposits/GDP, bonds and money market instruments/ GDP, foreign assets/GDP). The negative influence of the discount rate may be explained by the preparation of the specific process that conducted to the

[1] We also tried to use panel random-effects estimates. The obtained results are very similar to those with panel fixed-effects estimates and will be provided under request.

implementation of the single currency in the context of the EMU for almost all the EU countries included in this panel.

Table 1. Panel fixed-effects estimates for 11 EU countries*; time period between Q1 1980 and Q3 2006 (*N* = 1177)

	Estim. Coefficient	Standard Error	*t*-statistic	*P*-value
Ln (deposits/GDP)	.1314972	.01024	12.84	0.000
Ln (bonds, money market instruments/GDP)	.0229881	.0031124	7.39	0.000
Ln (foreign assets/GDP)	.033366	.0053136	6.28	0.000
Discount rate	–.0207109	.0010065	–20.58	0.000
constant	3.747554	.0174978	214.17	0.000
R-squared: Within = 0.6522 Between = 0.1594 Overall = 0.0838				
F(4,1162) = 544.74 Prob > F = 0.0000				

* Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom

For the second panel of countries we will take into account the obtained results for the Levin, Lin and Chu (2002) test and the possible non-stationary of the series of the logarithm of the ratio bonds and money market instruments to GDP. So, for this panel, we estimated two models: one including this series (whose results are reported in Table 2-A) and another one including its first differences (whose results are reported in Table 2-B).

Not surprisingly, the results obtained for the second panel are less consistent than those for the first panel of the 11 “old” EU countries. The second panel comprises fewer observations, a shorter time-span (Q2 1999 – Q3 2006) and more heterogeneous 26 EU countries (all EU members, except Luxembourg).

In all situations, the importance of the considered variables to the growth of the real GDP per capita is confirmed. The presented F-test confirms the existence of common slopes as a result of the process of financial integration. Nonetheless, again according to the obtained results for the F-test, it is clear that the countries have different intercepts, meaning that there are country-specific initial conditions. This is consistent both with the historically-known conditions and the fact that the financial institutions of these 26 countries have sometimes had to follow a specific course, facing different individual consequences, while adapting to the new conditions of the EU integration process.

The stronger heterogeneity of this second panel of countries is also evident by the obtained very small R-squared between (0.0770 in Table 2-A and 0.0474 in Table 2-B). The influence of the time period is still relevant but it is now shorter and the R-squared within falls down (to 0.3086 in Table 2-A and 0.2743 in Table 2-B).

Furthermore, some doubts arise in what concerns the influence of the ratio bonds and money market instruments to GDP. If we ignore the possible non-stationary of the series (in Table 2-A) we confirm the positive influence of this variables in the real GDP per capita growth but if we consider the first differences of the series, there is a change in the obtained signal for this variable. The explanation may be found not only in the mathematical meaning of the first differences but also in the greater volatility of the bonds and money market instruments in 26 different EU countries, including the new member-states and particularly those were changes were very quick and remarkable in order to adapt to the new conditions.

Table 2(A). Panel fixed-effects estimates for 26 EU countries*; time period between Q1 1999 and Q3 2006 (*N* = 806)

	Estim. Coefficient	Standard Error	*t*-statistic	*P*-value
Ln (deposits/GDP)	0793755	.0150757	5.27	0.000
Ln (bonds, money market instruments /GDP)	.034813	.0062943	5.53	0.000
Ln (foreign assets/GDP)	.0578454	.0138953	4.16	0.000
Discount rate	–.0155739	.0012823	–12.15	0.000
Constant	6.040361	.0234574	257.50	0.000
R-squared: Within = 0.3086 Between = 0.0770 Overall = 0.0718				
F(4,776) = 86.58 Prob > F = 0.0000				

* Excluding only Luxembourg

Table 2 (B). Panel fixed-effects estimates for 26 EU countries*; time period between Q1 1999 and Q3 2006 (*N* = 780)

	Estim. Coefficient	Standard Error	*t*-statistic	*P*-value
Ln (deposits/GDP)	.1070918	.0149473	7.16	0.000
D1.Ln (bonds, money market instruments/GDP)	–.0668194	.0160015	–4.18	0.000
Ln (foreign assets/GDP)	.0553991	.0141734	3.91	0.000
Discount rate	–.0140031	.0012876	–10.88	0.000
Constant	5.998085	.0233594	256.77	0.000
R-squared: Within = 0.2743 Between = 0.0474 Overall = 0.0443				
F(4,750) = 70.86 Prob > F = 0.0000				

* Excluding only Luxembourg

5. Concluding remarks

This paper confirms the influence of financial intermediation on the output growth, here represented by the growth of the real GDP per capita, as well as the still considerable differences among EU member-states.

We contribute to the existing empirical evidence by introducing four variables to represent the role of financial intermediation, more precisely, the growth of three ratios: deposits/GDP, bonds and money market instruments/GDP, foreign assets/GDP as well as the discount rate.

We use panel fixed-effects estimates and we find that these variables are relevant to the explanation of the output growth in the two considered panels of EU countries: one with the 11 “old” countries (Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom) for the time period Q1 1980-Q3 2006 and a second panel that includes the 26 EU countries (all actual EU members, except Luxembourg) for the period between Q1 1999 and Q3 2006.

Our estimates show relatively more homogenous results for the first panel, with common slopes, that is, for this group of 11 EU countries. Nevertheless, in this panel there are still different intercepts, which is evidence of the specific initial conditions of these “old” and relatively more homogenous countries.

Although the results obtained for the second panel are less consistent, they confirm that even with the necessary changes and adaptation to the new conditions of the EU and EMU, and the increasing competitive environment, there is still evidence of integration among the EU members. But there is still clear evidence of the country-specific initial conditions.

This is consistent with the historically-known integration processes, since the EU financial structures are undergoing remarkable transformations, although considerable differences among EU member-states still persist.

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APPENDIX I – Summary Statistics

PANEL I (11 EU countries*, time period: Q1 1980 – Q4 2006)

Variables	Mean	Std. Dev.	Min	Max	Observations
Ln (real GDP *per capita*):					
overall	3.784406	1.600977	.92294	6.58768	N = 1177
between		1.668891	1.222639	6.255734	i = 11
within		.170227	3.455159	4.126225	T = 107
Ln (deposits/GDP):					
overall	1.423353	1.403039	–.06464	6.04847	N = 1177
between		1.434835	.5847764	5.689049	i = 11
within		.308766	.3659827	2.362488	T = 107
Ln (bonds, money market instruments/GDP):					
overall	–.2934713	1.694187	–7.46515	2.17415	N = 1177
between		1.1969	–2.545149	1.356671	i = 11
within		1.25173	–5.213473	4.425827	T = 107
Ln (foreign assets/GDP):					
overall	.2406778	1.026987	–2.11716	4.39025	N = 1177
between		.782307	–1.249594	1.535656	i = 11
within		.7055925	–1.683436	4.823975	T = 107
Discount rate:					
overall	7.319773	4.600431	1	26.552	N = 1177
between		2.433329	4.584112	12.07303	i = 11
within		3.971974	–1.753255	21.79875	T = 107

* Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

PANEL II (26 EU countries*, time period: Q1 1999 – Q4 2006)

Variables	Mean	Std. Dev.	Min	Max	Observations
Ln (real GDP *per capita*):					
overall	6.051169	2.678176	1.349683	12.66796	N = 806
between		2.72726	1.443205	12.42524	i = 26
within		.108951	5.524112	6.514984	T = 31
Ln (deposits/GDP):					
overall	1.295129	1.519575	–2.773942	6.048469	N = 806
between		1.528612	–2.488645	5.997196	i = 26
within		.2439945	–.3845825	1.981867	T = 31
Ln (bonds, money market instruments/GDP):					
overall	–.0795288	1.750138	–5.396411	2.286376	N = 806
between		1.695878	–3.744696	1.986972	i = 26
within		.5423645	–2.622679	1.495855	T = 31
Ln (foreign assets/GDP):					
overall	–.080594	2.21202	–10.41371	3.237338	N = 806
between		2.240099	–9.219169	2.771956	i = 26
within		.2489937	–1.275133	.6851328	T = 31
Discount rate:					
overall	5.429781	5.112387	.973333	35	N = 806
between		4.393802	2.209677	24.39968	i = 26
within		2.747811	–11.39656	16.07494	T = 31

* Excluding only Luxembourg

APPENDIX II – Panel unit root tests – Levin-Lin-Chu

PANEL I (11 EU countries*, time period: Q1 1980 – Q4 2006)

Variables	Coefficients	*t*-value	*t*-star	*P* > *t*	*N*
Ln (real GDP *per capita*)	–0.50284	–18.882	–23.35118	0.0000	1060
Ln (deposits/GDP)	–0.06984	–6.182	–2.46167	0.0069	1060
Ln (bonds, money market instruments/GDP)	–0.07578	–6.553	–1.64051	0.0504	1060
Ln (foreign assets/GDP)	–0.21635	–15.160	–13.53890	0.0000	1060
Discount rate	–0.04413	–4.791	–1.89933	0.0288	1060

* Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom

PANEL II (26 EU countries*, time period: Q1 1999 – Q4 2006)

Variables	Coefficients	*t*-value	*t*-star	*P* > *t*	*N*
Ln (real GDP *per capita*)	–1.01649	–28.060	–18.99290	0.0000	750
Ln (deposits/GDP)	–0.40333	–13.622	–5.38484	0.0000	750
Ln (bonds, money market instruments/GDP)	–0.20377	–8.980	–0.24078	0.4049	750
D1. Ln (bonds, money market instruments/GDP)	–0.99368	–27.028	–21.88740	0.0000	725
Ln (foreign assets/GDP)	–0.30000	–11.244	–2.56601	0.0051	750
Discount rate	–0.22683	–10.965	–3.31138	0.0005	750

* Excluding only Luxembourg

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The Ineffectiveness of the State as a Regulator in the Global Economy

1. Introduction

Critics of capitalism believe that crises appear as a consequence of deregulation, privatisation and reducing the role of the state in the economy. Companies have only one objective, which is often ruthlessly pursued while they incur an often excessive investment risk. The global market is largely a game without any rules and without any arbitrator who would have the appropriate disciplining means at his disposal. Undoubtedly, the crisis has spawned the emergence of new challenges that require the state to play the active role of the state in various areas. The states according to these critics should operate as business owners and regulators of the market. Unfortunately, in both of these functions the governments have not always proved themselves. Thus, a lively discussion on the role of the state in economy has begun. More often than not it is stipulated, that these huge flows of capital must be kept under some control. To the declining role of the state pointed to the need to settle this issue at some higher level. **It is important therefore to discover, how capital market development led to a change in the role of the state.** "Incompleteness of globalisation", understood as a lack of globalisation at the political and regulatory levels, is often identified as an important factor. Most of the recently submitted proposals for the prevention of crises point to the need to increase the state's role and international supervision (regulation).

The global market is largely a game without rules and without an arbitrator able to dispense the necessary medicine. Undoubtedly, the crisis has caused the emergence of new challenges, which require the active role of the state in various areas. States play the role of the owners of companies and market regulators. Unfortunately, governments have not been performing these functions adequately. Those therefore, who themselves committed many mistakes, must improve not just the malfunctioning market, but also a defectively functioning state; or, to put it other words, they must improve themselves.

2. The impact of the capital market on changing the state's role – restrictions in the conducting of monetary, fiscal, and exchange rate policies

The last crisis has caused increased state intervention in many countries. Previously, in many regions of the world the role of the state was being reduced. State intervention was limited, state planning eliminated or reduced, the importance of market mechanisms increased. Functions of the state shifted from control of economic processes towards creating the conditions for competition and development. This is a consequence of the dominance of liberal theories. Despite the almost universal awareness that the market is unable to cope with all the problems of today's world, quite often the negative consequences of state intervention in the economy are emphasised. It is often indicated that, with state intervention, things would go from bad to worse.

In the period of globalisation, the state has lost much of its traditional role. For instance, the state's role in shaping foreign economic relations has changed. Countries with open economies must have an economic policy that takes external conditions into account. Economic policies aimed at ensuring macroeconomic stability, low inflation, controlled budget deficit and balance of payments are restricted, as is the interest rate and exchange rate policy[1].

Investment decisions and directions of the flow of capital are largely contingent upon the macroeconomic situation of the country or region[2]. Very high mobility on modern capital markets means that governments find it increasingly difficult to conduct monetary policy. There may be situations where it will be difficult to determine the country of origin of the majority of the financial institutions. As suggested by some, however, this is of little importance vis-à-vis the prospect of achieving maximum profits[3]. It is the capital having the choice that dictates the conditions to which countries must adapt if they want the capital to flow in.

Mainly less developed countries, and less stable politically, must compete for capital. Their shortcomings (increased risk of the investment) must be compensated with lower taxes or lower social burdens. Low competitiveness of many economies

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1 Globalizacja, mechanizmy i wyzwania, edited by B. Liberska, PWE, 2002, p. 34.

2 Investors' decisions are largely affected by the assessments of the rating agencies, which critically evaluate monetary, financial and fiscal policies. Politicians' mistakes, irresponsible behavior, or public statements may destabilise financial markets, leading even to severe crises. Building investors' confidence is a lengthy process, while it is very easy to lose this confidence.

3 On all the levels the systemic error underlying global integration makes itself evident: while the flow of goods and capital is globally available, regulation and control remain a prerogative of the nation-state. Economy devours politics (H. P. Martin, H. Schumann, *op. cit.*, s. 253).

and the accompanying high investment risk leads to an increase in interest rates on the debt issued by them (interest rate must compensate for high risk). The consequence is an increase in market interest rates and a reduction of resources available to the companies (crowding-out effect). In addition, inflowing foreign capital leads to currency appreciation. In such circumstances, little is needed to bring about a sudden capital flight.

The opening of capital markets means that monetary, fiscal and exchange rate policy is subject to external verification. Lack of financial discipline, populist decisions and simple mistakes cause a loss of confidence of foreign investors. In such a situation speculative attacks can easily occur. The effect of the interest rate, the basic instrument of monetary policy, is increasingly conditioned by changes in interest and exchange rates in foreign markets. Conducting monetary policy is becoming more complex. The effects of decisions made are less certain and more difficult to predict.

Nation-states increasingly lose control over financial flows and their own economic policies, while they become more and more subject to competitive pressures for further growth in deregulation and liberalisation. According to Dahrendorf, uncontrollable processes on the financial markets increasingly cause instability and chaos[4]. Under the influence of the iron grip of the new "Capitalist International" entire countries and their social structures waver in their foundations[5]. Threatening to flee, the capital enforces drastic tax breaks, subsidies or free billions in infrastructure. Alone, no nation is able to resist this pressure.

According to H. Martin and H. Schumann deregulation instead of state supervision, trade and capital market liberalisation, and privatisation of public enterprises became a strategic weapon of governments professing their faith in the market and of the international economic organizations controlled by them (IMF, WTO). Armed with these arguments, they joined the fight for freedom for capital, which continues to this day[6].

Most countries in the world try to attract foreign investors by creating a favourable environment for business. There are also those that are not conducive to entrepreneurs. According to a report by the World Bank, Poland is such a country. In 2009 it took the 153rd place among the 183 countries evaluated. A year earlier, it had a slightly better position – 142nd. The World Bank rating was mainly focused on tax issues: in Poland, the business operator had to pay 40 different taxes, as opposed to 12 in the Czech Republic and 16 in Germany.

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4 R. Dahrendorf, Nieświęte przymierze, „Polityka" 1998, No. 9.
5 H. P. Martin, H. Schumann, *op. cit.*, p. 12.
6 *Ibidem*.

Table 1. Examples of countries in the ranking

	Ireland	Denmark	Poland	Belarus
Ranking	6	13	151	183
The total tax rate	9	9	40	107
Number of tax payments per year	76	135	395	900
Time spent on tax formalities (in hours per year)	26.5	29.2	42.5	99.7

Source: World Bank Report, 2009.

Countries that until recently have sought to encourage domestic companies must stop these actions, because they distort competition by the unequal treatment of entities. At the same time wishing to attract foreign capital, they must support foreign investors, worsening competitive conditions for local businesses. Many entities that benefited from state subsidies, lost them, and instead had to face increased competition are often supported by their own states.

The crisis, however, led to the emergence of various protectionist trends. Some countries have tried to link public assistance provided by them with requirements such as maintaining production in the country of origin at the expense of reducing production in other countries. France, for instance, gives a good example of such an approach. Renault, which received 4 billion Euros in state aid, was forced to desist from assigning the production of a new Clio to its plant in Turkey and to maintain production in France. That decision led to losses in Turkey, Spain and Slovenia. The French Economics Minister also announced that the country might increase its stake in Renault to 20% (it was previously 15%) in order to increase the impact it has on the decisions of the group. Renault's production plans, in his view, are a political issue and the last word belongs to the President of France.

Increasing openness of the economies and growing capital flows make it difficult to have a fiscal policy uninfluenced by international circumstances. Fiscal policy affects investment decisions. It is increasingly difficult to determine where the tax liability arises when capital and production are on the move. Globally operating businesses have managed to involve many countries in the world into a „contest of tax systems". Since different countries compete to attract investment, they are left with no choice but to cut taxes. This leads to the governments and their autonomy in decisions concerning the tax rates, as they always have to take the reaction of the owners of surplus capital into consideration[7]. Not all

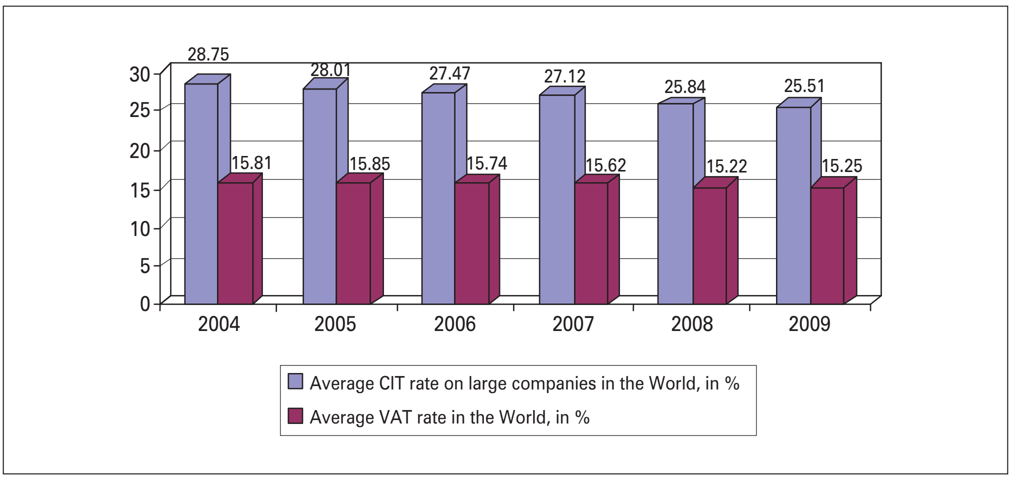
[7] President Chirac defined the entire financial sector as a vicious lot, and the broker caste as the "AIDS of world economy" ("The Economist", October 7, 1995). Tietmeyer, Chief of the Bundesbank said in 1996 during the World Economic Forum at Davos, that most politicians still do not realise

countries lend themselves to this pressure[8]. It is worth noting, however, that tax cuts do not have to automatically lead to an increase in foreign investment. They are just one of many elements affecting the expected rate of return for investors. Various studies show that stability of regulations and legal protection for investors is more important for them, than some differences in taxes.

Many governments have reduced corporate taxation in recent years and introduced various investment incentives as well, and this has encouraged foreign investors to allocate capital in their country. The costs associated with it, however, were passed on to individuals. In many countries, taxes on individuals remain at high levels. A strong progressive tax led to the outflow of domestic capital and, therefore, Sweden for instance, has significantly reduced the scale of progression.

As is clear from a KPMG report, the crisis slowed down the decline in income tax rates on large companies. The average tax rate on the income of companies decreased from 32.69% in 1999 to 25.51% in 2009. Some countries have recently even increased taxes. Lithuania raised the income tax from 15 to 20% and the VAT was raised in Ireland from 21 to 21.5% in Hungary from 20 to 25%, in Estonia from 18 to 20%, in Latvia from 18 to 21%, Lithuania from 18 to 19%.

Figure 1. Changes in VAT & CIT rates in the World



Source: KPMG.

how much they are controlled, or even steered, by the financial markets ("Frankfurter Allgemeine Zeitung", February 3, 1996).

8 In some countries an opposite process may be observed. Poland is among the exceptions. Despite lowering the corporate income tax to a flat 19%, many other taxes and fees went up. The number of changes in the tax regulations only leads to the conclusion that no "sane" investor should ever invest here. Rapid changes in regulations make reliable analysis and investment risk assessment virtually impossible. Poland is becoming ever less friendly for both domestic and foreign investors, which is visible in various rankings.

In the 1960s and early 1970s in most developed countries the share of the budget expenditure in GDP increased. Since the early 1980s the increase occurred mainly in continental European countries; at the same time this share declined in the U.S. and Britain. In Europe, the highest share of budget expenditures is in the Scandinavian countries (e.g. Sweden, approximately 60%) and the lowest in Ireland (33%). In the 10 new EU member states this share is on average 42%[9]. At the beginning of the 21st century in most OECD countries there has been a decline in the share of taxes and spending in GDP.

There are significant differences in the structure of budget revenues in each country. In Europe the main source of revenue is VAT and excise, and the United States, Canada and Australia – income taxes. The differences also apply to compulsory social insurance contributions charged to labour costs. In Europe they are higher than in the United States. The lowest premiums (less than 15%) are in China, India, Indonesia and Brazil. The highest (above 35%) in Germany, Belgium, Hungary and Italy. Significant differences also exist in the structure of expenditure.

The tax system has a major impact on capital market development. Taxes influence investing entities, entities that seek access to financial resources and financial intermediaries. Because of the differences in taxation between countries, there is no level playing field. At the same time opportunities for tax evasion increase. Excessive fiscal stringency undermines incentives to save, invest and work, increases transaction costs and the level of risk associated with making and business[10]. There is, however, no automatism. At the beginning of the process of globalisation it was thought that this process would benefit mainly rich countries. Today it can be seen that less developed countries can also profit from this. The country that has benefited most from globalisation is China. Until recently, it was often stressed that globalisation is a threat to fragile states, but for the efficient and disciplined ones it creates opportunities for faster economic development. In light of recent events this opinion should be reconsidered carefully. If we assume that a fragile country is a country that conducts irresponsible policies, as the U.S. in recent years has done, then the opinion is still valid.

Investment attractiveness of the country significantly impacts investment risk. This risk is dependent on many factors. Macroeconomic performance, financial equilibrium, creditworthiness, access to bank financing, access to capital markets and stable regulations to protect the interests of investors, inter alia, are all important factors. For many institutional investors, liquidity of the portfolio

[9] J. W. Bossak, *op. cit.*, SGH, Warszawa 2006, p. 256.
[10] *Ibidem*, p. 261.

understood as the ability to quickly exit from the investment in a situation of rapid deterioration of the situation in a given country or region, or due to increased spending and demand for free resources (e.g., the need for redemption of units discontinued by the funds), has the greatest importance. Little or nothing must be done to make the negative effects of an investment reveal themselves. By contrast, taking advantage of the opportunities usually requires effort, thought and consistent action.

As shown by past experience, one of the consequences of the crises was an increase in the deficit in public finances.

Table 2. Central budget deficits relative to GDP

Country, year of crisis	Deficit a year before the crisis	The highest deficit (year)	Increase (– decrease) deficit
Argentina, 2001	–2.4	–11.9 (2002)	9.5
Chile, 1980	4.8	–3.2 (1985)	8.0
Colombia, 1998	–3.6	–7.4 (1999)	3.8
Finland, 1991	1.0	–10.8 (1994)	11.8
Indonesia, 1997	2.1	–3.7 (2001)	5.8
Japan, 1992	–0.7	–8.7 (1999)	9.4
Korea, 1997	0.0	–4.8 (1998)	4.8
Malaysia, 1997	0.7	–5.8 (2000)	6.5
Mexico, 1994	0.3	–2.3 (1998)	2.6
Norway, 1987	5.7	–2.5 (1992)	7.9
Spain, 1977	–3.9	–3.1 (1997)	–0.8
Sweden, 1991	3.8	–11.6 (1993)	15.4
Thailand, 1997	2.3	–3.5 (1999)	5.8

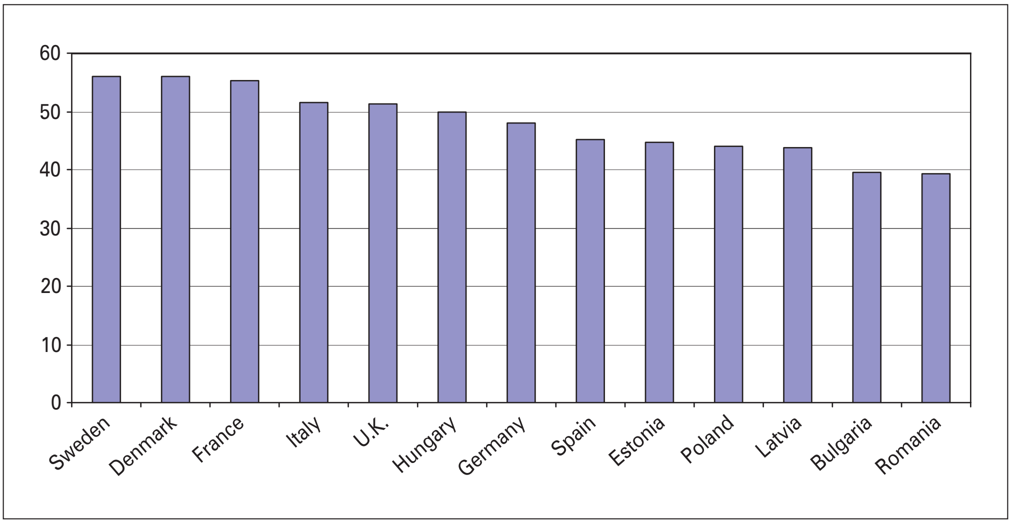
Source: C. M. Reinhart, K. S. Rogoff, The Aftermath of Financial Crises, San Francisco, 2009.

Financial assistance from the International Monetary Fund and the World Bank was dependent on the fulfilment of a number of conditions including: lower inflation, reduced taxes, reduced budget deficit, reduced subsidies to enterprises, removal of regulations restricting the free market. These recommendations have largely led to reducing the role of the state. The outbreak of the crisis in 2008 brought about a curious effect: that those who until recently postulated diminishing the role of the state, began – rather recklessly – pumping huge amounts of money into the economy, not really thinking about the consequences. They wanted to stop what was inevitable anyway.

Decisions taken by various countries to reduce the impact of the current crisis are similar to those taken by Japan 10 years earlier. Monetary and fiscal policy instruments were used. The greater concern is rather the U.S. than European countries, because of the limitations set up in Maastricht.

The fight with the crisis has increased the share of public expenditure relative to GDP. In the old EU countries this ratio is now higher than in the countries of Central and Eastern Europe.

Figure 2. Expenditure of states in 2009, as % of GDP



Source: Eurostat.

The planned budget deficit of the United States in 2010 reached 1.6 trillion U.S. dollars. Over the last decade, government expenditure in the U.S. rose twice. Credit rating agencies lower the ratings of more and more indebted countries (Greece, Portugal and others). **Growing budget deficits may lead to a global fiscal crisis.**

One of the major questions that arise here concerns the fairness of spending billions of dollars on rescuing reckless investors and companies, who stood on the verge of bankruptcy. Supporters of this approach argue that it protected the world from a far deeper crisis, saved jobs, etc. Opponents indicate that no problem has been solved; only time was bought. The increased debt carried by states will be an enormous challenge (burden) in coming years. According to Prof. S. Hanke the fatal reaction in Washington has changed, "a painful but short-lived recession into, perhaps, a several years long permanent crisis[11].

[11] „Rząd zawsze może zrobić coś głupiego" ('The government can always do something stupid"), Gazeta Wyborcza, November 17, 2008 r.

In his opinion, in the absence of government support the market alone would solve the problem. Unprepared and chaotic moves and making people scared, undermined confidence in the market and the crisis deepened. Aid extended by the government to insolvent borrowers could lead to even greater problems (increase in the deficit, internal debt, inflation). By helping banks, insurance companies and automotive industries the government put itself in a position, that will make it difficult to refuse assistance to individual borrowers, who can not afford to repay the growing loan instalments.

Looking at various measures adopted in recent months (e.g., "injecting" 130 billion U.S.$. into AIG), one can have doubts about the effectiveness of such actions. It is certainly not conducive to reducing systemic risk[12]; to the contrary, systemic risk is increased as companies are encouraged to behave just as before. One could say that AIG is an institution that is too large to fail. If, however, such institutions are not allowed to fail, excessive leverage, or excessive speculation, will not be reduced in the future.

The negative experience with state intervention has led many to conclude that the lesser the role of the state, the better. It does not appear, however, that such a conclusion is fully justified[13]. Please note that the absence of state in the economy could be as damaging as an excess of it[14]. In view of increasing costs and risks associated with globalisation, there is a need to increase the role of the state in order to decrease the adverse effects of this process. In the economy, when the state is omnipotent, as well as when its role is unduly limited, anarchy, risk, and transaction costs increase and the economic activity of society is reduced[15]. If state intervention helps to increase accumulation, employment, productivity, entrepreneurship and innovation, then the country does not limit economic freedom, but increases it (for example, Japan after 1949). The state should not substitute for the market, but to steer (regulate) it in the direction of boosting entrepreneurship and structural change[16].

In my opinion, state support was necessary, but poorly executed. Nothing was done to eliminate at least some irregularities. Even a well thought out

[12] The AIG Group issued hundreds of billions of dollars of mostly unsecured Credit Default Swaps (obligation to repay debt due to the second party to the transaction).

[13] "In contemporary capitalism the state is an active participant of economic processes everywhere, and to a greater degree than in the past, and in countries aiming to develop quickly the need for such activity is particularly strong. This is not contrary to market economy principles". Z. Sadowski, Polityka długofalowego rozwoju kraju a akcesja do Unii Europejskiej, Warszaw 2002, p. 7.

[14] H. Chołaj, *op. cit.*, p. 422.

[15] These are the conclusions of the World Bank (Word Development Report 2001, Building Institutions for Markets). F. Fukuyama has a similar approach, Budowanie państwa. Władza i ład międzynarodowy w XXI wieku, Rebis, Poznań 2005.

[16] J. W. Bossak, *op. cit.*, p. 40.

support, but carried out by only one country, is ineffective. Additionally, please note that administering the medicine to one segment of the economy may move the problems into other segments. **The attempt was to fight only the effects, not the causes**. The effects of these activities are already visible. The speculative bubble begins to grow again. Managers benefiting from state aid continue to pay themselves huge bonuses, as if there was no crisis and nothing happened. Government action is, for them, an incentive to repeat what they did before the crisis. To simplify the problem, one could say that no matter what they do, they will still get their bonus. Only the paymaster changes.

The state has an important role to play in economic and social development. However, the scope and direction of the impact of the state must change. The state should be more effective and less expensive. An efficient state[17] is needed, inter alia, to introduce regulations and institutions that will allow for more appropriate market development and improving the welfare of the population. The state is necessary to implement appropriate foundations for the market. The absence of such foundations increases the uncertainty and increases transaction costs.

3. Institutional determinants of capital market efficiency – actions of the state to limit agency costs

The economic system of the country is part of the institutional system of state[18]. Various institutions are the foundation for order and social harmony. The modern economy could not function effectively without civil law, legal protection of creditors, regulation of companies, etc. However, the excess of the institutions (the state) may limit the freedom, activity and entrepreneurship. Institutions define the limits of acceptable behavior, define the limits of the economic game and enforce compliance at the same time.

The task of state institutions and public entities in the economic sphere is primarily to ensure the protection of property rights, freedom of economic activity and competition, promoting entrepreneurship, growth, employment and

[17] It is important to note, that there is a difference between the normative and the positive role of the state, or – to put it otherwise, between what the state should do to create conditions increasing the welfare of a society, and what it in fact does (R. Musgrave, The Theory of Public Finance, 1959). The supporters of an increased role of the state see the normative role, where their opponents are likely to look at the problem from the point of view of the positive (or rather, negative) role of the state. Looking at different countries trying to adapt to new challenges one has the impression, that the problem lies not with the lack of possibilities, but with the lack of willingness to adapt, combined with swimming against the current.

[18] J. W. Bossak, *op. cit.*, p. 19.

economic equilibrium[19]. The development of entrepreneurship depends on the degree of openness or restrictiveness of the law and the degree of compliance. Properly operating institutions created by the state are conducive to the reduction of transaction costs and risk. The operation of the businesses generates costs of acquiring information, of ensuring transparency, promotion costs, and other costs related to the economic system[20]. High transaction costs occur when institutions perform poorly.

Determination of an adequate role of the state is one of the most difficult problems that arise in the process of globalisation[21]. The macroeconomic policy is a very important issue; it should be shaped so as to foster economic growth. The budget deficit and inflation must be reduced. Whenever a deficit occurs, it is important how it is financed. In constructing the budget, it is of paramount importance to have the share of fixed expenditure not too high. This increases flexibility. A budget should also include off-budget operations. This will make the better assessment of government finances possible[22].

In discussions on the role of the state, demands appear to increase or reduce its role. Such an approach leads to many misunderstandings. One should rather focus on the efficiency of state, rather than its strength. It is often indicated that the resources limited as a result of tax competition do not allow the state to play an active role. Many actions, however, do not require, in my opinion, additional funds. Often more efficient use of resources already held suffices[23].

A new market order may be built only when the market and competition work under a certain institutional framework (legal and ethical rules). Markets must meet certain conditions. Please note, however, that coordination must not be excessive. The state should reduce any imperfections, both its own, and the market's. The role of the state must be complementary with the role of the market.

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[19] *Ibidem*, p. 23.

[20] K. Schenk, Economic Institutions and Complexity, Structures, Interactions and Emergent Properties, "Journal of Evolutionary Economics", May 2005, Vol. 15, p. 13.

[21] H. Chołaj, *op. cit.*, p. 424.

[22] Poland is, again, a negative example. Instead of concentrating on the sanation of public finance, the entire effort goes into activities only apparently reducing debt. That is i.e. the underlying reason behind the proposals to grab a part of resources from pension funds and transfer them to state social security. Instead of reforming the agricultural pension system, very disadvantageous actions are proposed.

[23] Public expenditure in OECD countries in the early 1970s stood at 32% of GDP, in 1990 rose to 41%, and in 1998 to 43%. The mean yearly GDP growth was 3.4% in the 1970s, 2.9% in the 1980s, and 2.4% in the 1990s. At the same time countries whose public expenditure did not exceed 25% of their GDP developed at a yearly rate of 6.6%. A. Piński, J. Piński, Belka pod nogami. Jak zniechęcano nas do przedsiębiorczości, „Wprost", September 12, 2004.

In considerations concerning the role of the state, two basic functions are usually identified: operational and systemic[24]. The operational function relates to direct state interference in economic activity. Within the systemic function, the state serves as the creator, supervisor and manager of the economic system. Creating institutions which support the functioning of the market and enterprises, improving the quality of resources and capacity is most important. It is necessary to develop a long-term economic strategy. There is therefore no question of limiting the functions of the state, but only of a change in approach. According to J. H. Dunning, the State should restrict the operational functions (be "leaner"), reduce red tape (be "flexible"), and take systemic actions (creation of new institutions and regulations).

When pointing to the weakness of the state in carrying out its stabilising functions, several causes are often given:

- delays in the monetary mechanism,
- crowding out effect,
- political business cycle,
- inflation expectations,
- real business cycle[25].

The problem is that there is a growing a gap between the increased role that the State has to play, and the possibilities of its fulfilment. The World Bank report on the world economy indicates the applicability of a two-part strategy[26]:

- the role of the state should be adapted to the possibilities. Countries that are trying to do too much, having too small resources, often do more harm than good,
- the capacity of the state should be increased by strengthening public institutions. Effective rules should be introduced, arbitrariness avoided, and corruption fought.

The main impact of state should concentrate on regulations, especially those that limit the scale of operations, which are outside the sphere of the real economy, including excessive leverage and taking excessive risks. This should not, however, lead to excessive growth in the role of state, to the unnecessary development of new controlling institutions. Solutions combining the good sides of the market with necessary state intervention where the market cannot cope should be sought.

[24] J. H. Dunning, Goverments and Macro-Organization of Economic Activity, w: Goverments, Globalization and International Business, New York 1977.

[25] A. Lipowski, Ekonomiczna zawodność państwa-krytyczna analiza ujęcia antyetatystycznego, Ekonomista 2/2002, Warszawa, p. 170.

[26] World Development Report 1997: The State in a Changing World, Oxford University Press for the World Bank, New York 1997.

Many statements on the causes of crises often point to the ineffectiveness of prudential regulations. This leads to the logical conclusion that these regulations should be changed (tightened). The majority of the proposals go in this direction. When regulating different areas of market activity it should be borne in mind, however, that regulation turns off the natural market forces. And when these rules fail, it is often proposed that further regulation be introduced. Such an approach is, in my view, questionable, and for a number of reasons. First of all, causes of the crisis are much more complex. Second, a number of attempts to tighten restrictions proved ineffective (new instruments to circumvent new regulations were devised). Thirdly, it leads to various adverse effects (reduction in capital inflows, or increase in the cost of capital).

The basic problem boils down to the fact that a number of specific solutions currently proposed have already been attempted. Problems arising in different countries resulted in the imposition of various restrictions on the movement of capital. However, this did not bring the desired effect. This concerns for example the so-called Tobin tax, the taxation of short-term capital market operations, or prohibition or restriction on short sales. Attempts to administrative reduce speculative capital flows[27] (restoring restrictions on transactions previously liberalised), undermined confidence in the authorities' policy, increasing the risk in this country. This resulted in reducing capital flows, while making it difficult for companies to access capital, and increasing the cost of its acquisition. The new role of the state certainly cannot be confined to the role of caretaker[28] of the new order, if only because the new order does not yet exist. Swift action is needed.

In my opinion, improving market efficiency and reducing the negative impact of the market on the functioning of the businesses requires an active role of the state, but you have to do it in a thoughtful and comprehensive manner (taking into account the different situations and reasons). Do those, who have to decide about these changes, have enough courage and wisdom to admit that they are accomplices who led to the present situation? A brain is needed to admit this, to realise what the real causes of instability are, and what are the consequences of your actions. Can regulators, while attacking speculators and shortsighted managers and capital markets, break away from populism and

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[27] For example, in Chile, mandatory non-interest bearing deposits equalling 30% of the value of financial investments made there by a foreign entity were introduced. Another limitation was the requirement that the capital flowing to remain in this country at least a year. In some countries, using tax preferences for capital gains, these are restricted only to long-term investments.

[28] Neo-liberals represented by Milton Friedman and Friedrich August von Hayek believed that the state should only be a night guardian. There is a certain evolution of views, particularly with regard to Friedman.

short-term political objectives? A good example of such populism is, for example, the attempt to administratively reduce excessive salaries of managers. These salaries, undoubtedly in many cases, are obscenely excessive and unrelated to the results, but the currently proposed way of resolving this problem is in my view inappropriate. The main problem is not high salaries, but excessive risk-taking incentive, and detachment of the motivating system from the long-term results. There is no doubt that often the salary and bonuses are obviously too high, as evidenced by the many previously described examples. It's hard to imagine, however, that the state defines the level of wages and the amount of bonuses paid. Punishing anyone who got a bonus of more than 25 thousand Euros or pounds is not the solution. We must look for systemic solutions. Proposals to place "caps" on wages appear often, but I do not think that it is an appropriate solution[29]. Another example of such populist measures are the so-called "parities" in the supervisory boards. In 2003 Norwegians introduced a requirement, that women should constitute 40% of supervisory boards' members. Similar solutions were adopted in Spain, but they will not be in force until 2015. The third country is France, where companies were given six years for the introduction of "parity". If you do not do this, all the decisions of boards will be void. At least one woman has to appear in every council at the next exchange of the boards.

A basic condition for the effectiveness of any solution is to understand the causes of irregularities. G. Sorman argued that the deregulation of financial markets brought about mainly an increase in speculation and therefore there is a need to establish rules according to totally new principles[30]. This thinking does not give opportunities to develop appropriate solutions. One-sidedness in the approach to the role of capital market leads nowhere. It is clear that the capital market is imperfect, and the state as a regulator of this market is imperfect too. Just as different solutions on the capital market led to a crisis, the state has also participation in provoking it.

The problem is also that many borrowers and investors, especially individual have a very low level of knowledge. Many of them are simply illiterate, and do not understand what they sign. Very often they do not read the documents they sign. A number of vendors take advantage of this. The behavior of these sellers is unethical, but charging them with sole responsibility is not appropriate. Those who

[29] Poland has considerable experience in restricting wages of boards in state-owned firms. As these wages are not linked with the size of companies, the difficulty in the management, or results achieved results achieved, the jobs often go to losers, who are unable to find better paid positions in private companies. Different ingenious methods to circumvent these restrictions have been devised. Another anomaly is that the board members of such companies may earn significantly less than their subordinates who are not covered by this law.

[30] G. Sorman, Kryzys dopiero przed nami, Tygodnik Idei, Europa Dziennik, 9–10 May 2009.

want "a free ride"[31] also must bear responsibility for their mistaken decisions. I am fully aware that sometimes it is very difficult to read a large number of annexes to the contracts, the small print, or very extensive tables of fees and commissions. However, this may not be the basis for shifting responsibility to others.

The European Commission has concluded that such investors should be given extra help and issued the MiFID directive. Under this directive the seller of financial products should assess the investor profile in a detailed survey, and determine the suitability of the service proposed. The investor takes the final decision anyway. Will this change the situation significantly? I do not think so. Those who mindlessly invested will continue to do so. Without imposing liability for the decisions taken at three levels (managers, state and investors) the volatility in capital markets cannot be reduced.

Below I present schematically the causes of instability of capital markets. Creating the conditions for a safe capital market depends primarily on creating the basis of stable functioning and development of individual countries. Capital market development requires the active role of the state. This applies mainly to establishing specific regulations to ensure the safety of this market. The following factors have a great significance:

- regulations defining the principles and procedures of public trading in securities (regulations concerning the preparation of prospectuses in public offerings and the scope of the periodic information, regulating the secondary market and settlements),
- institutional arrangements, to ensure fair trading and competition (the licensing of stock exchanges, brokers, investment advisers, investment funds),
- actions to ensure the smooth functioning of the securities market and protect participants of this market (a system of civil and criminal liability),
- confidence in the public trading of securities on a given capital market.

Several areas of activity may be indicated. The first priority is to create conditions for better access to reliable information and the introduction of appropriate corporate governance. This depends primarily on creating appropriate regulations and institutions to disclose important information, providing equal access to information, implementing international accounting standards and protecting the interests of different shareholders. The protection of small shareholders must be increased, corporate management improved, international accounting standards – disseminated. Consideration must be given to the issue

[31] This type of wording should probably not be found in this work, but I was provoked by the statement of one of the professors of economics, who often complained that "the banks are doing him in". It is interesting, whether when the products offered by banks and other financial institutions could achieve above-average profits, their customers also feel "done in".

of determining the values of individual assets and their impact on financial statements. An important area, which also should be regulated, is the credit rating industry. These regulations should encourage transparency in their functioning. Not just the rating itself is important, but also the way it is determined.

The second line of action concerns adequate supervision. The financial sector must be properly supervised. This would make early detection of threats and countering them effective. Erroneous or insufficient information about the financial position of enterprises[32] may delay the market's reaction. Delay increases the violence of the reaction.

CRISIS MAP

I. REASONS OF INSTABILITY OF THE CAPITAL MARKETS

1. PRIMARY CAUSES

Conflict of agency (costs of agency)

- **change in ownership structure** – Separation of ownership from management – acceptance of excessive risk-taking by managers due to lack of responsibility (distorted ratio of risk to rate of return), shortening the investment horizon, short-term increase in the company value at any price
- **irresponsible actions of the state** – The state can also be seen as an agent. It is a specific agent. However, states have enormous resources at their disposal, often not very well managed and are not generally liable for its actions. The State does not function well as a business owner and regulator. Pursuing expansionary economic policy stimulates excess demand, leading to overvaluation of securities and real estate and speculation

2. SECONDARY CAUSES

- **technical progress** (Internet, computerisation, telecommunications) – improved access to information facilitated investment decisions
- **liberalisation** – facilitated movement of capital on a large scale
- **development of capital market**:
  - Development of institutional investors administrations with enormous resources aimed at short-term gains
  - The dynamic development of financial instruments to facilitate the creation and movement of capital (leverage is easier) and the relocation and reduction (often illusory) of risk

II. ATTEMPTS TO SOLVE THE PROBLEMS

1. ATTEMPTS TO DATE (REDUCING COST OF AGENCY)

- **Market** – Aggressive incentive systems
- **State** – Regulations (prudential, concerning information disclosure, protecting the interests of different shareholders
  - Providing financial support to vulnerable subjects (socializing losses, spreading responsibility, encouraging similar actions in the future)

2. **BASIC DIRECTION OF PROPOSED CHANGES**

- **Better accountability (Eliminating the asymmetry of responsibility)** of managers and other capital market participants for their incorrect decisions (appropriate actions of both market and state)
- **better regulation** concerning the protection of investors and the transmission of reliable information, coupled with effective enforcement (appropriate action of the State)
- **the creation of supranational supervision** (Appropriate action of groups of countries and international organizations)

[32] Companies should publish financial statements, verified by independent auditors.

A major factor in the development of each country is an appropriate legal and institutional system that protects investors (Corporate Governance.) The possibility of raising capital by companies in foreign markets depends on, inter alia, reducing the risk of expropriation of shareholders by managers. Research shows that the development of legal protection of investors is an important factor in the development of financial markets. Outside investors financing a company are usually concerned that the benefits they expect may not materialize, because the main shareholders and managers can expropriate them (by, for instance, "stealing the profits" selling production or assets at depressed prices to other companies controlled by them[33]). In such a situation money will not return money to investors, but increase the benefits of insiders (managers and major shareholders)[34].

Better protection[35] makes investors willing to pay more for domestic assets. They pay more because they believe that better legal protection will result in a higher return, higher gains on interest or dividends. Securities prices grow in such circumstances[36]. Weak protection, on the other hand, increases the risks of expropriation of shareholders by entrepreneurs who control the company[37]. Empirical studies therefore confirm that better legal protection of shareholders results in a higher valuation of the assets of enterprises.

Not only relevant legal regulations are important, or the creation of appropriate institutions, but also and above all, adequate law enforcement. The third priority concerns, therefore, an effective system of criminal liability and civil liability.

Previous experiences in various countries show that there were some shortcomings in all these areas. However, in my view, the greatest, problem is the lack of an effective system of civil and criminal liability. This includes two aspects: responsibility and efficiency in its enforcement.

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33 Other forms of action to the detriment of small shareholders may be excessive wage, or the hiring of family members or friends who do not have the appropriate qualifications.

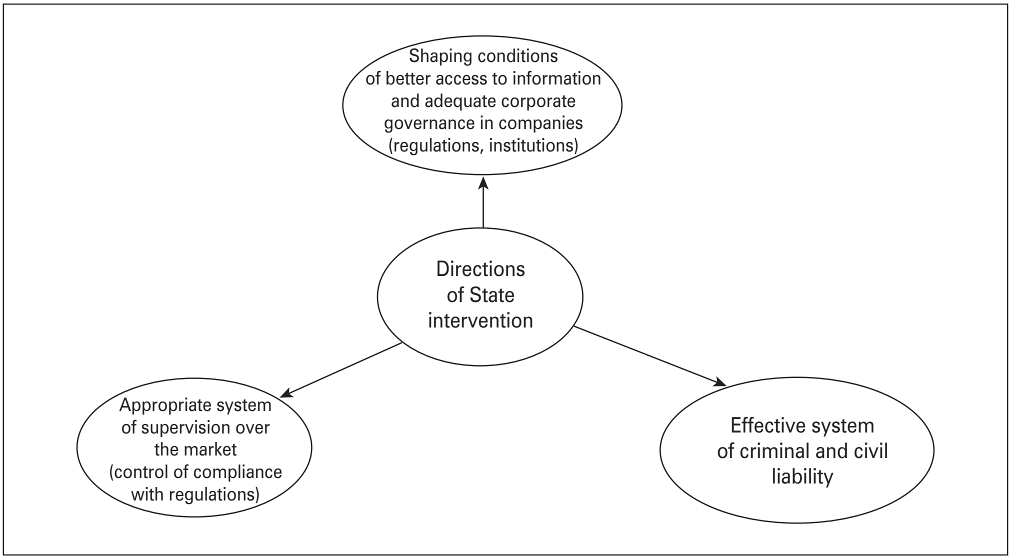
34 R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny, Investor Protection and Corporate Governance, P. 2.

35 The literature indicates that in countries whose legal system is based on civil law, there is greater state intervention in economic activity, and consequently weaker protection of private property, than in systems based on common law.

36 It is worth remembering especially when discussing privatization and valuation of companies.

37 R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny, Investor Protection and Corporate Governance, Department of Economics, Harvard University, Cambridge, 2000.

Figure 3. Main areas of state activity in increasing effectiveness of capital markets



Source: own work.

As regards the scope of a manager's responsibility, I would point to two basic problems. The first concerns the limitation of liability to direct losses caused by their decisions. And these losses should not be seen as deterioration in the financial results of the company only, because in such a situation a manager can at most lose his job. Responsibility usually occurs only when there is the so-called intentional act, or deliberate violation of specific provisions. Taking excessive investment risk and potential losses due to this do not cause negative consequences for managers. **There is an obvious asymmetry of responsibility**. In the event of bad decisions shareholders lose capital invested by them, and managers at most lose their jobs. When, on the other hand, they take the right decision, they receive a huge bonus. Is it not possible to implement a solution whereby the deterioration of the results leads to giving back their earlier bonuses? In this situation, their inclination towards risk would be much lower, they would carefully approach the different financial instruments.

The managers' incentive systems should therefore be so modified, as to encourage them to take long-term action. This can be achieved through:

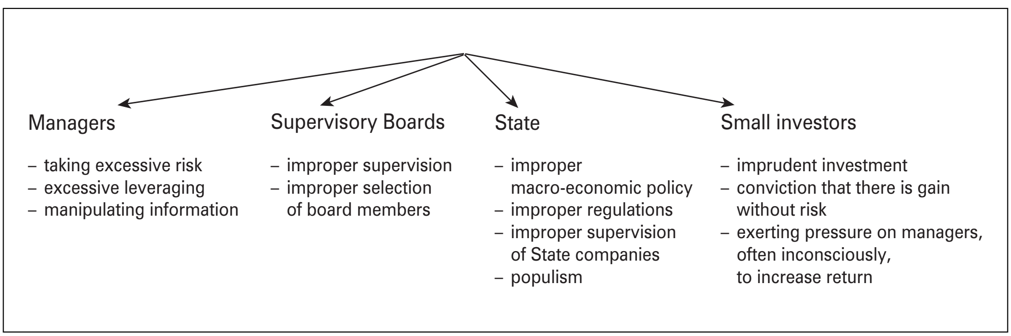
- withdrawal of "golden parachutes" and guaranteed bonuses paid in the case of dismissal for poor performance or violation of law,
- reducing the amount of bonuses in relation to the basic salary,

- deferred bonuses related to future results,
- possibility to demand repayment of the bonus, when future results turn out to be below expectations (extension of the assessment period),
- annual bonuses in escrow accounts, which may be withdrawn in case of losses.

The State should establish regulations to facilitate or even impose the obligation to apply such solutions. The criterions of selection and responsibilities of members of supervisory boards must be also changed. This could result in that fewer politicians and public officials, having neither qualifications nor motivation for proper supervision, and interested only in the easy extra income, would apply for seats in the supervisory boards.

The second problem concerns the scope of entities subject to this responsibility. Undoubtedly, the negative role of the managers is not subject to any doubt. But it must be kept in mind, that the State, investors, and borrowers, are also responsible. Too easily and too often we release these other parties from liability. Such an approach makes it difficult to introduce various solutions to eliminate anomalies in the capital market. **Frequent changes in regulations (taxes) affect the investment perspective shortening it, and increase speculation that is leading to the instability of capital markets.**

Figure 4. Consequences of lack of accountability for decisions made



Source: own.

Enforcement of liability, set aside concerns about its scope and subjective, leaves much to be desired.

Activities to increase the competitiveness of enterprises are important. One can speak about a new concept of economic policy of the State in conditions of globalisation, which is designed to shift the emphasis from direct government regulation of economic mechanisms, to creating conditions for increasing competitiveness[38]. Businesses gain more from reducing red tape, increasing the transparency of regulations, limiting the amount of changes in the rules, than from obtaining new subsidies, especially when, moreover, resources are becoming scarce. Many countries have taken an active policy aimed at increasing the competitiveness of enterprises and economies. Within the framework of macroeconomic policy, measures are taken to shape the structure of the economy and its exports in line with trends of changes in global demand. The opening of the national economy to the external markets offers opportunities to increase economic growth in the long term. Raising the international competitiveness of enterprises should be supported, i.e., by the expansion and maintenance of modern infrastructure. Developing economies and businesses increasingly require a higher level of applied technology and increasingly high qualifications. The state plays an important role in their development.

Other activities are related to the creation of conditions for fair competition. I.e., monopolies in different areas of the economy should be restricted. An important issue is to reduce the size of companies. Situations, where firms are too big to fail should be avoided. Institutions offering safe instruments should be banned from carrying out activities with a high risk. Analysing the different solutions used previously we should, in my opinion, consider the regulations introduced in 1933 in the United States; I mean the Glass-Steagall Act, separating commercial banking, investment and insurance services. Such separation allows the development of appropriate regulatory instruments and separation of safe activities from the more risky ones (speculative, easily leveraged). This would reduce the negative effects of transferring the results of excessively risky actions to those who often over many years saved, for instance in banks (not willing to take too high risks). The appropriate course of action is deposit insurance up to certain amounts. This will increase transparency and competition on the market. There is also a need to take action to harmonise tax systems. Such actions are taken by the OECD and the European Union.

Since excessive leverage, excessive risk taking, and manipulation of information are largely a consequence of the separation of ownership from management, putting in place measures that prevent excessive fragmentation of ownership should be considered, at least in relation to companies that raise equity in a public market. **Regulations that block the effective impact of shareholders on the company must be changed.** A striking example of the pathology occurring here is the opposition of the largest owner of Kraft, Warren

[38] The New Political Economy of Globalisation, Vol. I, Part II: The State, ed. R. Higgott, Payne A., 2001.

Buffett (Owner of Kraft by proxy, Berkshire Hathaway), against the takeover of Cadbury. The opposition turned out to be unsuccessful, since shareholders did not have real influence on such an important decision made by "their" company. In the U.S., already at the beginning of the 1930s regulations, which led to the growth of influence of the managers, often at the expense of the interest of owners, were introduced. The powers of the owners must be increased; regulations that increase the alienation of the owners of public companies have to be reduced.

Politicians are often reluctant to such changes. And they introduce laws, which deprive them of control over markets with reluctance[39], forcing the transfer of control to financiers. Resistance also occurs on the part of families that control large corporations. Family property, which is prevalent in many Asian countries, is regarded as one of the factors that contributed to the financial crisis in the area. Managers of big companies, that are financed through internal sources or through affiliated banks[40] are also opposed to such reforms. This makes much of the bank loans go, in these countries, to several major companies, which hinders access to finance for small firms that could compete with large companies. The protection of foreign investors, while contributing to the development of capital markets and facilitating the funding of small businesses, is at the same time a major threat to the inefficient firms, which must lead them to block such reforms. It is often easier to use political influence to block the reforms than to take action to improve efficiency. Poor corporate management of such companies provides safe funding, secure policy and secure markets. They are therefore keen to keep the existing system[41]. The difficult start of many less developed countries, due to, inter alia, lower competitiveness, conditions the adaptation processes in a particular manner. This does not mean, however, that these countries are predetermined to be losers.

You cannot focus on regulating the names, you need to regulate risk. Restricting or prohibiting certain instruments (securitisation, short-selling) is not a solution, but ways to reduce excessive risk should be found. Moreover, the steps currently taken by the U.S. government do not solve any problems in my opinion[42], and only perpetuate the existing anomalies and accelerate the next crisis. Rescue (support) of private institutions by the state increases the risk of actions known as "moral hazard".

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[39] Such control may be effected, e.g., by large corporations. In many countries, politicians interfere in the management of the companies in which the state has a stake.

[40] C. Mayer New issues in corporate finance, "European Economic Review" 1998, No. 32, p. 1167–1188.

[41] R. L. La Porta, et al. ... Investor Protection, p. 25.

[42] I am thinking long term. In the short term, you can talk about some of the apparent benefits such as slowing decline in production, the number of bankruptcies, etc.

One must always remember that too much detail in regulations reduces the flexibility of the market. Action must be taken, for instance, so that reduced tax rates are accompanied by increased revenues for the budget, or at least not by a significant drop in these revenues. This may happen when the tax reduction is accompanied by an increase in economic activity. This is not an easy task and there is no automatism here. The history of individual countries provides ample evidence that in some situations, tax cuts led to an increase in activity, but there are also cases where there was no such link. This is due to the fact, that investment decisions are conditioned by many factors, not just the amount of taxes.

It is not a passive adaptation, as some suggest, to the demands of capital, that matters, but a knowledge of mechanisms that decide about specific behaviours of that capital· Capital movements, including speculation, are subordinate to the objectives of the owners of capital. Understanding the determinants of these processes will make it easier to adapt to them and benefit from opportunities associated with this.

The error of submission, long known in the economy still valid; rationality at the micro level is not the same as rationality at the macro level. Reflections on changes in the state's role cannot be treated here as an argument that this error does not exist. This problem occurs all the time, in many cases even intensifies. The market alone will not solve this problem. Dilemmas relate only to how the state can help reduce market failures[43].

Due to the excessive regulation in the European Union, it will be harder to get out of recession. Ideas for additional regulation (increased control over banks, barriers to investment, protection of different industries by the state) have the potential to widen the gap between the EU and America in the future.

A greater government intervention in the economy may take such forms as in the U.S. (plan of Treasury Secretary Paulson), France under Sarkozy's leadership, or Switzerland. This third example is more market-friendly, more thought out. In Switzerland, before the intervention occurred, authorities explained by what results they expect to achieve, what steps will be taken and when the State will withdraw from intervention.

In conclusion, it must be said that as the capital market develops, the state largely loses its ability to act. To attract capital, the state must submit to the requirements of capital. Taking action unfavourable to capital means that capital leaves (this is a kind of punishment). From this point of view we can say

[43] In this work, of course, the considerations do not apply to the market as such, but generally they are confined to the capital market.

that the state loses its significance, because it may not take certain actions at will. Incompleteness of political and economic globalisation promotes the growing strength of the capital market. The flow of labour remains blocked, while capital is on the move. Despite these limitations of the States' ability to act, there are new trends and the impact of new challenges. Without the active role of the State the adverse consequences of development of capital markets cannot be restricted. These measures must however be carefully considered and subjected to certain logic. It is essential to identify the causes of instability.

4. The incompleteness of globalisation – the need to create a supranational supervision

Widespread liberalisation of capital markets led to the fact that these markets largely slipped out from any control. Economic globalisation is not accompanied by simultaneous globalisation in the political sphere, which results in the fact that we can speak of the incompleteness of globalisation[44].

As already mentioned an important factor in the volatility of capital markets is taking excessive risks and information asymmetry. The inability of the market itself to eliminate these causes of weakness points to the need for greater regulation and supervision by the State.

Many point out, that a principal mean to combat the crisis is restructuring the regulatory oversight of securities market. There are some indications that it should be more systemic and flexible, so that it can respond more quickly if it appears that some measures introduced cause unintended consequences. The need for a systematic approach results from the interaction between international markets. Attempts to regulate the global flow at the local level proved to be ineffective. You can talk about "competitive speculative arbitrage", or competition between national regulators for foreign capital.

It is also indicated ever more often, that a new international financial architecture needs to be agreed, however, on a super-national basis. Already many years ago H. Kaufman proposed the creation of a global institution to exercise supervision over both commercial banks and non-bank financial intermediaries[45]. It seems that this will be very difficult, due to different interests and diverging views

[44] For more on this topic see works by W. Szymanski, who in addition to incompleteness in the political sphere also points to the incompleteness in the economic sphere, namely the lack of freedom of movement of labor and agricultural products. This is due to the protection of their interests by the highly developed countries.

[45] H. Kaufman, Developing the West Global Financial Crises, "Washington Post, 28/01/1998.

on these issues. In the meantime, extensive use of already existing international institutions is paramount[46].

One of the key problems is that, to date, no international actor that can identify the global targets has developed. There are neither rules, nor institutions provided with adequate means to force market actors to comply with such rules. Any discussions on this issue reveal a huge conflict of interest in the global economy. A further asymmetry between the capacity of the state and expectations for coordination also reveals itself.

Although the institutions subject to supervision operate globally, each country has so far implemented financial supervision on its own. It also occurred, that there were inconsistencies between the different national regulations. This resulted in the foreign activities of financial institutions often slipping out of any control. Operating in various markets simultaneously created possibilities of distorting the picture of the financial situation of an institution. Additional problems are associated with tax havens, where supervision practically does not exist. This makes not only tax evasion, but also disrespecting prudential regulations, relatively easy.

Eliminating these problems requires the creation of supranational supervision that should have the right to review the activities of the entire financial groups, regardless of where their business is conducted.

Attempts to reduce the impact of crises often result in an increased state interventionism. Protectionism and state intervention in the economy grow, which greatly impedes the introduction of trans-national solutions. This suggests that such solutions should be introduced in more peaceful times, but unfortunately then the desire (compulsion) to introduce them is also much smaller.

Existing institutions – the World Bank and IMF are not sufficiently representative to obtain the legitimacy necessary for global management. One of the lines of action is taking steps aimed at reforming the existing institutions in order to make them more efficient and reliable. This, however, requires a community of interests. Activities can be effective only if they give a global dimension. In the case of the IMF the main concern is its rather low acceptability, due to its record of activities. Assistance provided by this institution in many cases contributed indirectly to insure (reduce) the risk of the capital market. Investors expected, that should problems in individual countries arise, the IMF will come to their aid, and hence were willing to accept an apparently higher risk. I do not think, however, that Stiglitz was right when he argued that the

[46] Several institutions may be named, i.e.: Committee on the Global Financial System (CGFS), International Association of Securities Commissions (IAIS), International Accounting Standards Committee (IASC), Global Forum on Company Management,, standardized data system about the development of individual states (SDDS).

IMF is not guided by the desire to assist such countries in trouble, and takes action that only allows highly developed countries to withdraw their capital[47].

The void caused by the lack of adequate systemic solutions was partially filled by the creation of ad hoc agreements on cooperation between groups of countries, taking over the role of "steering committees in the world economy" (G7, G8, and G20)[48]. Several meetings, during which it was attempted to determine the directions of future changes, were held. G-20 summits took place in November 2008 in Washington and in London in April 2009. Also, very much to the point, during these meetings it was admitted that the effectiveness of the proposed solutions requires the involvement of many more countries, not just the most developed ones. It should therefore be a G-192, but it is hard to imagine that such a broad forum could take any decisions.

Heads of G-20 states[49], at a meeting held in November 2008 in Washington pledged to take action in several areas ranging from greater market transparency, strengthening the control system, and ending with the reform of international financial institutions.

1) improving market transparency:
   - financial supervisory authorities are to cooperate with the private sector in properly implementing new accounting rules,
   - requirements concerning the content of reports published by financial institutions on their financial condition will be tightened,
   - supervision will ensure completeness and correctness of these reports,
2) strengthening the control system:
   - system of financial market regulation should prevent the crisis from spreading to other sectors of the economy,
   - international rating agencies will be reformed, so that they can provide objective information to the market. These agencies will be subject to monitoring, and the obligation of registration,
   - financial institutions should hold capital reserves, such as not to undermine confidence in the banking systems. The amount of a bank's capital will depend on the structure of its loan portfolio,
   - a strong system of supervision of the liquidity of international financial markets will be created,
   - a reform of bankruptcy laws applicable to international corporations will be carried out.

[47] J. Stiglitz, Globalizacja, PWN, Warsaw 2004, p. 28–36.
[48] J. W. Gołębiowski, Global Governance, Koncepcje-doświadczenia-perspektywy. Instytut Gospodarki Światowej, SGH, Warszawa 2008, p. 23-25.
[49] Forum affiliating industrialised countries and developing countries.

3) market management:
   - bank risk management procedures need to be strengthened. Financial institutions should improve internal controls,
   - procedures to better manage liquidity will be created,
   - protection of the markets from turbulence should be an objective of the banks, and therefore they should reform their management systems with this aim in mind,
   - risk management systems in relation to structured products will be created.
4) promotion of the integrity of financial markets:
   - the main objective of the State is to protect investors and consumers,
   - the threat to the stability of international markets will be eliminated, through increasing cooperation between national financial supervision authorities,
   - the fight against money laundering and financial terrorism will be expanded.
5) reform of international financial institutions:
   - The Financial Stability Forum will be expanded and new members admitted,
   - The IMF should become a major centre for the analysis of the current crisis and will develop appropriate conclusions,
   - capital resources of the World Bank Group should be increased,
   - credit markets will be more accessible to developing countries,
   - Bretton Woods system should be reformed so as to correspond with the evolution of the global economy, the role of developing countries is to be raised,
   - IMF surveillance over all countries will be strengthened, and more attention paid to the financial sector,
   - developed countries should increase their role in supporting economic growth in poorer regions of the world.

The summit's final communiqué stated that, with deteriorating economic conditions around the world, there is a need for a broader policy response, based on a closer economic cooperation, in order to restore growth, to avoid a negative domino effect, and to support the emerging-market economies and developing countries.

Other regulatory areas discussed are:

1) the valuation of assets by the so-called fair value – valuation of assets at market prices, regardless of their degree of liquidity. Listed companies

using International Financial Reporting Standards (IFRS) estimate the financial instruments (derivatives, bonds and others) at a fair value. In the case of companies not complying with these standards valuation is based on historical value (the value of expenses incurred) The use of fair value results in unrealised gains (gains on the valuation of assets) in the companies in good times, and during a crisis there are losses resulting from lower valuation. Losses from the valuation, when their level exceeds the value of equity, are the basis for the bankruptcy of companies, which significantly contributes to deepening the crisis. This is particularly true when, to cover losses, other assets are sold quickly. Both valuation gains and losses are unrealized values, which show the differences between the historical costs of acquisition (construction) of assets, and their market value on the balance sheet. Gains and losses realised may vary significantly from the unrealised gains and losses (resulting from valuation). Valuations are subject to large fluctuations. Changes in the market are automatically reflected in the valuations. The use of historical prices, however, reduces the transparency of financial statements and makes it difficult to compare the financial situation of companies in different periods or to compare different companies;
2) greater transparency of banks, private equity and hedge funds. These institutions, unlike the so-called public companies, have limited publication obligations. This reduces transparency and comparability.

In assessing the setting of different peaks, it should be noted that the root causes of instability of capital markets were not fully realised, and without this it is difficult to propose appropriate solutions. What was proposed is, in my view, incomplete and too vague, and as usual the problem lies in the details. It is difficult, on the other hand, to imagine that in a crisis situation, with so many conflicts of interest, such a group could come up with something more concrete. I do not think that these meetings could soon translate into practical solutions. Some changes probably will occur, but they will be insufficient to face the next problems. Again, there are demands to introduce a Tobin tax, but its implementation does not appear possible.

A significant change is a departure from the spirit of liberalism, which has largely lost its monopoly (at least verbally). We must however add that blaming everything on neo-liberalism is wrong. Neo-liberalism is not the problem, but rather a weakness of market mechanisms. The market coordination is weak. Lack of accountability of the decision makers, resulting in excessive speculative capital movements, and speculative bubbles, does not encounter appropriate market barriers or state regulations. **Market failures can be dealt with by**

appropriate state intervention. However, the weakness of states can not be solved by increasing the role of the state.

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Sustainable Consumption as a Challenge for 21st Century Communities

Sustainable development is the one that meets the needs of the present without compromising the ability of future generations to meet their own needs[1].

World Commission on Environment and Development
Brundtland report, 1987

1. Introduction

At the beginning of the 21st century, when speaking about consumption and consumers, we increasingly refer to two research areas – consumerism and sustainable development, also to sustainable consumption. Both notions are connected with social prosperity growth. There is, however, a different time horizon, in which consumption is perceived in these notions. There are also different consumer attitudes toward values recognised as important and prominent, as well as toward consumption, which translates into different market behaviours of consumers: some are in favour of the idea of consumerism, others are closer to balanced development and consumption. As a result we notice that consumerism and sustainable consumption are characterised by different objectives and also detailed development tasks, in particular in the social sphere. There is a question then: if, in the turbulent times in the global social and economic system, is it possible to achieve the sustainable development in which the economic growth is accompanied by the qualitative growth represented by social and civilisation progress adequate to the above mentioned growth including also sustainable consumption?

[1] UN Documents: Report of the World Commission on Environment and Development: Our Common Future. http://www.un-documents.net/wced-ocf.htm

2. Consumerism

Within the conditions of the European Union accession[2] more and more frequently the problem of sustainable development is raised in Poland in an economic and social context. So far social and economic growth, where one of the objectives is the rise in prosperity, has been identified with the real rise in income, which enables a broader and more dynamic satisfaction of needs. Free flow of goods and services, opportunity to buy products on credit, ("buy today, pay tomorrow"), information revolution stimulating e-purchases[3], popularisation of materialist system of values resulted in the fact that consumption became a value of its own, leading to the phenomenon of consumerism.

Consumerism, as the researchers indicate, **is the identification of modern societies in economically developed countries.** However, the cult of possession cannot be attributed to one definite social group, job category or geographical zone. The desire to multiply material goods includes more and more numerous consumers[4]. S. Sivaraksa describes consumerism as a religion of consumption – ascribing the conclusive significance to purchasing power. He claims that consumerism has succeeded, to a large extent, in dominating the contemporary society because individuals have been alienated from their culture and have separated themselves from others[5].

The roots of consumerism date back to the economic boom in the USA after World War II, and then to the 1960s in Europe. The rise in purchases and consumption took different forms. It referred to both rich social groups and those less wealthy. It was connected with the inclusion, for the first time, of children and youth as the active participants of the market as the ones to advise, choose, purchase and decide. It was when the American market discovered for the first time the potential and promising prospects of young consumers as

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[2] Communique by the Commission Balanced Europe for Better World Communique: Strategy of Balancved Growth of the European Union (Proposal of the Commission for the European Council in Gotenburg), Brussels, 15 May 2001 COM(2001)264 final.

[3] More: A. Dąbrowska, M. Janoś-Kresło, A. Wódkowski, E-usługi a społeczeństwo informacyjne (E-services in relation to information society) Difin, Warsaw 2009.

[4] Oblicza konsumpcjonizmu (Faces of consumerism) ed. B. Mróz, Warsaw School of Economics in Warsaw, Warsaw 2009, p. 10, also: B. R. Barber, Skonsumowani, Jak rynek psuje dzieci, infantylizuje dorosłych i połyka obywateli (Consumed, How market spoils children, infantilises grown ups and swallows citizens), Muza SA, Warsaw 2008; G. Ritzer, Mcdonaldisation of society, Muza SA, Warsaw 1999, G. Ritzer, Magic world of consumption, Muza SA, Warsaw 2001, K. Sitkiewicz, State of thirst, Faces of Mcdonaldisation, CeDeWu.pl Wydawnictwa Fachowe, Warsaw 2009.

[5] S. Sivaraksa, Przeciwwaga dla konsumpcjonizmu,(Counterbalance for consumptionism), in: Uważność na targowisku. Globalny rynek i masowa konsumpcja a świadome życie (Care in the market place. Global market and mass consumption in relation to conscious life), ed. A. H. Badiner, Jacek Santorski &Co, Warsaw 2004, p. 159.

market participants. Up till now the baby boomers and "X" generations have been a symbol of hedonistic materialism. This stage of transition is also connected with the origin and foundations of a consumption community, whose highest priority, because of a better quality of life in relation to the past, is consumption, while social morality, politics and customs are subordinated to consumption.

The stage to speed up and enhance the scale of consumerism growth was the 1980s giving rise to the beginning of the globalisation of markets and consumption. The g**lobal economy together with its rules of penetration in all fields of life cause simply the explosion of the phenomenon of consumerism.** It is confirmed by the performance of companies such as: Coca-Cola, Nike, Microsoft, IBM, Levi's, CNN, Marlboro or MTV. The analysis of this phenomenon in the economic aspect indicates increasing rationalisation of production, but at the same time reveals the formalisation of social relations, growing social inequalities as well as dangerous climate change and ecological negligence.

For many years features of global changes have been indicated in the natural environment connected with the globalisation of the world economy, among others[6]: excessive use of resources, degradation of the environment through excessive exploitation of forests and other ecosystems, chaotic destruction of the environment for urbanisation, development of a mass tourism infrastructure, the growing problem of waste and ecological disasters.

It should be stressed though that the issue of developed consumption does not equally concern all modern societies. According to *The Millennium Development Goals Report 2007* as many as 900 m people live for less than one dollar a day[7].

In order to raise the level of consumption in particular countries, the growth in "means of consumption" has been initiated, and to be more specific: the consumption machinery represented by shopping centres and malls. It is connected with further expansive activity, insufficiently accounting for the needs of a man as a social entity and not only as a consumer and broadly perceived environment where the global community live. The opponents of consumerism assess this phenomenon negatively, calling it sometimes the "religion of consumption". While the proponents point to its important positive aspects as growth stimulation, job creation, creation of new opportunities to select goods and services as well as competitive prices. They treat accompanying technological innovations as a factor contributing to the growth in efficiency and labour productivity. The Internet is regarded as a higher standard of living and economic growth source.

6 WBGU, Welt im Wandel, Changing world)Jahresgutachten 1996, Berlin-Heidelberg-New York 1996, p. 5.

7 The Millennium Development Goals Report 2007, UNDP, New York 2007, p. 7.

Consumerism is reflected in numerous ways. It is confirmed by different styles of life and self-creation in modern society together with new phenomena and tendencies in consumption like[8] ecologisation, dematerialisation, servicisation, home-centrism, privatisation, homogenisation and heterogenisation, deconsumption and prosumption and virtualisation. Also mass culture, homogenisation of culture and consumerist society are typical elements of the development of consumerism[9].

Currently, together with less significance of international borders, consumerism favours erasing cultural differences, uniformity of societies and their mass consumption. At the same time, numerous styles of life of modern societies develop and there are polar opposites of over and under consumption. To help develop this phenomenon there are the latest information and communications technologies and basic rules of the manufacturing process and the production sphere, such as: efficiency, measurability, steerability and predictability. They result in more and more effective production and more and more wasteful consumption.

It is important, however, that consumption, which takes over some new functions now, should not lose its primary natural qualities[10] and shift into consumerist civilisation characterised by the creation of newer and newer artificial needs to stimulate new consumption.[11]. Adam Smith, as early as 1776 in *An Inquiry into the Nature and Causes of the Wealth of Nations* said that umlimited consumption was the most powerful enemy of stable economic growth. It is obvious that **excessive consumption is not inherent in the idea of sustainable development**, whose integral element is sustainable consumption, similarly consumption asceticism is caused by poverty. One of the objectives of sustainable development is to shift to stable, sustainable consumption, which means that social and individual prosperity is not identified only with the consumption of goods

[8] New Development in Global Consumer Trends, April, 2004, pp. 3–13. www. Datamonitor.com

[9] A. Olejniczuk-Merta, Konsumenci przełomu XX i XXI wieku (Consumers of the turn of the 20th and 21st centuries), in: Konsumpcja w Polsce 2000–2007 (Consumption in Poland in 2000–2007), ed. A. Kusińska, A. Olejniczuk-Merta, Instytut Badań Rynku, Konsumpcji i Koniunktur, Warsaw 2008, pp. 105–119.

[10] E. Lipiński perceives consumption as important human investment and described it as a process in which a man not only performs the process of life but also extends, deepens and changes it. In this sense, consumption is not only the goal of production but it is its assumption, condition and driving force. The process of consumption makes human intellectual and moral power grow, the manufacturing capacity is enhanced, imagination develops and mental power grows. Consumption becomes the largest manufacturing power as during the time off work and off production time, the human individual develops, in: Cz. Bywalec, L. Rudnicki, Konsumpcja (Consumption), PWE, Warsaw 2002, p.105.

[11] L. Hostyński, Wartości w świecie konsumpcji (Values in the world of consumption), Uniwersytet Marii Skłodowskiej-Curie, Lublin 2006, p. 173.

and services. The concept of sustainable development is based on the patterns of consumption and production which are environment friendly and do not result in the degradation of natural resources, which protect the natural environment and promote the fair distribution of prosperity, reduce poverty through the changes in the civilisation model, system of values and methods of management.

As mentioned before, the problem of developed consumption does not concern all modern societies. The obligations undertaken at the World Summit in relation to sustainable development in favour of the reduction of poverty concern, among others 50 per cent reduction in the number of people living below the poverty limit (by 2015) and a considerable improvement in the standard of living of at least 100 m inhabitants of slums (by 2020).

3. Sustainable development in relation to the quality of life

Before we move on to discuss the main topic, we will present the origin of sustainable development as an element of building the society responsible for the state of the natural environment and the living conditions of future generations as well as civilisation growth.

In the last few years the problem of sustainable development has been increasingly referred to in economic literature as well as educational programmes addressed to consumers[12].

The UNO conference held in Stockholm on 5 July 1972 was of breakthrough significance for the concept of sustainable development. The report on the *Human Environment* presented there discussed the threats to the world and environment in connection with the accepted ways of social and political growth. The initiated issue of the necessity for changes in the contemporary economic order and relations between the human economy and environment in order to sustain the safe existence of future generations was continued in June 1992 in Rio de Janeiro at the UNO conference **"Environment and Development"**, which was attended by 179 representatives of countries from all over the world. The conference resulted in the common stance on the necessity of changes in the contemporary economic order and relations between the human economy and environment, which is indispensable in order to sustain the safe existence of future generations.

[12] The problem of sustainable development and sustainable consumption in different consumer areas on the market of goods and services is raised by A. Dąbrowska in an interactive educational EU programme Dolceta– www.dolceta.eu/polska/Mod5.

The notion of sustainable development was defined in the Act on Environmental Protection of 27 April 2001 (Law Journal No.62, item 627, with later amendments). As stated in the Act: **"sustainable development is the type of social and economic growth with the process of integration of political, economic and social activities with sustained nature balance and stability of essential natural processes in order to guarantee the possibility of satisfying the basic needs of particular communities and citizens in relation to both the present and future generations".**

Sustainable development from the economic perspective consists of limiting the degradation of the natural environment as a consequence of social and economic processes.

Following D. Kiełczewski, it is worth quoting the stance worked out at the UNEP Governing Council 3rd Session on the necessity of reorientation of the development of social and economic growth in order to create the society implementing the idea of sustainable development: **"Societies recognising the superiority of ecological requirements, which cannot be disturbed by the growth of civilisation as well as cultural and economic growth, able to self-steer its development in order to sustain homeostasis and symbiosis with nature, thus respecting economical production and consumption as well as the utilisation of wastes, careful about the future consequences of undertaken actions, i.e. also the needs and health of future generations"**[13].

The last decade of the last century and the first decade of the present century saw premisses of broader more real understanding of the idea of sustainable development and stricter premisses of discerning limited resources.

The achievement of stable conditions of long term prosperity is connected with accomplishing some crucial goals e.g.[14]:

1) **ecological**, which require sustained biological diversity, integrity of nature systems, biological production, i.e. respecting the objective of justice for non-human beings. It concerns the protection of water resources, seas and oceans, fighting desertification and drought, protection of mountain areas, fighting deforestation, protection of biodiversity, protection of

[13] D. Kiełczewski, Konsumpcja a perspektywy zrównoważonego rozwoju (Consumption in relation to sustainable development), Wyd. Uniwersytetu w Białymstoku, Białystok 2008, p. 16.

[14] D. Kiełczewski mentions three objectives: ecological, economic, social and psychological, see above, p. 33. In document "Agenda 21" the following objectives are mentiond: social, economic, ecological and institutional. Compare: M. Keating, Szczyt Ziemi. Globalny program działań (Earth Summit, Global plan of action), Wyd. GEA, Warsaw 1993.

atmosphere, proecological development of biotechnology and balancing agriculture and wastes management;

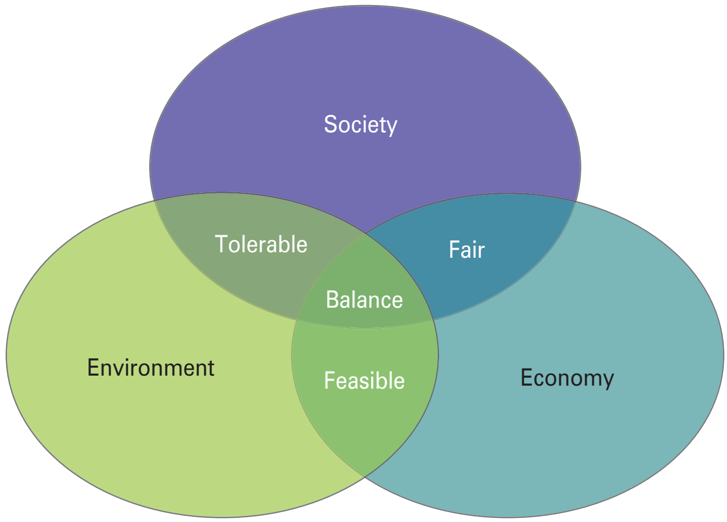
2) **economic:** referring to further growth in material prosperity, better access to useful goods and services and stable economic growth. The implementation of this objective should result in the change in the consumption model, balance between material and non-material components of prosperity, clean production growth and international cooperation in favour of sustainable development;
3) **social:** focusing on ensuring access to socially desirable goods, meeting basic material needs (reduction of poverty), maintaining cultural diversity, ensuring institutional stability, guarantee of social justice and share in social and political life. These objectives also include: the fight against poverty, balancing demographic processes, access to education and health service, protection of cultural diversity as well as the development of self-governance and democracy;
4) **psychological:** nothing but ensuring the balance between material prosperity and non-material components of prosperity;
5) **institutional:** referring to the integration of environmental policy with economic and social policy, development of international law, development and fast flow of information, development of scientific research in favour of sustainable development, enhancing the role of the most important social groups in decision processes.

At present, J. Sachs claims sustainable development should meet four synthetic objectives:

- limitation of human pressure on ecosystems and climate,
- approaching demographic balance,
- liquidation of the poverty trap,
- improvement of the process of global problem solutions[15].

[15] Compare J. Sachs, Nasze wspólne bogactwo. Ekonomia dla przeludnionej planety (Our common wealth. Economy for the overpopulated planet), PWN, Warsaw 2009, p. 15.

Major dimensions of sustainable development are as follows:



Source: www.dolceta.eu/polska/Mod5, author A. Zbierzchowska.

The literature on sustainable development claims that the basic objective is not the rise in the level but the quality of life. Quality is a normative notion concerning the individually accepted values in one way or another, the aspirations and expectations of individuals and social groups, which the individual is connected with. The quality of life is discussed also as a dynamic category changing in time and space[16].

According to A. Campbell the quality of life depends on the degree of satisfaction in the following areas determined in advance: marriage, family life, neighbours, acquaintances household activities, job, living in a given country, residence, leisure, living conditions, education acquired and standard of living[17].

E. Skrzypek perceives the quality of human life as the sum of efforts, struggle and fight often against oneself. It is the skill to make the right decisions and also to reach a compromise, but first of all it is the skill to make decisions

[16] K. Baumann, Jakość życia w okresie późnej dorosłości — dyskurs teoretyczny (Quality of life in the period of late adulthood –theoretical discourse), http://www.viamedica.pl/gazety/gazetaK/darmowy_pdf.phtml?indeks=9&indeks_art=69 [10.04.2009].

[17] A. Campbell, P. Converse, W. Rodgers, The quality of American life, Russel Sage Fundation, New York 1976; A. Aleksińska, Pojęcie jakości życia (The notion of quality of life), http://www.psychologia.net.pl/artykul.php?level=231 [12.04.2009].

and accept consequences with all the responsibility. It is also the quality perceived by the environment reflected in the way we live, dress, drive, feed, spend leisure time, treat other people, are open to human problems etc. In other words, the quality of life translates into the quality of an individual[18].

T. Słaby underlines that the quality of life is connected, apart from categories like the level and dignity of life, with the diagnosis of the degree of satisfaction of many human needs as a synonym of social changes resulting from economic changes[19].

The problem of the quality of life, considered in the context of sustainable development, is connected with the necessity for changes in the way of thinking, with the new philosophy of life – acceptance of new values and styles of life as well as the development of living conditions, which is different than so far[20]. Its objective is to improve the quality of life, both through seeking new values and needs in social life and new styles of life and through the different development of living conditions than so far.

4. Sustainable consumption as an integral element of sustainable development

The International Institute for Environment and Development describes sustainable consumption as a strategy creating demand, trying to use environmental resources and business services in order to meet the needs and improve the quality of life of all, with the simultaneous recovery of nature's capital for the future generations[21]. It is necessary to resign from the needs that are artificial or unnecessary for consumers from the perspective of their lives and development and expanding eco-effective goods and services.

Speaking about sustainable consumption it is necessary to consider the diversity of goods and services that meet customers needs, that is why we may distinguish food consumption, non-food product consumption, satisfying the needs connected with learning, education and culture, recreation and entertainment,

18 E. Skrzypek, Czynniki kształtujące jakość życia (Factors determining the quality of life), http://www.idn.org.pl/Lodz/Mken/Mken%202001/Referaty%202001/14.pdf [8.04.2009].

19 T. Słaby, Poziom i jakość życia (Level and quality of life), in: Statystyka społeczna, Social Statistics, ed. T. Panek, PWE, Warsaw 2007, p. 99.

20 G. Dobrzański, Dylematy trwałego rozwoju (Stable growth dilemma), in: Sterowanie ekorozwojem (Eco-growth steering), ed. B. Poskrobko, Vol. 1: Teoretyczne aspekty ekorozwoju (Theoretical aspects of eco-growth), Politechnika Białostocka, Białystok 1998, pp. 163–164.

21 M. Kozakiewicz, Zrównoważona konsumpcja – trendy kształtujące naszą przyszłość (Sustainable consumption – trends shaping our future), http://www.opoka.org.pl/biblioteka/X/XB/konsumeryzm.html [12.03.2009].

transportation needs and security. Each of them is specific in its own way and is connected with sustainable consumption, e.g. food consumption is connected with the problem of packaging, non-food consumption with the use of electric energy as well as other non-renewable resources, which exerts definite environmental pressures, recreation and tourism with due respect to nature etc. Paradoxically, the economic crisis may contribute to the development of a sustainable consumption pattern.

D. Kiełczewski claims that "sustainable consumption is such a structure of a consumption system within which the shape of individual relations and connections and interdependences between them enable the implementation of objectives of sustainable development. As a result, the consumption of the present generation does not limit consumption possibilities of future generations according to the postulate included in the Brundtland Commission definition[22]". According to the report, as it has already been mentioned, "…at the present civilisation level, sustainable development is possible, i.e. the growth in which the needs of the present generation may be satisfied without reducing the chance of the future generations to satisfy theirs".

Poland started to act in order to implement the resolutions of the Summit in Johannesburg preparing the government document: *Poland's obligations resulting from the resolutions included in the Plan of Action of the Johannesburg Earth Summit.* The strategy includes also a postulate of undertaking "integrated actions affecting the patterns of consumption and production" according the *OECD Environmental Strategy for the First Decade of the 21st Century* (May 2001).

The strategy attempts to identify the directions and tasks which under the condition of the Polish economy could contribute to desirable changes in the patterns of production and consumption through the restructuring of the existing resource intensive sectors and shifting to the knowledge and service based economy. The following trends were regarded basic: impact higher responsibility of producers and consumers for environmental effects of their activities through obligatory legal, administrative, economic and financial regulations, as well as behaviours of voluntary character; pro-ecological investment and the impact on models of manufacturing, distribution and use of energy[23].

Sustainable consumption, as observed by D. Kiełczewski is balanced in the following aspects:

- **economic**, which means the determination of the effective proportion between current and future consumption, which means that the

[22] http://www.un-documents.net/wced-ocf.htm, op. cit. [10.04.2009].

[23] Strategy of changes in patterns of production and consumption into those in favour of stable and sustainable development, Ministry of Economy, Labour and Social Policy, Government document approved by the Government on 14 October 2003, p. 5.

consumption processes do not contribute to the essential distortion of economic balance,

- **ecological**, which means maximisation of consumption usefulness with the simultaneous retention of usefulness and the quality of natural resources and environment, enabling the direct consumption of natural goods, non-material level of consumption adjusted to the requirements of the circular economy, which is synonymous with the imperative of preference given to forms of consumption possibly least harmful to the environment,
- **social**, i.e. consumption is relatively equally distributed, thus available to everybody, irrespective of time and space at least within the area of goods desirable socially; socially sustainable consumption means also the imperative of the preference of the forms of consumption which possibly insignificantly cause social problems or contribute to solving them e.g. creating new jobs, contributing to the development of cultural diversity etc.,
- **psychological**, which means that the consumption processes cause the rise in the quality of life, i.e. the determination of optimal balance between material consumption and the satisfaction of material needs,
- **demographic**, which means that demographic determinants do not constitute stable barriers for consumption growth; the life span is growing, the consumers health condition is improving and demographic or social and professional affiliations do not constitute substantial barriers for the consumption of goods socially desirable,
- **spatial**, i.e. ways to satisfy needs do not disturb the rules of spatial order,
- **intertemporal**, which means that the above dimensions of balancing consumption are possible to attain in an unlimited time perspective[24].

5. Impact of consumer education on the development of sustainable consumption

The creation of social patterns of stable, sustainable consumption resulting from conscious consumer decisions will be a long process as the level of knowledge of stable, sustainable consumption is still relatively low. Due to this, consumer education is very important to refer to both consumers and the world of business. In Poland, work in this area is being done fairly

[24] D. Kiełczewski, Konsumpcja a perspektywy zrównoważonego rozwoju (Consumption in relation to sustainable development prospects), *op. cit.*, p. 61.

comprehensively, which is confirmed by numerous conferences, among others the conference organised by the Institute for Sustainable Development together with the Polish IUCN office – „The Role of NGOs in Creating Pro-Ecological Patterns of Consumption”[25]. It was the meeting, the first in history, of several dozen people, representatives of consumer and ecological organisations dealing with health prevention, ecological food producers as well as representatives of international organisations and entrepreneurs. The same institute together with the Polish Ecological Club, Masovia Region and the Forum for the Activation of Rural Areas is carrying out a project “A Wise Pole before the Event or Care for the Future Quality of Life” financed from European Union Funds[26].

The universality and accessibility of information services have an essential significance for the development of knowledge of sustainable consumption. A. Toffler in the book “*Third Wave*”[27] points to the positive relations between the development of information technologies and the reduction of industry pressure on the environment and that there is symbiosis between the problems of the information society and sustainable development.

There are a lot of features of the information society and knowledge based economy which are coincident with the objectives of sustainable development as well as sustainable consumption, namely[28]:

- the development of non-material service sector results in the fact that more and more services can be met through e-services[29],
- the development of information technologies to develop teleworking and e-learning, which reduces the transport burden for the environment, in particular in towns,
- rapid development of fast air and rail networks makes consumers resign from individual transport in favour of public transport,
- the development of ecological food, which may reduce the natural environments burden[30],
- development of consumer education leads to pro-ecological behaviours (use of renewable sources of energy, recycling and a higher demand for energy saving products etc.)[31].

25 http://www.opoka.org.pl/biblioteka/X/XB/konsumeryzm.html [10.04.2009].
26 http://www.ine-isd.org.pl/index_ekoherkules.php [5.04.2009].
27 A. Toffler, Trzecia fala (Third Wave), Rebis, Poznań 1998.
28 D. Kiełczewski, Konsumpcja a perspektywy zrównoważonego rozwoju, *op. cit.*, s. 46.
29 More on e-services: A. Dąbrowska, M. Janoś-Kresło, A. Wódkowski, E-usługi a społeczeństwo informacyjne (E-services in relation to information society), *op. cit*.
30 Por. W. Łuczka-Bakuła, Rynek żywności ekologicznej (Market of ecological food), Polskie Wydawnictwo Ekonomiczne, Warsaw 2007.
31 Por. www.dolceta.eu.polska/Modul5

They include a large part of the answer to the question asked on the first page of the present paper concerning the implementation of sustainable consumption. They are an integral part of ten strategies of sustainable consumption:

1) **Structural changes:** the long-term strategy of structural change is the transition from an economy and lifestyle associated with the industry to sustainable, i.e. reaching more than incremental improvements in productivity.
2) **Fair consumption:** the strategy emphasises the importance of fair consumption, and not just „ecologisation of wealth".
3) **Focus on services:** the strategy focuses on the relations between environmental resources and services, which is required to fulfil all the needs and improvement of the quality of life (referring to, among others, nutrition, housing, mobility and leisure).
4) **Changes in market opportunities for entrepreneurs:** the strategy makes entrepreneurs launch a new generation of sustainable goods and services on the market and expand their responsibilities, to include the impact caused by a lifetime of goods and services.
5) **Activities within the area of demand:** the strategy applied in the area of demand in order to ensure the social, economic and ecological benefits within the product chain.
6.) **Patterns and causative factors:** the strategy deals with patterns and causative factors such as income, demographic factors, technology, culture and values, ways of land use and social policy as well as consumer.
7) **Priority for the North:** the starting point is a triple imperative of change in consumption patterns in the North, resulting from 1) high direct costs of ecological consumption in the 2) the significance of consumption in trade with other regions and flow of investment capital and technology, and 3) the significance of lifestyle changes in the North as an example for ecologisation of the South.
8) **Common concern, different reactions:** Increasingly, sustainable consumption is becoming a subject of concern in different countries, both rich and poor. However, as they have different priorities, the activities must be based on cultural conditions.
9) **Individual versus collective consumption:** the strategy recognises the individual and collective dimension of consumption – in a supermarket and library.
10) **Value based strategy:** the strategy is based on ethical values and seeks to stimulate greater responsibility for the consumption choice.

The above deliberations prove that the answer to the question asked at the beginning is positive. We believe that the problems of global, sustainable development, including sustainable consumption, are soluble, though difficult. It can be done within the coming decades if the following objectives are met:

- overcoming barriers of limited skills of cooperation in global terms,
- arrangements, also in global terms, concerning:
  1. prevention of climate change trends,
  2. stabilisation of the number of the world population,
  3. putting an end to extreme poverty,
  4. international cooperation to solve problems of dynamic activity and creativity of the NGO sector[32].

Due to the significance of the issue raised, it is worth, at least in a few sentences, to refer to children and youth, who have an enormous impact on the market. They exert an increasingly big impact on the decision made by their parents, that is why producers salesmen or service providers pay more and more attention to the consumer choices made by this group[33]. It is worth watching commercials that call young people to buy, buy and buy or they will be worse, uglier and more unhappy. Also grown-ups succumb to this magic. Is it possible to push through the idea of sustainable consumption among young people in these circumstances? It seems that at present, young people should deepen their knowledge of sustainable consumption through new more convincing ways of communication. It is to focus on consumer protection and education as well as shaping social attitudes adequate to global development challenges. The interactive programme Dolceta is one of them. The consumer should become a pattern to follow. The one to make responsible consumer decisions and be aware of their consequences, taking partial responsibility for future development of society and the natural environment.

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[32] J. Sachs, Nasze wspólne bogactwo... (Our common wealth), *op. cit.*, p. 16.

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Basel II and the consequences of its implementation on the SMEs system

1. The importance and the role of SMEs in the global economic system

Günter Verheugen (current Member of the European Commission Responsible for Enterprise and Industry), in the preface of the SMEs user guide[1], declared: "Micro, small and medium-sized enterprises (SMEs) are the engine of the European economy. They are an essential source of jobs, create entrepreneurial spirit and innovation in the EU and are thus crucial for fostering competitiveness and employment".

I think this phrase explains very well the attention that in Europe and in the other big economic areas (like the U.S. and Asia) is addressed to the SMEs ("Small and medium size enterprise").

Moreover, SMEs are seen as the instruments that enhance the competitiveness within the EEA ("European Economic Area"), which represents one of the main achievements of the famous Lisbon Strategy[2].

As for the definition of SME, it depends mainly on the economic environment that is considered and on the area in which it operates. Generally speaking, the institutions of a certain economic area aim at finding a definition as much

[1] See European Commission (enterprise and industry publications), "The new SMEs definition. User guide and model declaration", 2005, retrieved on 20 September 2009 from http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm

[2] The Lisbon strategy, better known as the "Lisbon Agenda", is the result of the works concluded by the European Council in Lisbon, Portugal, in 2000. It surely represents one of the most important development plans ever undertaken by the European Union. The main goal of the Lisbon strategy was to make the EU "The most dynamic and competitive knowledge-based economy in the world..." (see Lisbon European Council 23 and 24 March 2000, Presidency conclusions, retrieved on 5 December 2008 from http://www.europarl.europa.eu/summits/lis1_en.htm#a). About the goals set up in the framework of the Lisbon Strategy between the representatives of the singular Member States in terms of competitiveness, production and employment, see among others publications, George M. M. Gelauff and Arjan M. Lejour, "The new Lisbon Strategy: An estimation of the economic impact of reaching five Lisbon Targets", Industrial Policy and Economic Reforms Papers No. 1, January 2006, available at the following link: http://ec.europa.eu/enterprise/enterprise_policy/competitiveness/doc/industrial_policy_and_economic_reforms_papers_1.pdf

homogenous as possible in order to guarantee an equal treatment for the SMEs, for each kind of business or activity they are involved in.

In the European Union, the European Commission issued for the first time in 1996 a Recommendation[3] in which it gave a definition of "micro, small and medium-sized enterprises", in order to uniform various definitions of SMEs.

Then, the latest economic and financial developments occurring in the EEA, the increasing number of Member States, and the recognition of a much more complex and complicated business environment, convinced the Commission to adopt an entirely new Recommendation that gives the definition of SMEs. The Recommendation 2003/361/EC[4] officially came into force on the 1st January 2005.

In the new Recommendation, the definition of SMEs reflects the main idea to reserve the special status of SME just to the enterprises which really "deserve" it. In fact, under the old provisions, it was formed a large group of enterprises that even responding formally to the parameters lay out for the definition of SMEs, substantially were leading businesses in a larger scale, therefore enjoying a quite relevant economic power but at the same time treated as SME, harming in this way the entire SMEs category More precisely, the main motivations that lead to the new definition of SMEs are listed in the SMEs user guide[5].

The Recommendation provides for general and objective criteria that enterprises have to comply with in order to establish whether they can be considered SMEs, namely: i) The "staff headcount" criterion; ii) The "financial" criterion.

Under the "staff headcount" criterion, it is stated that a firm, in order to be considered a medium size enterprise, must employ up to 250 persons (a person is considered as an AWU, "Annual working unit"; consequently, people employed on a part-time contracts basis are considered fractions of an AWU), while to be considered a small size enterprise it must not employ more than 50 persons. Moreover, organisations with up to 10 persons employed are considered micro enterprises[6].

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[3] See Recommendation 1996/280/EC of 3 April, 1996, "Concerning the definition of small and medium-sized enterprises", OJ L 107 of 30 April 1996. It has to be kept in mind, however, that a Recommendation is a kind of "soft law" used by the Commission, and therefore, in general, the positive or negative results of the implementation of a Recommendation it depends ultimately by the interpretations given by the national normative.

[4] See Commission Recommendation 2003/361/EC of 6 May 2003, "concerning the definition of micro, small and medium size enterprises", in OJ L 124/36 of 20 May 2003.

[5] See European Commission (enterprise and industry publications), "The new SMEs definition. User guide and model declaration", 2005, retrieved on 20 September 2009 from http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm

[6] See art. 2, par. 1, 2, 3 of the Annex to the Recommendation n. 2003/361/EC, cit.

The "financial" criterion is fundamental to establish the actual scale and scope of the enterprise activity. The ceilings have considerably increased in comparison to the provisions contained in the 1996 Recommendation, taking into account the different size of both prices and costs of production which occurred in the market during the last decade. To be considered an SME, an enterprise must not exceed the limit of €50 million annual turnover (it was 40 million in 1996) and a €43 million annual balance sheet (27 million in 1996).

The SMEs sector is recognized as crucial for the promotion of the competition and the economic growth. Consequently, its presence is necessary also to increase the standards of living of people, especially those from the developing countries. Many analysts have developed theories establishing the link between the reduction of poverty and the economic growth (focusing on the SMEs promotions)[7].

The centrality of the SMEs action toward the globalised economy has been the reference point of an OECD act that enhanced the role vested by the SMEs sector. The "Bologna Charter on SME Policies"[8] is an act which was adopted on 15 June 2000, in Bologna, Italy, where representatives of more than 40 countries (including the most industrialised ones), recognised the relevance of the SME sector.

In Europe, SMEs are considered the backbone of the economy: this assumption is supported by the statistics carried out by Eurostat[9], in which it is stated that in the European Union (considered as the European 27 Member States, included therefore the "new" European Members) among the approximately 20 million enterprises active in the non-financial business economy, the incredible majority (99.8%) is formed by SMEs, while only a small minority (0.04%) is represented by the large enterprises[10]. Around two/third of jobs of the non-financial business economy workforce in Europe is employed in SME (67.1%), and these jobs represents 57.6% of value added[11].

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7 See, for instance, W. Luetkenhorst, 1 June 2004: "OECD Ministerial Conference on SME Development", Workshop 4: enhancing the role of SMEs for Development, in which is described the key role that SMEs vest in the developing Countries in order to reduce the poverty.

8 The Bologna Charter, retrieved on 16 June 2009 from http://www.oecd.org/document/17/0,3343,en_2649_34197_1809105_1_1_1_1,00.html

9 See such statistics of the Eurostat document at the Eurostat website, retrieved on 18 November 2008 from: http://epp.eurostat.ec.europa.eu/portal/page/portal/european_business/special_topics/small_medium_sized_enterprises_SMEs; http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-08-031/EN/KS-SF-08-031-EN.PDF

10 These statistics are considered at the year 2006.

11 The value added indicates, like it is described in the "methodological notes" of the EUROSTAT document, "the turnover, plus capitalized production, plus other operating income, plus or minus the changes in stocks, minus the purchases of goods and services, minus other taxes on products which are linked to turnover but not deductible, minus the duties and taxes linked to production. Alternatively it can be calculated from gross operating surplus by adding personnel costs".

Additionally, according to the results of the research carried out by the OECD Ministerial Conference on SMEs in 2004[12], in the OECD countries[13], the SMEs sector amounts to almost 95% the total number of enterprises, representing more than a half of the total private employment of the OECD area.

The role of SMEs is even bigger during the times of profound financial crisis such as this current one because SMEs can constitute an important source of employment[14].

Recently, an important act has been adopted, called the "Small Business Act for Europe" (SBA)[15], which is addressed to independent companies with less than 250 employees. The SBA aims at recognition of the central role of SMEs in the EU economy as well as at the creation of a rational and a comprehensive policy for the SMEs sector. This act reflects the European Commission political will to improve decisively the approach to the entrepreneurship by developing the principle "Think Small First" and facing the major problems affecting the actions and activity of SMEs[16].

Actually, the provisions contained in the SBA in favor of the SMEs sector are truly remarkable, and European SMEs will surely benefit from them, if they will be implemented in an efficient way during the next few years, especially at the local and the national level by the Member States.

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[12] See "Second OECD Conference of Ministers responsible for Small and Medium-sized Enterprises (SMEs)", in: Promoting Entrepreneurship and Innovative SMEs in a Global Economy; Towards a More Responsible and Inclusive Globalization; Istanbul, Turkey, 3-5 June 2004. This Conference represented an occasion for the participants Countries to implement the measures taken in the Bologna process. It is worth note that one of the main themes of the Conference has been also the preparation of a special report on the systemic measurement of the SMEs behavior in order to obtain reliable statistics (See the report: "SME Statistics: towards a more systematic statistical measurement of SME behavior", retrieved on 9 January 2009 from: http://www.insme.org/page.asp?IDArea=1&page=process_sme-conference-2004).

[13] The OECD ("Organization for Economic cooperation and development") is represented by 30 Countries, among which 20 are founding Members (Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States); the remaining 10 Members have been admitted to the Organization later (Japan, 1964; Finland, 1969; Australia, 1971; New Zealand, 1973; Mexico, 1994; Czech Republic, 1995; South Korea, 1995; Hungary, 1996; Poland, 1996; Slovakia, 2000).

[14] On this point, see among others: Thurik, Roy A., Martin A. Carree, Andre van Stel and David B. Audretsch, Does Self-Employment Reduce Unemployment? Journal of Business Venturing, 23(6), 2008; David Audretsch, Rob van der Horst, Ton Kwaak, Roy Thurik: "First Section of the Annual Report on EU Small and Medium-sized Enterprises", EIA European Commission DG Enterprise and industry, January 12th 2009.

[15] See Small Business Act for Europe (executive summary), 2008, Brussels: European Commission, retrieved on 10 September 2009 from http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/SBA_IA

[16] For a full analysis of the objectives and the state of implementation of the provisions and programs contained in the SBA, check the European Commission portal, enterprise and industry sector, at the following link: http://ec.europa.eu/enterprise/entrepreneurship/sba_implementation.htm

2. Basel II and the practical consequences for the SMEs' access to credit

Basel II is an act issued by the Basel Committee for Banking Supervision (BCBS), an organisation hosted within the BIS[17], formed by the s.c. G-10 (ten central banks with the most advanced and powerful banking systems), which provides the rules to calculate the capital requirements for the activities of banks. In particular, Basel II consists of three "Pillars": 1) the first one, is describing and disciplining the minimum capital requirements as well as indicating the methods of risk measurement); 2) the second one, stating a set of the rules for the risk control and the rules of organisational nature to be adopted by banks and financial institutions; 3) the third one, organising the market control and imposing the total respect of transparency rules allowing the market to consider the general state of solidity of banks.

Basel II has had several effects on the credit proceeding involving SMEs in Europe as well as in all the other major economic areas.

It is important to remind people that the Basel Committee itself, from the beginning of the reform process of the capital adequacy normative, was concerned with the consequences of the Basel II normative on the SMEs. One evidence is that before reaching the final version of the Basel Accord, it changed three times the formulas for the calculation of the risk weighting for retail and SMEs exposures[18].

Moreover, the Basel Committee together with the international banking community conducted the QIS 5 ("Quantitative impact study 5") in order to analyse the effects that the new Pillar I provisions would have on capital requirements (it was published on June 2006[19]). This study concluded that the new rules should not increase capital requirements for the corporate loans in general or for the loans to SMEs in particular, at both an international and European level, whatever approach is used (Standardized or IRB).

Also the European Commission, concerned with the doubts arising on the Basel II provisions and consequences for the SMEs sector, published a report in the "Observatory for SMEs in Europe" in order to analyse the situation of the SMEs credit access[20]. In the report, it was stated that among the range of

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[17] For further information about the Basel II, the Basel Committee and the BIS, visit the official website: www.bis.org

[18] See Basel II Comprehensive version, cit., par. 13.

[19] The results obtained with the QIS5 can be consulted in the B.I.S. website, retrieved on 13 December 2008 from: http://www.bis.org/bcbs/qis/qis5.htm

[20] See European Commission, "2003 Observatory of European SMEs", whose reports are retrieved retrieved 15 February 2008 from: http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-observatory/index_en.htm

problems daily faced by the SMEs, only for 13% the difficulties with the access to credit were considered as a constraint to the business activity.

Furthermore, concerned with the unexpected consequences of Basel II, the European Parliament requested the Commission to prepare a report on the consequences of the introduction of the Basel II normative on the European economy in general, and on the SMEs sector in particular. Such a report was prepared in 2004 by PricewaterhouseCoopers and NIESR[21].

The report, after analysing many different national studies and the general European structure of the European SME sector, concluded that all the worries and the concerns for possible undesired effects of the new normative on the SMEs segment are unwarranted. In the report, it is even stated that after the complete introduction and systemisation of the IRB approaches, the capital requirements relating to the European SMEs are expected to decrease considerably[22].

Moreover, a European Commission-funded project for European SMEs was launched in order to get background information and in this way to be better prepared for the new normative contained in Basel II[23].

Before further proceeding in the evaluation of the effects of Basel II on SMEs, it is important to shortly describe how the first Pillar of Basel II affects the process of lending to SMEs.

The consolidated version of Basel II considered the possibility for credit institutions to classify SMEs as "retail" or as "corporate" entities[24]. Such a division is made according to the scale of their total exposure. In fact, the normative distinguishes among "retail" exposures (towards the borrower that meet all the criteria set out in par. 231. In general, banks can consider SMEs as retail entity if their exposure is less than € 1 Million) and "corporate" exposure (par. 218), i.e. "a debt obligation of a corporation, partnership, or proprietorship". Par. 218

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[21] See PricewaterhouseCoopers, Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms in the EU Final Report, 8 April 2004, MARKT/2003/02/F.

[22] See, for instance, pag. 10 of the report, where it is stated: "Concerns have been expressed that certain sectors of the economy could be disadvantaged by the new rules, particularly lending to SMEs.. This study suggests that these fears are not always wholly justified, especially in respect of SME lending where the minimum capital requirements are likely to fall" (see Section 5.4.3).

[23] It is the project "Impact on SMEs of the Basel II accord on capital adequacy rules: information dissemination through the organization of conferences, including relevant background material". For more information on the activities of the project, which were held in the period 31 March 2004 and 31 October 2005, see, retrieved on 30 July 2009 from: http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1008&userservice_id=1

[24] See "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version", June 2006, B.I.S., par. 231 ss. (retrieved on 9 November 2009 from http://www.bis.org/publ/bcbs128.htm).

continues stating that "Banks are permitted to distinguish separately exposures to small- and medium-sized entities (SME), as defined in paragraph 273".

Yet, in order to be considered retail entities (and therefore, for banks, to be able to keep more favorable capital requirements), Basel II provides an additional qualitative requirements, i.e. that *"the exposure must be one of a large pool of exposures which are managed by the bank on a pooled basis"(Par. 232).*

Instead, for credits given to SMEs which are classified as "corporate", Basel II provides special treatments in terms of "discount" of the capital requirements, when the exposure is made in favor of enterprises with less than €50 million in sales[25].

The reason why Basel II concedes a special regime for exposures towards small businesses is that it considers them less dangerous in terms of credit default ratio and less subject to the business cycle.

Under the new A-IRB approach, banks are able to classify SMEs borrowers as "retail" or as "corporate", using the formulas given in the final version of Basel II[26].

In order to calculate the necessary capital requirements, banks must take into account the set of variables provided by Basel II for the calculation of the capital requirements, i.e.:

- the asset correlation (R),
- the capital requirement (K),
- the risk weighted asset (RWA), i.e. a bank's assets weighted according to credit risk connected to the operation.

Plus, the set of variables that must be provided by banks themselves, i.e.:

- the PD, "Probability of Default": such a parameter measures the possibility (with a percentage from 0 to 100) that the borrower, within a defined time limit, for example 1 year from the conclusion of the agreement, will be default, i.e. will not be able to repay the obligations assumed with the bank,
- the LGD ("Loss Given Default"), which is the percentage of the credit that the bank assumes to lose, in case of the borrower default,
- the EAD ("Exposure at Default"), measuring through internal estimation the trend of the exposure from the moment when the analysis starts to the moment of the default,
- the Maturity (M), i.e. the effective duration of the credit.

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[25] See Basel II comprehensive version, cit., par. 273.

[26] In particular, the classification o fan SME as retail follows the same formula used for "other retail exposures", while for SME considered as corporate, it has to be applied the "corporate formula" plus the firm-size adjustments. See Basel II comprehensive version, cit., par. 330 and 272–273.

Finally, the firm-size adjustment that Basel II (par. 273) provides in case of SMEs treated as corporate must be taken into consideration. It has to be stated that despite the aforementioned "discount" provided by Basel II for SMEs "corporate", some authors (providing the analysis of the expected capital requirements in certain countries for loans to retail and corporate SMEs), assumed that Basel II will be more convenient for SMEs considered as retail. Conversely, the capital requirements are likely to increase (even if only slightly), if SMEs are considered as corporate[27].

As a consequence, banks would be "constricted" to consider a big percentage of SMEs, which are their borrowers, as retail. The number of such SMEs would increase if the banks calculate also risks other than the credit risk (i.e. the operational and market risk).

Considering the special regime reserved for small businesses by the definitive version of the new normative, the literature showed a general positive attitude to the new capital requirements[28], praising the lower amount of capital that banks would have to keep in order to open a credit line for the SME segment, either using the Standardized Approach or the IRB (Advanced or Foundation) Approach.

More specifically, the authors who are proponents of Basel II normative in terms of lending activities for SMEs, mainly reached the following conclusions:

- the concerns about the possible negative influences of the Basel II normative for the SMEs sector are generally not justified[29],
- the full implementation of the A-IRB approach in substitution of the standardised one, will oblige banks to review and modernise their internal systems and procedures. In this way it will be possible to manage the SMEs portfolios in a more efficient way, For example using a "hard information system" for SMEs, such as scoring or rating models for

[27] See Altman and G. Sabato, "Effects of the new Basel Capital Accord on Bank capital requirements for SMEs", 2005, cit., which provided the expected capital requirements for SMEs (retail and corporate) for the US, Australian and Italian market.

[28] See, among many other, Fabi, Laviola, P.M. Reedtz, "The treatment of SMEs loans in the new Basel Capital Accords: some evaluations", Banca Nazionale del Lavoro Quarterly Review; Mar 2004; 57, 228; ABI/INFORM Global pag. 29, in which it is stated that the as for the treatment of SME loans, it is "not expected a reduction of credit or an increase in interest rates on loans to this type of borrowers"; Jaime Caruana, "Consequences of Basel II for Smes", European Parliament Workshop on the "Consequences of Basel II for SMEs", Brussels, 10 July 2003 (BIS review 32/2003).

[29] See for instance, apart from the study given by Pricewatercooperhouse, before mentioned, a working paper from UEAPME (the "European association of craft, small and medium-sized enterprises»), «UEAPME Memorandum for the Election to the European Parliament", April 28, 2004, retrieved on 24 August 2009 from: www.ueapme.com/enter/dwnlds/040428_EP_final_en.doc, in which it is stated that "Basel II implementation should be used to improve access to finance for Crafts and SMEs".

automated decision[30]; moreover, the full adoption of the A-IRB approach, even if leading to high costs in the short term for banks, will lead to a significant reduction of the transaction costs (especially with SMEs) in the long run,

- with the full implementation of the Basel Accords, the smaller banks, specialising in smaller businesses lending, would gain competitive advantage, due to their less risky position in incurring default risk. On the other hand, also large, internationally active banks would have the possibility to reduce such a "competitive gap" in relation to the smaller banks thanks to the full adoption of the A-IRB approach (this approach is not affordable, at least in the short term, for the small banks so they would keep the standardised approach), gaining in lower capital requirements and especially in improvements of the internal credit procedures and credit risk management[31],
- as for the SMEs sector, an increase in the lending activity was expected, especially by large banks that would find this type of business activity particularly profitable. Even admitting that SMEs were going to face an increase in the credit prices in the short term, common was the conviction that stated "thanks to the new techniques for credit risk discrimination and to the most advanced risk-based pricing methods, good quality firms will likely enjoy benefits in terms of lower credit prices"[32], so that a sort of "Darwinian selection" among the firms was predicted. Moreover, such a selection was forecasted also for banks. According to these predictions, Basel II rules would change the relationships between banks and SMEs in a positive way for both kinds of institutions[33]. This type of change

30 See among others: Allen & Overy Briefing Paper n. 4, "Internal Ratings Based Approach to Credit Risk In The Banking Book", A&O Regulatory Capital, November 2008 (retrieved July 2008 from: www.allenovery.com/AOWeb/binaries/49150.PDF), in which it is stated that: "The IRB Approach is consistent with the modern credit risk measurement and management practices of some sophisticated banks. It is credit risk sensitive and complex".

31 On this point see, among others, Kolari, James W., and Hwan G. Shin. "Assessing the Profitability and Riskiness of Small Business Lenders in the U.S. Banking Industry", (2004), available at the link: http://www.sba.gov; and Berger, Allen N., "Potential Competitive effects of Basel II on banks in SME Credit market in the United States", 2004, cit.

32 Altman and Sabato, 2005, cit., pag. 17.

33 See for instance, P. Ciocca, Banca d'Italia Vice General Director, "Basilea 2" e "IAS": più concorrenza, minori rischi", VIII Convention ABI "Realizzare Basilea 2 e IAS: Tendenze, Criticità e Soluzioni", Rome, 29 November 2004, in which the Author explains that (literally translated):" Basel II is enhancing the efficiency of banks. Banks (small and bigger) with minor capital requirements are awarded, which use more precise methods in the quantification and more efficacy in the credit risk management. In this sense, the new Basel Accord represents a factor of Darwinian selection, among the best banks. It will improve the competition, redistributing the market shares".

would take place because of the full grade of transparency that Basel II would introduce in the credit decisions[34].

In the next part of the this article, evidences of possible negative influences of Basel II normative in terms of lending activities to SMEs are presented.

3. The disadvantages of Basel II for SMEs' access to credit

In the author's view, Basel II as it is currently structured, is not likely in the long term to favour the activity of SMEs despite the fact that (theoretically) the Basel II normative was designed to promote the access to credit. Consequently, the normative aimed at the emergence of the SMEs start-ups because it provides lower capital requirements for banks that grant credits for the SMEs sector, intended as "retail" customers.

In fact, it is *in primus* possible to raise some concerns about the impact of Basel II on the way that banks used to analyse the merit of credit. The reason for this lies in the fact that the smallest banks do not have the same possibilities to implement fully the I.R.B. ("Internal Rate Based") Approach as the large and internationally active banks do. The main barrier for small banks and credit institutions that want to adopt the I.R.B. Approach is the problem of financing as this approach requires massive initial investments in terms of capital, management, and technologies.

This statement is supported by the works of several authors who predicted that Basel II would excessively favour the biggest banks that have the financial resources to implement the I.R.B. model and adopt it for safe loans. This may cause the competitive advantage to be a privilege only of larger banks as opposite to the small ones which are constricted to reduce their market share and the possibility to perform higher risk policies in order to expand. Furthermore, it may create a paradoxical situation in which larger banks are financing primarily low risk credits, while smaller banks are financing higher risk credits[35]. Certainly, in this way the development of credit lines facilities for SMEs is not favoured as was initially assumed.

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[34] On this point, see a document prepared by European Commission (Directorate-General for Enterprise and Industry Financing SMEs, Entrepreneurs and Innovators), "Round table between banks and smes- transparency and dialogue, final report",June2007. The document is retrieved on 10 October 2009 from: http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1064&userservice_id=1

[35] On this point, see Repullo and Suarez,"Loan Pricing under Basel Capital Requirements,"Journal of Financial Intermediation, 13(4), 496–521, 2004; Hendrik Hakenes and Isabel Schnabel, "Bank Size and Risk-Taking under Basel II", Preprints of the Max Planck Institute for Research on Collective Goods, Bonn, 2005/6.

Considering the generally diffused conviction that the smaller the business is, the greater is its probability of default when it receives a credit line[36], it is possible to imply that the utilization of the new I.R.B. Approach may lead to higher capital requirements for banks with exposures both towards retail and corporate SMEs. A survey shows how these effects, for the SMEs segment, will be created not only at the national level, but also in some cases at a regional one. For instance, it has been calculated that in Calabria (one of the Italian Regions), "*The IRB approach produces a major capital absorption compared with the standard approach (8%). Specifically, the average of the capital requirements registered by the firms analysed is equal to 9.76%*"[37].

As for the correlation between the possible "discrimination" between small and large banks and the enhancement of lending activities for SMEs, it is important to notice that the variables used for the calculation of the banks capital requirements (which will be further described) can vary according to the legal form of the SME involved; e.g. they can vary from sole traders, partnerships to limited liability companies etc.

Indeed, there is different information available for each kind of legal form that can collaborate to form the internal models by banks, in order to assign an internal rating to the customer. Some quantitative and qualitative variables such as the number of employees, the legal form of the business, the region where the main business is carried out, the industry type, etc.[38] are used for all kinds of firms. Other kind of variables, such as a set of balance sheet variables (i.e. financial ratios) are used to create the internal rating by banks for SMEs which are partnerships and/or limited companies. However, for the customers that are sole traders such information is usually not available; therefore, banks must rely on a set of "personal information" about the owner that do not include financial ratios but instead consist of the description of the client's behaviour with products of other banks or public credit institutions, etc.

Moreover, information about the SMEs borrowers vary among the large banks that rely on "hard" information about the transparent borrowers thus gaining the competitive advantage and the smaller banks (like community banks)

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[36] On this point, see especially the US literature, Berger, Allen N., and Gregory F. Udell. "Collateral, Loan Quality, and Bank Risk", Journal of Monetary Economics 25, 1990.

[37] See D. Federico, A. Notte, "Credit Risk Modeling for Basel II Capital Requirements: Evidence for the SME Sector in Calabria", Atti della XLIV Riunione Scientifica Università della Calabria, 25–27 giugno 2008 (post-session paper), in which are studied the consequences on the SMEs sector active in Calabria (Italy).

[38] See on this point Grunert, Jens, Lars Norden, and Martin Weber. "The Role of Non-Financial Factors in Internal Credit Ratings", in Journal of Banking and Finance 29,2004, for further discussions about the role of nonfinancial factors in internal credit ratings.

that build their competitive advantage granting loans to borrowers based on "soft" information about opaque borrowers[39].

Consequently, in the author's view the full implementation of Basel II in a given country can, in the long run, benefit mostly the large credit institutions, which can count on higher availability and the quality of information for the definition of the customers internal ratings[40]. This could also exacerbate the aforementioned effect of a reduction of credit lines facilities for SMEs that paradoxically could be more likely financed by small banks than by the bigger ones.

Apart from the possible discrimination between large and small banks due to the Basel II normative, there is other evidence, in the author's view, that confirm the possible negative influences of Basel II rules for SMEs.

More precisely, under the Standardized Approach, there are actually no differences between the old and the new normative in terms of capital requirements for lending activities when the loans to the SMEs "corporate" (always 8%) are considered, but there are some savings if the SMEs "retail" are taken into consideration as the ratio changes from 8% in Basel I to 6% in Basel II[41].

Under the I.R.B. Approaches, it is very hard to state whether there are (or will be) any savings with the respect to the old procedure, as these approaches are connected with the specific strategy of the single banks towards their own credit portfolios. In fact, banks under Basel II are now able to decide upon their own "credit strategy" in order to obtain a more personalised philosophy of the credit proceeding[42].

Furthermore, it has to be noticed that the risk-sensitive rules provided by Basel II imply bigger difficulties for SMEs-borrowers to "deserve" credit from banks and financial institutions, as they will need to improve their creditworthiness[43]. This, of course, can imply as well more costive procedures and initial investments

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39 The distinction between "soft" and "hard" information is nowadays accepted by the entire doctrine (see among others Berger and Udell,"Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure", Economic Journal, 112, F32–F53, 2002; Stein (2002), "Information Production and Capital Allocation: Decentralized versus Hierarchical Firms", Journal of Finance, 57, 1891–1921, 2002; Carter and McNulty,"Deregulation, Technological Change, and the Business Lending Performance of Large and Small Banks", Mimeo, 2004; Cole, Goldberg, and White, "Cookie-Cutter versus Character: The Micro Structure of Small Business Lending by Large and Small Banks," Journal of Financial and Quantitative Analysis, 39(2), 227–251, 2004.

40 See on this point also Berger, Allen N.: "Potential Competitive effects of Basel II on banks in SME Credit market in the United States", 2004, available at the link: http://www.federalreserve.org

41 See Basel II comprehensive version, cit., par. 69.

42 For a better analysis of the way the banks are now estimating their own PD and LGD, using the IRB approaches, see among others Heitfield Erick. "Rating System Dynamics and Bank-Reported Default Probabilities under the New Basel Capital Accord",2004, available at: http://www.defaultrisk.com

43 On this point, see Rym Ayadi, "Sme financing in europe: measures to improve the rating culture under the new banking rules", in Financing of smes in europe, Vienna: SUERF (SUERF Studies: 2009/3), pag. 59 ss.

for the firms involved, in order to improve their ratings, increase their capital structure, and actively maintain a good house-bank relationship[44].

As for SMEs sector, apart from the perspective of much higher cost of credits, there is another potential disadvantage for borrower firms, i.e. the situation in which the SME decides to ask for credit abroad. Considering that Basel II in this case provides that companies when they get credit from abroad, must apply the country credit rating of the country in which they operate.

This can lead in the future to a considerable increase in the costs in foreign trade financing and in credit usage abroad for SMEs. Therefore, after the full implementation of Basel II, internationally active banks could be motivated to reduce loans for the entities based in emerging markets. For instance, considering the impact of Basel II normative on the Turkish SMEs, it has been stated that "Turkish companies could not get a credit rating over the country rating from the independent rating agencies in the market. This would lead to a situation where their costs in foreign trade financing and in credit usage abroad would inevitably increase"[45].

In the developing countries and in countries where foreign banks are particularly strong[46], there is the fear that the full implementation of the Basel II, especially the usage of the I.R.B. Approach, will lead to a strong contraction of credit lending for SMEs, due to the following facts[47]:

- foreign banks (usually large and internationally active) that are able to implement the I.R.B. Approach will have an incentive to lend money to large companies as they consider them generally less risky,
- in parallel, small and local banks continuing to use the Standardized Approach, will prefer to lend to SMEs,

[44] On this point see Jan Henneke and Stefan Trück, "Asset Correlations and Capital Requirements for SME in the Revised Basel II Framework", 2004.

[45] See Tamer Aksoy, Sezer BokzuŞ, "The major effects of Basel II to small and mid-sized enterprises: an empirical work on companies quoted to kosgeb".

[46] E.g. Mexico, Eastern Europe and low-income Countries like Uganda and Tanzania; for further information, see the reports of the World Bank at the official website www.worldbank.org; see also: "Strong Growth in Europe and Central Asia, But Risks Include Uncertain External Financing", in the New Report "Global Development Finance 2008: The Role of International Banking", Release No. 2007/58/DEC, in which the implication of the current credit crunch for the economic growth of Countries with a large presence of foreign banking are taken into consideration.

[47] For further deepening on this point, see R. Bailey: "Basel II and developing Countries: understanding the implications", Development studies Institute, London school of Economics, Working paper series n. 05–71, December 2005; Stephany Griffith-Jones, "Implications of Basel II for Stability and Growth in Developing Countries; Proposals for Further Research and Action", Institute of Development Studies University of Sussex, (Paper prepared for I base Rio Meeting on Financial Liberalization and Global Governance: The Role of International Entities, 19–20 March 2007).

- therefore, the situation in which in the developing countries there will be a division of lending policies between large and small banks, the latter only concentrating their lending activities on SMEs is probable; this can naturally create the instability within the entire financial market in the long term,
- further imbalances in the financial markets may be created by the fact that if large and foreign banks, using the I.R.B. Approach, prefer to lend to large (therefore less risky) companies, there is the possibility that on a given territory the local banks will become the most important source of financing for the SMEs. The main consequence could be that local and national governments will be requested to increase the number of complementary actions and special plans in order to raise up the public lending to SMEs.

Another consequence for SMEs is the possible link that may arise between the SMEs assets and the securitisation process. An interesting survey delivered by Standard & Poor's[48] shows the possibilities given by the securitisation (through special financial instruments, C.L.O., "Collateralised Loan Obligations", i.e. a form of securitisation where payments coming from business loans are pooled together and passed on to different classes of owners in various tranches) of SMEs – related assets. The report shows the possible benefits that banks will receive in terms of capital relief from securitising such as assets, recalling the higher capital requirements that Basel II set for the SMEs segment. Moreover, such an instrument as the securitisation should be able to benefit the same SMEs, in terms of enhancing an access to financing and lowering the cost of credit[49].

However, the same report states that in order to create positive effects, the securitisation of SMEs-related assets needs some essential prerequisites, such as an adequate legal and regulatory framework (i.e. predisposition of efficient securitisation laws and the presence of a sufficient institutional capacity at financial authorities)[50].

3.1. Further considerations of the effects of Basel II on the SMEs

Various authors focused on the "bad perception" of Basel II given its very restrictive set of rules for SMEs, which are perceived as "victims" of the normative because banks are not eager to grant credit to them due to their high-risk activities.

48 See Emanuel Salinas, "Securitization of loans to SMEs in Western Europe and Latin America", Standard & Poor's Structured Finance, Bratislava, May 15, 2008.

49 On this point, see also European Commission, "Fifth round table between bankers and SMEs" – SMEs and securitization, final report, discussion paper, published on 14 June 2007.

50 Other prerequisites named in the report are, for instance: economic factors (like the predisposition of a stable and sound financial environment), market infrastructure (like the settlement of strong creditors rights).

According to the critics of the normative, negative opinions (at least in part) belong to a sort of "strategic propaganda" plan created by the commercial banks themselves, ready to use the new rules as a proper "scapegoat"[51]. However, as was previously shown there is indeed some evidence of possible negative influences of Basel II for the SMEs activities.

In the author's view, what is important to consider is that Basel II is addressed to a large set of countries that very often are non-homogenous, as far as the culture of conducting business activities is concerned. This is particularly true for the SME sector. Nowadays, the big enterprises or multinational corporations have achieved the aim to render homogeneous the realisation of their own business plan despite the location thus they bring into force the strategy "think globally, act locally". Instead, SMEs usually stress more their local uniqueness by conducting their businesses in such a way that allows them to express economic, but also cultural and folkloristic characteristics of the region in which they were born and developed. That is why up to now the consequences of the full implementation of Basel II on the SMEs sector have been described on a national basis[52].

Therefore it seems that, despite the justified comments related to the disadvantages that Basel II may bring to the SMEs sector in terms of loans contraction by banks, it will be possible to carry out a more sincere and exhaustive judgment on the effects of Basel II (not only the negative ones but also the positive,

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51 Very interesting, from this point of view, the comment given in the work of Gottfried Haber, "Basel-II: International Competition Issues", International Atlantic Economic Society, Springer, 2007 where He says that: "The bad reputation of Basel-II does not follow from sound knowledge of the rules, but from a "strategic misuse" of Basel-II by commercial banks… From a marketing point of view, Basel-II is a very nice tool to communicate to the customers, how "benevolently" the commercial bank would be willing to grant nearly unlimited loans without any securities at virtually zero interest rates to the customers – only, if there were no regulatory constraints, preventing the "nice bank" from doing so".

52 Some references for a deeper analysis of such issue in some of the G-10 Countries: i) for Germany, see: Joachim C. Bartels, "Basel II and the Survival of the SME. Are Lenders and Borrowers Ready to Comply with Basel II?", in Business Credit, November 2002; Axel A. Weber, "Bank Relationships, Financial Integration, and Monetary Policy", Keynote Speech at the DIW-Conference "Bank Relationships, Credit Extension, and the Macroeconomy", Deutsche Bundesbank speech, Berlin 3 June 2005; ii) for France see: Valèrie Golitin, "SMEs financing under Basel II", Banque de France Bulletin – Excerpts from the September 2007 issue; Commission Bancaire, 2006 annual report, retrieved 4 October 2009 from: http://www.banque-france.fr/gb/supervi/telechar/cbreport/annual-report-commission-bancaire-2006.pdf; iii) for Italy see: Chiara Bentivogli, Emidio Cocozza, Antonella Foglia e Simonetta Iannotti, "The Bank-Firm Relationships After Basel 2: A Survey on Italian Firms", Bank of Italy Occasional Paper No. 6, February 2007; for more information on the US market see United States Government Accountability Office (GAO): "New Basel II Rules Reduced Certain Competitive Concerns, but Bank Regulators Should Address Remaining Uncertainties", GAO-08-953, September 2008; Berger, A. N., "Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States", Journal of Financial Services Research, Vol. 28, No. 2, 2006; see also Cynthia L. Course, "Basel II: The Impact on Competition in the U.S. Financial Services Industry", federal reserve bank of Philadelphia – bank resources publications – June 2009.

especially in terms of benefits brought by more transparent markets and lending policies). However, such an overall judgment could be presented only when the rules of the normative will be globally accepted and implemented in a harmonised way. The implementation by the relevant national regulators should be conducted in such a way that i.e. each country will have no possibility to circumvent the Basel II rules and will be somehow "forced" by the financial markets to adhere to the international best practices defined by the Basel-II regulations.

4. The SMEs sector and Basel II in the midst of the current financial turmoil

The global financial crisis started in 2007 with the US sub-prime mortgage crisis. This caused also a worldwide credit crunch, which is affecting globally the SMEs cash flows, in terms of decreasing access to financing and the increasing cost of credits. The problem is complex and crucial, especially given the importance of the SMEs sector for the different economies.

In a survey prepared in 2009, the OECD deeply analysed the impact that the current financial crisis is having on SMEs activities[53], and found out that:

- SMEs are suffering the most from the financial crisis, and are more vulnerable when compared to other organisations (pag. 7),
- the necessity, for national government, to support the SMEs sector using "reliable governance, tax, regulatory and legal frameworks" (pag. 10), in a way that anti-crisis packages used by governments will not impair the fair competition or, even worse, will not raise protectionist policies,
- all the measures undertaken by countries were divided into two main groups: i) short-term emergency measures, i.e. measures that could be reversed, such as tax measures; ii) long-term measures in order to make "structural improvements and institutional changes in the SME financial environment". The OECD suggests that governments consider the long term measures, as they are essential for the recovery from the crisis and the innovation-led growth,
- countries should take into consideration a set of special recommendations prepared by the OECD.

[53] See OECD: "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses", OECD Centre for Entrepreneurship, SMEs and Local Development, 2009. Such document shows the findings and the outcomes from the Turin round table, which was held in Turin, Italy, on 26–27 March 2009, under the auspices of the WPSMEE ("the OECD Working Party on SMEs and Entrepreneurship") at the invitation of Banca Intesa Sanpaolo.

In general, the OECD found that the main indicators of the crisis which is affecting the SMEs sector across the countries are, generally: i) payment delays on receivables for enterprises; and ii) increase in reported defaults, insolvencies, and bankruptcies[54].

It has to be said that at the national level, many measures were undertaken in order to face the problems that the credit crunch created for the SMEs access to finance. The various anti-crisis packages followed three different lines of action: i) The "stimulation of demand" (through the issue of special consumption packages, infrastructure programmes, tax policies); ii) measures for "credit enhancement", such as recapitalisation of national banks and in general special measures for the preservation of the SMEs financing, including public credit guarantees; iii) "labour market" measures (especially using extended temporary unemployment programmes). Accordingly, the OECD distinguished in its analysis three different groups of anti-crisis measures adopted in the various countries: i) measures supporting sales, cash flows, and working capital; ii) measures to enhance SME's access to liquidity, mainly to bank lending; iii) measures aimed at helping SMEs to maintain their investment level and more generally to build their capacity to respond in the near future to a possible surge in demand[55].

However, the author acknowledges that as most of the measures in favour of SMEs are very recent, they cannot still be evaluated *in toto*. Moreover, it would not be correct to judge the quality of interventions made on the basis on the limited number and the temporal character of such measures. To really support the SMEs sector, in fact, long term/structural measures, and reforms aimed at giving SMEs a "friendly" business (especially legal and regulatory) environment are necessary in order to "protect" this sector, also when the current financial crisis is over. For instance, recently the European institutions took into consideration two legal mechanisms to achieve a further development of the SMEs sector: i) the creation of a unique business patent[56]. This, in the view of the Commission, will increase the level of legal certainty, besides reduce costs and improve access to patent litigation for businesses and, furthermore, support growth and innovation thanks to prompt settlement of disputes over intellectual property, and; ii) the enhancement of the development of SMEs s.c. "clusters" (i.e. networking, cooperative among SMEs. In general, clusters can be defined

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[54] OECD "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses", cit., pag. 18.

[55] OECD "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses", cit., pag. 30.

[56] The European Commission very recently issued a recommendation to the European Council "To authorize the Commission to open negotiations for the adoption of an agreement creating a Unified Patent Litigation System", Brussels, 20 March 2009, SEC (2009) 330 final.

as "geographic concentrations of interconnected companies and institutions in a particular field"[57]).

As for possible implications of Basel II, in the author's view, it is still difficult to assess the possible impact of the full implementation of Basel II normative on the enormous financial crisis that has been hitting the SMEs sector, especially as far as access to financing is concerned.

This is due to the fact that Basel II was implemented in Europe only in 2008, in the USA in 2009, and in the rest of the world the times of implementation, are still relatively long to come. From this point of view, the author shares the opinion of the European Commission, which stated that it is still impossible to assess the effects of Basel II during the current financial crisis. The judgments are difficult even though the Japanese supervisors, having implemented the Basel II normative on 1 January 2007, declared that Basel II "have alleviated the effects of the turmoil on the financial markets. The higher capital requirements for trade in complex securitizations and increased incentives for improved risk management have helped to safeguard the stability of the financial system"[58].

Also the OECD[59], after describing the concerns about Basel II as a pro-cyclical normative: "despite the revisions of the rules already described, and the way in which changes in the legal framework for banking linked to Basel II and changes in the banks' risk management and internal controls are actually introduced at the country level", states in the end that "only experience can show whether Basel II – as implemented today – will result in higher borrowing costs for SMEs or even in some cases in their exclusion from borrowing from banks".

In any case, it is possible to analyse the potential effects that the new capital requirements may conduce during the prosecution of the credit crunch toward

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[57] This is the definition of the term "cluster" which has been given by Porter, M.E. (1998). "Clusters and the New Economics of Competition", Harward Business Review Volume 76 (Issue 6), 77ss. For Further information on clusters see, ex multis, E. Callegati, S. Grandi, "Cluster Dynamics and Innovation in SMEs: the Role of Culture", Working Paper No. 3/2005, Torino, Università di Torino, July 16, 2008, available at the link: http://www.eblacenter.unito.it/WP/2005/3_WP_Ebla.pdf; Cardi, P., Cilento, M., Coppola, D., Guerrieri, P., Ripa, E., Zanchiello: "L'Evoluzione Normativa dei Distretti Industriali", Napoli, Stoa, 2006. See also Liyang Hou, Davide Maria Parrilli, "European SME Clusters under the Perspective of Taxation and Competition", in "The dynamics of trade: law and economics", S. M. Kierkegaard, ed., 2nd Intl. Law and Trade Conference, Prague, pp. 399–409, September 3–5, 2008. In this work the authors focus on the possibility for SMEs clusters to expand through the usage of two branches of law, Taxation law (alighting especially on the legislative measures adopted by the recent Italian experience) and competition law.

[58] See Answer given by Mr McCreevy on behalf of the Commission, European Parliamentary question of 9 January 2008, E-5488/2007.

[59] OECD: "The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses", 2009, cit., pag. 26.

the SMEs world on the basis of the findings coming from the legal and economic literature, and of the opinions released in the interviews with the experts.

Banca d'Italia, in a paper prepared at the end of 2007[60] focused on the relationships between banks and SMEs, found that even though Basel II has been (especially recently) the object of many critics in Italy[61], the new normative, when correctly implemented, forces banks to introduce the transparent rating scoring processes[62], thus favouring reciprocal "virtuous relationships" between the SMEs and banks.

On the basis of the findings from a survey conducted on a sample of Italian SMEs[63], it could be noticed that the adoption and full implementation of the Basel II normative may lead to new opportunities for Italian enterprises in terms of better relationships with banks.

However, the study concludes that in order to achieve a higher growth of the economy, a higher grade of transparency of the information will be necessary as well as different, more risk allocated bank capital, which must be translated into availability and a lower cost of credit for SMEs.

Indeed, according to Christophe Leitl (honorary president of Eurochambres)[64], it seems that the access to finance is still considered one of the main constraints experienced by European SMEs. Moreover, Leitl states that an "immediate regulatory action to mitigate pro-cyclical effects" of Basel II is necessary. In the contrary case, it will surely lead to negative effects for the availability of loans in the short period. In another interview, Leitl declared that in order to reduce the possible pro-cyclical negative effects of Basel II on the SMEs, "one possible

60 See Anna Maria Tarantola (Banca d'Italia): "Banche e imprese: opportunità e sfide alla luce di Basilea II", intervention within the seminar "Banca e Impresa. Nuovi scenari, nuove prospettive", held in Florence, Italy, on 10 December 2007.

61 See, ex multis, F. Fiordaliso, "La qualità dell'impresa: fattore competitive nel processo di valutazione del merito creditizio", CEDAM, Padova, 2008; F. Lenoci, S. Peola: "Negoziare con le banche alla luce di Basilea II", IPSOA, 2004; A. Dell'Atti: "Basilea II e piccole banche. Organizzazione, gestione e scelte strategiche", Edibank, Rome, 2007; G. Gobbi: "Tendenze evolutive del rapporto del rapporto banca-impresa", in "Il rapporto banca-impresa in Italia, a cura di S. Monferrà, Bancaria Editrice, Roma, 2007; A. Malinconico: "Garanzie e bank lending. Basilea II e le novità sulla gestione del rischio di credito", Bancaria Editrice, Roma, 2008; A.G. Quaranta: "Attribuzione dello scoring aziendale nel contesto di Basilea II", Rivista Bancaria, n. 2-2008.

62 On the importance that credit ratings will play in the near future after the full implementation of Basel II see, ex multis, Czarnitzki, D. and K. Kraft (2007) "Are Credit Ratings valuable information?", Applied Financial Economics, Vol. 17, No. 13, pp. 1061–1070.

63 See C. Bentivogli, E. Cocozza, A. Foglia e S. Iannotti, "I Rapporti Banca-Impresa dopo il Nuovo Accordo sul Capitale: un'Indagine Territoriale", in Questioni di Economia e Finanza, numero 6, Banca d'Italia, Febbraio 2007. The investigation was conducted on a sample of 4600 Italian enterprises, aiming to find the average level of consciousness of entrepreneurs of the possible effects of Basel II in the SME sector.

64 See the interview to Mr. Leitl: "Eurochambres: SMEs need 'strong commissioner' for enterprise", made by Gary Finnegan and published on Euractiv on 29 September 2009.

way has been pointed out recently by the scientific advisory board of the German Ministry of Economy in a letter to the former minister Glos underlining that "during the ongoing crisis strict application of Basel II should be suspended (e.g. rules concerning delayed repayments of loans)"[65].

In the author's view, however, the suspension *tout court* of the Basel II unfavourable rules might occur as a hasty solution which will not lead to positive effects, at least in the long term. If negative impacts of the normative on the SMEs or any other business sector, are registered, it will be necessary to revise the entire structure of the normative. It could be necessary to create a corpus of rules that will contain the knowledge gained by learning from the past mistakes and eventually, to "drive" the SMEs sector not only to the recovery from the current financial turmoil, but also to the restart after the crisis is over.

From this point of view, the author's shares the opinion of the Italian leader of Confindustria (the Union of Italian Industrials), Emma Mercegaglia, who in an audition of the Commission for the "productive activities" before the Italian Chamber of Deputies[66] said that in order to help the SMEs to face the current financial crisis, it will be necessary to make the rules of the capital requirements less severe for banks, thus favoring loans to SMEs.

Stressing the fact that also the German Union of Industrials agrees with such a vision, Mercegaglia said that the measures above described should last at about 18 months, and be directly connected with the provision of credit to SMEs. The measure should be as well accompanied by special "fiscal interventions" to consent banks in order to (at least partially) compensate for a possible increase of risks and costs.

Finally, Mercegaglia stated that the temporary measure should be connected to a general renegotiation of Basel II on European level. She is convinced that this a medium-long term objective that has to be thoroughly evaluated. For instance, Mercegaglia proposed that such renegotiation might provide for higher patrimonial

[65] See SME Union press release, of 17 February 2009: "SME UNION President Leitl demands EU-Guarantee Fund for SMEs: 10 Million SME would benefit from the fund", retrieved on 28 September 2009 from: www.sme-union.org/viewdoc.php?LAN=en&FILE=doc&ID. The solution of a possible suspension of Basel II rules toward the SMEs sector created moreover a debate in the German literature. For instance, Martin Hellwig: "Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis", Preprints of the Max Planck Institute for Research on Collective Goods Bonn 2008/43, pag. 65, says: "I consider it likely that the implementation of this new Basel Accord will actually strengthen the features of regulation that have contributed to making the current financial crisis as serious as it is".

[66] See Camera dei Deputati, "Indagine conoscitiva sulla situazione e sulle prospettive del sistema industriale e manifatturiero italiano in relazione alla crisi dell'economia internazionale" of 23 September 2009, retrieved on 14 October 2009 from: http://nuovo.camera.it/459?shadow_organo_parlamentare=1503&eleindag=/_dati/leg16/lavori/stencomm/10/indag/crisi

requirements during upturns periods, in order than to lower them in times of downturns, avoiding (or at least mitigating) possible pro-cyclical effects.

5. Summary and conclusions

In the present work, the author investigated the effects that the normative Basel II has had on the SMEs sector, which is considered a crucial sector for the global economy. Both positive and negative aspects of the full implementation of Basel II were presented.

Firstly, the author demonstrated the interconnections existing between a possible discrimination among large and small banks, and the lending policies in favour of the SMEs establishment and activity.

Then, a set of possible negative consequences coming from the full implementation of Basel II were described, i.e.: i) in the case of the adoption of the Standardised Approach, the capital requirement will remain more or less the same as it was provided in the old normative Basel I; ii) as for the adoption of the I.R.B. Approach, the possible "discounts" for banks in terms of lower capital requirements ultimately rely on the possibility for SMEs to increase their own creditworthiness. This is translated, for the SMEs involved, in higher costs to maintain a good rating and a general good relationship with the banks; iii) the SME may face some disadvantages when it is requesting a credit abroad, as Basel II states that in such case the country rating must be applied. This can cause a reduction of lending activities for SMEs established in emerging markets; iv) consequently, in the developing countries the full implementation of Basel II may lead to an "institutional division" in terms of lending policies between large, internationally active banks (which can afford the I.R.B. Approach and are therefore more likely to lend to less risky companies), and small banks (that will lend mainly to SMEs, not being able to implement the I.R.B.). The author also considered the possible increase in the securitisation of SMEs loans due to more risk-sensitive lending activity of banks, which can lead to positive effects only if specific requirements are respected.

It was also stated that for the SMEs sector, the effects of Basel II have yet to be studied on a national (and sometimes, as described, sub-national) basis, also considering the numerous options for banks and national discretions for national legislators left by the normative. Therefore, only when the Basel II is finally harmonised in all the countries and the legal orders to which is addressed, it will be possible to study its implications on SMEs considered in macro-areas (e.g. Europe, the U.S.A., etc.).

In the final part of the work, considerations on the effects that the current financial crisis (started in the second half of 2007 with US sub-prime mortgages crisis) brought to the SMEs sector were presented. As for the role of Basel II during the crisis, the author gave evidence that, despite it still being too soon to give a definitive judgment, it is possible to forecast a further exacerbation of the pro-cyclical effects of Basel II.

On this latter point it has to be considered also that, in order to face the effects of the financial crisis, the Basel Committee already settled, at the end of 2009, a set of modifications to the Basel II normative that aim at an increase in the banks capital and liquidity requirements, and a consequent increase in their risk sensitiveness. The author, as the SME activity is considered the riskiest activity, is afraid of the fact that a further strengthening of the risk sensitiveness can be translated in a general minor availability of loans for SMEs.

Therefore, is could be concluded that even if a complete review of Basel II is not mandatory, it would be necessary, in downturns periods, to introduce a regulation that allows for the adoption of temporary measures (in order to give relief to the SMEs), but issued in an optic of structural reforms. In the author's view, such measures should be issued taking into account the needs of SMEs, *in primis* the access to credit for the conduction of their activity: this can represent a right mix for a restart, after any financial crisis, of the SMEs sector, which represents, the real backbone of the global economy.

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Consumer credit companies in Europe: an empirical analysis of their profitability

1. Introduction

In recent years, the diffusion of consumer credit has recorded high levels of growth throughout the most of Europe. This growth reflects changes both on the demand and supply sides of the market. On the demand side, household borrowing in the last twenty years has been driven by income growth together with relative economic stability, a reduction in intergenerational transfers and the decline of the informal credit market. On the supply side, a raft of expansive factors include market liberalisation and the consequent heightened competition among lenders, technological innovation and improved techniques for the measurement and control of credit risk, a widening in the range of products supplied, and a reduction in interest rates and generally easier access to credit (Crook 2006).

Lending volumes can be expected to grow further as a result of changes in socio-cultural variables and new spending models that have made personal indebtedness more acceptable. Lenders may have considerable interests in stimulating this potential demand. Incentives for developing consumer credit activities include, in addition to attractive profitability levels, further performance improvements offered, for example, by cross-selling and the development of a range of lending products targeted and marketed to specific customer types. The new European Consumer Credit Directive – whose aim is to harmonise fully core areas relating to consumer credit contracts – may further contribute to the expansion of the consumer credit market through the conduit of a market without internal frontiers and a high and equivalent level of protection of EU consumer interests.

The aim of this paper is to analyse the profitability of the consumer credit industry. To this end data from the financial statements of a sample of French, German, Italian and Spanish consumer credit companies over the period 2005–07 will be examined. Following Molyneux and Thornton (1992), Demirgue-Kunt and Huizinga (2000), Athanasoglou *et al*. (2008) among others, we investigate the effect of firm-level and market-level factors on the profit of consumer credit companies. Firm-specific determinants of profitability involve size, risk and balance sheet structure. Market-specific determinants include explanatory variables related to the environment within which consumer credit companies operate. This second group of variables is likely to be relevant in the analysis of the determinants of consumer credit companies' profitability: despite the fact that, in recent years, the use of consumer credit has recorded high levels of growth throughout the most of Europe, the diffusion of consumer credit differs widely from country to country with resulting differences in the level of maturity and complexity of the industry.

Although there is an extensive empirical literature that examines the determinants of the financial sectors profitability, to our knowledge there are no previous studies that specifically focus on the consumer credit industry. As a result of the growth of the consumer credit industry in Europe in recent years, allied to forecasts for its continuing expansion in many European markets, an analysis of the profitability of consumer credit companies can contribute new discussion issues in the area of consumer credit.

The paper is organized as follows. Section 2 reviews some of the main contributions of empirical studies on profitability. Section 3 describes the main features of the consumer credit industry in Europe. Section 4 presents the data-set and the variables used to the purpose of the analysis. Section 5 outlines the econometric framework, Section 6 develops the empirical results and Section 7 concludes the paper.

2. Literature

As far as we are aware, no specific studies have directly addressed the analysis of the profitability of the consumer credit industry. Conversely, there is substantial literature that focuses on the determinants of bank profitability, proposing different explanatory variables according to the aim and nature of the analysis (Molyneux and Thornton 1992, Berger 1995, Rivard and Thomas 1997, Demirguc-Kunt and Huizinga 2000, Bikker and Hu 2002, Williams 2003, Berger and Mester 2003, Goddard, et al. 2004, De Young and Rice 2004, Stiroh and Rumble 2006, Bhuyan and Williams 2006, Berger and Bonaccorsi di Patti 2006, Hirtle and Stiroh 2007, Athanasoglou *at al.* 2008).

In the banking literature, the level of profitability is usually expressed as a function of internal and external determinants. The first group of variables, labelled bank-specific determinants, are related to firm management skills; the second group of variables, labelled market-specific determinants, are related to the environment that affects the performance of banks.

As regards bank-specific features, empirical analysis mainly focuses on variables such as size, financial structure, risk, operating expenses and income diversification.

Size is introduced to account for economies or diseconomies of scales and the adoption of entry-deterring strategies. Generally, the effect of a growth in size on profitability has been proved to be positive (Molyneux and Thorton 1992, Bikker and Hu 2002; Goddard *et al*. 2004, Demirguc-Kunt and Huizinga 2000). However, other studies suggest that the positive effect of increased bank size on profitability may be positive up to a certain limit, while beyond this point marginal cost savings can be achieved by greater size (Athanasoglou et al 2007); the effect of size could also be negative due to bureaucratic and other reasons (Eichengreen and Gibson 2001).

Bank leverage and capitalisation have been analysed in depth, but empirical results vary significantly. The effect of bank capitalisation on profitability is generally found to be positive. An increase in capital reduces the expected costs of bankruptcy; the lower likelihood of financial distress results in a lower cost of funding, leading to a positive impact on bank profitability (Molyneux and Thorton 1992, Berger 1995, Dermiguc-Kunt and Huizinga 2000, Goddard *et al*. 2004). Moreover, banks with relatively low capital respond to moral hazard incentives by increasing the riskiness of their loan portfolio, which results in higher nonperforming loans on average in the future (Berger and De Young 1997). However, there are also findings of a negative relationship between profits and equity. A relatively high capital-assets ratio could signify that a bank is operating over-cautiously, ignoring potentially profitable diversification or other opportunities and using more equity, which is more expensive than debt (Goddard et al. 2004, Angbazo 1997).

In the empirical literature, the effect of credit risk on profitability appears clearly negative; the greater the exposure to high-risk loans is, the higher the accumulation of loan loss is, implying a reduction in profitability (Miller and Noulas, 1997). Similarly, operating expenses are found to be negatively related to profitability: a reduction in expenses increases efficiency and, in turn, raises profitability (Bourke 1989).

Empirical findings related to potential diversification benefits are not unambiguous. Using a sample of banks from 7 European countries in the period 1994-2001, Stiroh and Rumble (2006) find that diversification gains are frequently offset by the costs of increased exposure to volatile activities, with an overall negative impact on performance. Also De Young and Roland (2001) find that a shift toward fee-based activities is associated with increased revenue volatility and lower risk-adjusted profits. Conversely, Maudos and Fernandez de Guevara

(2004) show that specialised banks exhibit higher unit costs on average and lower margins. Similarly, Carbò Valverde and Rodriguez Fernandez (2007) find that market power increases as output becomes more diversified towards non-traditional activities in European banking.

As for the external determinants, the most common market-specific variables used in empirical analyses are ownership structure and economic conditions.

The empirical literature has produced mixed evidence as to whether and how ownership status affects performance. Molyneux and Thornton (1992), who analyse the determinants of bank profitability on a sample of 18 European countries during the period 1986–1989, report that state-owned banks generate higher returns on capital than private sector competitors. Dermiguc-Kunt and Huizinga (1999) and De Young and Nolle (1996) suggest that foreign banks have higher margins and profits than domestic banks in developing countries, while the opposite prevails in developed countries. As regards economic conditions, Athanasoglou *et al*. (2008) analyse the performance of Greek banks over the period 1985–2001 and find the relevance of macroeconomic variables on the performance of the banking sector. The effect of the business cycle is asymmetric since it is positively correlated to profitability only when output is above its trend. Also Carbò Valverde and Rodriguez Fernandez (2007) find that macroeconomic factors, such as variation in the business cycle, explain some of the differences in bank margins across countries and regions.

3. The consumer credit industry: background

The diffusion of consumer credit as a percentage of GDP differs widely from country to country. However, in the last years there has been a rapid growth of consumer credit in most European markets. Such growing trends are positive not only in less mature markets – due in part to their low initial level – but also in more mature markets; this suggests that consumer credit is still a growing business (Appendix, Table 1a and Table 2a).

Over time, such growing trends have pushed lenders to focus increasingly on this area, with innovations both in credit risk management and in product and services design. In fact, demand growth and easier access to credit have led to more sophisticated techniques in order to manage increasing credit risk. At the same time, greater demand for diversified consumer credit solutions, heightened competition and resulting tighter margins have contributed to an overhaul of product portfolios in the search for expansion of potential customer bases to exploit cross selling opportunities and heightened effectiveness of customer loyalty programmes (Finlay 2005, Crook *et al.* 2007).

There are many example of such an overhaul of product portfolios. In recent years, there have been significant increases in the use of revolving credit cards on the back of strong growth in payment systems and card usage and further expansion is likely with the creation of SEPA – Single Euro Payment Area – and the shared infrastructure, standardised procedures and raised security levels it foresees (EPC 2006). Revolving credit cards are an attractive form of lending for financial intermediaries as they generate commission revenues associated with charge cards (annual fees, fixed charges, merchant and interchange fees), as well as interest income owed on instalment repayments. By monitoring customer spending, cards also provide useful information for lenders to improve their cross-selling opportunities. Finally, credit cards are suitable for the development of co-branding agreements aimed at increasing potential customer numbers.

In addition to the continuing expansion of revolving credit, lenders are refining product portfolios to satisfy specific market segments in order both to satisfy more effectively existing customer needs and to develop specific market niches, such as age-based segments (Salmi 2003, Ziederman 2002). Consolidation of loans represents a further addition to lenders' product portfolios. Borrowers with various loan liabilities can consolidate the single positions into a sole exposure at a longer maturity thereby, typically, enabling a fixed rate and more manageable monthly repayment instalments. Loan consolidation is widespread in the United States and is becoming increasingly more common in the highly competitive UK market (Dynan and Kohn 2007).

Finally, the range of consumer credit products is often complemented by loyalty and flexible repayment packages and by insurance products, such as payment protection insurance, which is a scheme that seeks to provide consumers with debt repayment cover in the case of an unexpected event, such as redundancy, illness or death. This form of insurance produces a cascade of positive externalities for lenders in the form of commission income generated by a product and lower risk levels. It also acts as an effective vehicle for penetrating relatively high-risk market segments thanks to the fact that the loan granted is fully secured (FSA 2007).

Although diversification in the supply of product and services is a common trend in all countries, the level of industry development and maturity in terms of product and services diversification is at the moment not heterogeneous across local markets. In France, for example, the consumer credit market is sophisticated and there exists a wide variety of products and services, while in Italy innovative consumer credit solutions or insurance services are still not so widely diffused[1].

[1] For a detailed analysis of the specificities of domestic consumer markets, for Italy, see Assofin (2007), for Spain, Banco de Espana (2007), for France, ASF (2007), and Deutsche Bundesbank (2008) for Germany.

Among countries, there are also differences in the type of lenders operating within the industry. In fact, consumer credit lenders can be categorised in universal banks, offering a broad range of financial services, and consumer credit companies. The latter, in turn, can be sub-divided into specialised financial intermediaries belonging to banking or financial groups and captive companies fully owned by manufacturing or retail groups. This categorisation is relevant since it reflects different levels of economic specialisation on the part of lenders. Universal banks are typically commercial banks which, as part of their traditional banking activity, offer lending products both to corporate and retail customers. Conversely, specialised banks and finance companies focus exclusively on lending to households with the supply of a wider range of consumer credit solutions. Similarly, captive companies are financial companies that also limit their activity to consumer credit, but the amounts advanced are destined exclusively to the purchase of the parent company's product (Vandone 2009).

The heterogeneity of consumer credit markets can be finally ascribed to differences regarding the determinants of household unsecured debt demand, such as age, income, employment status and wealth (Del Rio and Young 2005a, Leece 2000). Such differences in household propensity to hold debt, in the reference cultural model of consumption and in the determinants of consumer credit demand may, in turn, affect lenders' strategy and the supply of consumer credit solutions.

The high level of heterogeneity across consumer credit markets suggests that among market-specific determinants of profitability we have to account for environmental variables that specifically consider these features, such as the size of the market and the level of household debt together with per capita income. We will exploit this point in the next paragraph.

4. Methodology

4.1. Data

We analyse the profitability of a balanced panel of 110 consumer credit companies, both finance and captives: 24 from France, 27 from Germany, 25 from Italy and 34 from Spain[2]. We focus on these four countries because, although they are amongst the largest in Europe in terms of credit outstanding, the extent of

[2] All companies are members of their respective national associations. France: Association Francaise des Societés Financières (ASF); Germany: Bankenfachverband; Italy: Associazione Italiana del Credito al Consumo e Immobiliare (ASSOFIN); Spain: Asociacion National de Establecimientos Financieros de Credito (ASNEF).

consumer credit use and the speed of market growth differ (Table 1a and Table 2a in the Appendix). In particular, Spain, Germany and France have consumer credit/GDP ratios above the European average, whilst Italy is well below, though catching up fast. Moreover, in recent years, consumer credit debt levels in Spain have risen to an extent that the country's consumer credit/GDP ratio is now higher than France's, while in Germany the country's consumer credit/GDP ratio is falling slightly.

Consumer credit companies' financial statement data used in the analysis are sourced from the Bureau van Dijk's Bankscope database. The analysis concentrated on the years 2005, 2006 and 2007 (IAS/IFRS compliant). The use of national GAAP prior to 2005 and the absence of comparatives that differing national standards entail made a longer time horizon unworkable.

Unconsolidated company statements are used to focus on the specificities of consumer credit operations. For this reason, universal banks are not included in the sample and consequently consumer credit granted by them; the inclusion of universal banks with considerable operational differences and the absence of the comparatives this implies would otherwise impair the significance of the results[3].

4.2. Performance measure

A firm's profitability is typically measured by the indicators Return on Equity (ROE) and Return on Assets (ROA). The first, calculated as net income over total equity, shows how much profit a company earned on each euro invested by its shareholders; the second, calculated as net income over total assets, is an indicator of how profitable a firm is relative to its total assets, measuring the net profit generated for each euro of net assets.

Since ROE is inevitably linked to a company's level of capitalisation, ROA is better-equipped in a cross-country analysis of companies with different levels and types of financial leverage and it emerges as the key ratio for the evaluation of financial intermediaries' profitability (Rivard and Thomas 1997; Athanasoglou *et al.* 2005; Ben Naceur and Goaied 2008; Kosmidou 2008). We use profit before taxes since the level of taxation is different in each country. Table 1 shows ROA and ROE for the consumer credit companies making up the sample of each country and the panel over the period under observation.

[3] The sample is highly representative of the outstanding consumer credit granted by specialised lenders, accounting for, at year-end 2007, 72.6% for France, 92.4% for Germany, 85.6% for Italy and 83.1% for Spain.

Table 1. ROA and ROE by country and by year

	ROA					ROE				
	France	Germany	Italy	Spain	Panel	France	Germany	Italy	Spain	Panel
2007	0.0256	0.0067	0.0090	0.0137	0.0132	0.2594	0.0476	0.1975	0.1029	0.1467
2006	0.0258	0.0097	0.0097	0.0177	0.0157	0.3118	0.0870	0.2090	0.1291	0.1768
2005	0.0225	0.0101	0.0093	0.0175	0.0148	0.2503	0.0985	0.2230	0.1332	0.1710

Total number of consumer credit companies over the period 2005–07 for: France = 72; Germany = 81; Italy = 75; Spain = 102; Panel = 330.

4.3. Firm-specific and market-specific determinants

The model includes different explanatory variables commonly used in applied literature to analyse the effects on profitability of both firm-level characteristics and market-level characteristics.

Firm-level variables included in the model are those generally used to analyse the profitability of financial intermediaries and reviewed in Section 2: size, capitalisation, credit risk, operating expenses and income diversification.

Concerning market-specific variables, as already outlined in Section 3, the heterogeneity of the consumer credit industry across countries suggests including other variables than those generally used in the analysis of financial intermediaries' profitability, with the aim to capture the different degrees of diffusion of consumer credit and the household debt situation. Such variables are *credit diffusion*, *household debt* and *per capita income*.

The first explanatory variable, *credit diffusion*, is measured by the ratio of consumer credit to GDP, and captures the effects on profitability of the size of the outstanding consumer credit market. The expected sign of this variable is positive; when consumer credit is more diffused and commonly used among the population, consumer credit companies may have greater opportunities for scale and scope economies and higher possibilities of offering a range of product and services suitable to a more sophisticated demand. On the contrary, lower levels of consumer credit, typical of relatively immature markets, may hold back the development of product innovation, customer segmentation and cross-selling, which may have negative repercussions on lender's profitability.

The other two variables, *per capita income* and *household debt*, respond to the need to take into account that although it is commonly recognised that household borrowing can enhance economic welfare as it allows for consumption smoothing over the life cycle, there is concern that the growth of consumer credit may have resulted in the fact that an increasing quantity of consumer credit is taken on by high risk borrowers, due to the easier access to this market (Del

Rio and Young 2005b, Rinaldi Sanchez-Arellano 2006). This concern is potentially increased if consumer credit is associated with low income levels, which in turn may be a signal of financial and economic fragility. Based on these considerations we argue that the debt burden, the proxy of which is the ratio consumer credit to disposable income, may negatively affect firms' profitability. The same is for lower levels of per capita income. In other words, households with lower levels of income or higher levels of debt burden may be financially fragile and this may negatively affect the profitability of consumer credit companies.

Among market-specific variables, we also include two dummy variables to capture the characteristics of firm ownership. Giving the specificities of this industry, the relevant difference is between "captive" and "finance" consumer credit company, and between "domestic" and "foreign" holding company.

The dummy variable *captive* is equal to 1 when the consumer credit company is a captive. The expected sign is negative, due to the likely lower interest margins and smaller contribution of non-interest income. These performances are directly due to the structural differences that exist between the two company types: captives typically provide funds for the purchase of their parent companies' products as part of a sales strategy that seeks to develop brand loyalty via the conduit of cheaper credit terms, while consumer credit companies belonging to banking groups are likely to invest in product portfolios that guarantee a greater role of commission and fee-based revenues in overall net profit.

The dummy variable *foreign* is equal to 1 when the holding company is located out of state. The expected sign of this variable is not unambiguous: on one hand, in less mature markets large-size companies enjoying a consolidated position at home may use their expertise to introduce into foreign markets new product and services, with positive effects on profitability. On the other hand, it may be difficult and costly to enter a new market, especially if people are not used to consumer credit.

We finally use a set of dummy variables, *country*, to account for other differences that may influence consumer credit company profitability and which may not be strictly related to the characteristics of the consumer credit market, but, more generally, to the economic and regulatory environment[4].

[4] Our analysis does not include among regressors a measure of market concentration, although we are aware that studies dealing with the profitability of financial intermediaries generally do it, using structural measures, such as the Herfindahl-Hirschman index, or non-structural measures, such as the Ross-Panzar index. The rationale of our choice is that, as we already pointed out in Section 4.1, universal banks balance sheet only reports the aggregate amount of credit supplied to retail customers, with no distinction between secured and unsecured debt. This would have implied the construction of a market concentration index based only on consumer credit companies, which, however, would have been meaningless.

Table 2 reports the definition and the notation of variables used in the analysis; table 3 presents the descriptive statistics.

Table 2. Definition of dependent and explanatory variables

Variable	Measure
Dependent variable	
Profitability	ROA=Net profit before taxes/total assets ROE= Net profit before taxes/total equity
Firm-specific variables	
Size	Log of total assets
Capital	Equity/Total assets
Loans	Loans/Total assets
Net Interest	Net interest income/Loans
Other income	Other operating income/Total assets
Operating expenses	Overheads/Total assets
Credit risk	Loan loss provisions/Loans
Market-specific variables	
Captive	Dummy=1 if consumer credit company belongs to manufacturing or retail group
Foreign	Dummy=1 if foreign owned companies
Country	Set of dummy variables for countries (namely France, Germany, Italy and the UK)
Credit diffusion	Consumer credit/GDP
Household debt	Consumer credit/Disposable income
Per capita income	GNP/number habitants

The macroeconomic data value are obtained from national statistics (National Central Banks and Eurostat).

Table 3. Descriptive statistics of dependent and explanatory variables

Variable	Mean	Std dev	Min	Max	Mean	Std dev	Min	Max
	Panel				**France**			
ROA	0.0148	0.02121	–0.0779	0.1257	0.0247	0.0193	–0.0130	0.0687
ROE	0.1660	0.1768	–0.5926	0.8533	0.2487	0.2058	–0.2816	0.8533
Revenues	0.0617	0.0570	0.0030	0.4120	0.0755	0.0531	0.0189	0.2911
Cost to income	0.5492	0.2915	0.0204	3.1000	0.5938	0.2060	0.0204	1.1035
Size	14.1193	1.6817	7.1212	17.7688	14.4067	1.3245	11.8851	17.1878
Capital	0.1086	0.1078	0.0122	0.6528	0.1160	0.1175	0.0334	0.5966
Loans	0.8621	0.1589	0.1854	0.9970	0.7638	0.2140	0.1854	0.9936
Net Interest	0.0505	0.0426	–0.0226	0.2773	0.0648	0.0354	0.0000	0.1650
Other income	0.0195	0.0457	–0.0278	0.3864	0.0278	0.0482	–0.0027	0.2782
Operating expenses	0.0343	0.0439	0.0006	0.4034	0.0419	0.0329	0.0027	0.2238
Credit risk	0.0121	0.0124	–0.0097	0.0866	0.0127	0.0112	–0.0097	0.0387
Credit diffusion	0.0836	0.0160	0.0509	0.1042	0.0830	0.0001	0.0819	0.0822
Household debt	0.1260	0.0257	0.0733	0.1555	0.1229	0.0004	0.1224	0.1234
Per capita income	26.0061	3.0607	20.9330	30.6803	29.4791	0.9795	28.2980	30.6803
Captive	0.3091				0.4167			
Foreign	0.3000				0.0417			
Country France	0.2182							
Country Germany	0.2454							
Country Italy	0.2273							
Country Spain	0.3091							
	Germany				**Italy**			
ROA	0.0089	0.0175	–0.0779	0.0714	0.0094	0.0131	–0.0720	0.0305
ROE	0.0906	0.1080	–0.1864	0.3788	0.2261	0.2039	–0.5926	0.7618
Revenues	0.0791	0.0775	0.0086	0.4120	0.0441	0.0355	0.0121	0.1872
Cost to income	0.6292	0.3315	0.2805	2.8537	0.5205	0.3689	0.0857	3.1000
Size	14.1124	2.1160	7.1212	17.5333	14.8565	1.2657	11.1080	16.6576
Capital	0.1206	0.1089	0.02928	0.6528	0.0635	0.0705	0.0122	0.5263

continued Table 3

Variable	Mean	Std dev	Min	Max	Mean	Std dev	Min	Max
Loans	0.8500	0.1435	0.36088	0.9927	0.9055	0.0683	0.6533	0.9901
Net Interest	0.0596	0.0493	0.0099	0.2773	0.0333	0.0325	–0.0226	0.1693
Other income	0.0290	0.0729	–0.0278	0.3864	0.0140	0.0216	–0.0010	0.1221
Operating expenses	0.0528	0.0718	0.0056	0.4034	0.0242	0.0245	0.0020	0.0947
Credit risk	0.0131	0.0126	–0.0012	0.0493	0.0119	0.0157	–0.0021	0.0866
Credit diffusion	0.0983	0.0049	0.0923	0.1042	0.0575	0.0053	0.0509	0.0637
Household debt	0.1451	0.0030	0.1430	0.1494	0.0834	0.0081	0.0733	0.0929
Per capita income	28.3110	0.9302	27.2277	29.4866	25.3645	0.6489	24.5945	26.1720
Captive	0.4074				0.0400			
Foreign	0.2963				0.2400			
	Spain							
ROA	0.0164	0.0269	–0.0331	0.1257				
ROE	0.1227	0.1345	–0.2843	0.5254				
Revenues	0.0497	0.0450	0.0030	0.2101				
Cost to income	0.4673	0.2085	0.0325	1.2256				
Size	13.3519	1.4806	10.2435	17.769				
Capital	0.1275	0.1147	0.0244	0.6463				
Loans	0.9119	0.1382	0.1886	0.9970				
Net Interest	0.0454	0.0432	–0.0038	0.1928				
Other income	0.0091	0.0139	–0.0015	0.0804				
Operating expenses	0.0207	0.0175	0.0006	0.0908				
Credit risk	0.0111	0.0101	–0.0018	0.0577				
Credit diffusion	0.0924	0.0057	0.0849	0.0985				
Household debt	0.1443	0.0102	0.1308	0.1555				
Per capita income	22.1961	1.0113	20.9330	23.3955				
Captive	0.3529							
Foreign	0.5294							

5. Econometric specification

The general model to be estimated is of the following linear form:

$$y_{it} = \alpha + \beta X_{it} + u_{it} \tag{1}$$

where y_{it} is the profitability of consumer credit provider i at time t, with $i = 1, \ldots, N$, $t = 1, \ldots, T$, α is a scalar, X_{it} is a vector of k explanatory variables, β is a vector of parameters of the k explanatory variables, and u_{it} is the one-way error component model for the disturbances, with $u_{it} = \mu_i + \nu_{it}$, where μ_i denotes the unobservable firm- specific effect and ν_{it} the idiosyncratic error (Baltagi 2001). Note that μ_i is time-invariant and it accounts for any unobservable firm-specific effect that is not included in the regression and we can think of it as the unobservable managerial skills of the consumer credit company's executives.

Both static panel-data models (Fixed Effects FE and Random Effects RE) are estimated using ROA as the profitability variable.

Table 4. Consumer credit company data: Hausman Test FE versus RE

Variable	Fixed	Random	Difference	S.E.
Size	0.0049	0.0015	0.0034	0.0036
Capital	–0.0539	0.0333	–0.8724	0.0239
Loans	0.0449	0.0393	0.0056	0.0074
Net Interest	0.4991	0.5069	–0.0077	0.0385
Other income	0.5070	0.3726	0.1343	0.0523
Operating expenses	–0.1558	–0.3017	0.1459	0.0192
Credit risk	–0.6537	–0.6808	0.0271	0.0550
Credit diffusion	1.1848	1.2684	–0.0836	.
Household debt	–0.9469	–0.9671	0.0217	.
Per capita income	0.0023	0.0030	–0.0006	.
Chi^2 (11) = 126.07 Prob > chi^2 = 0.0000				

As regards the choice between a FE and a RE model, we use the specification test proposed by Hausman (1978), which is based on the difference between the fixed and random effects estimators. The null is that individual effects are uncorrelated with the explanatory variables. If the null is not true the random effects estimators become bias and inconsistent estimators of beta. In this case, the μ_i unobservable individual specific effects are assumed to be fixed parameters to be estimated, ν_{it} independent and identically distributed IID $\left(0, \sigma_\nu^2\right)$, the X_{it} are assumed independent of the ν_{it} for all i and t. As indicated by the Hausman test, the difference in coefficients between FE and RE is systematic, providing evidence in favour of a FE model (Table 4). We also verify for Mundlak (1978), who provides a specification test robust to heteroskedasticity and autocorrelation, and we find again that the null is not true and, thus, the Within estimator is consistent (χ^2 (10) = 58.96 Prob > χ^2 = 0.0000).

We finally compute the Granger causality Wald test to investigate the existence (and direction) of causality between the determinants and the profitability (Granger, 1969).

6. Estimation results

Table 5 reports the Stata output reproducing the Within estimates, while results of the Random Effects estimates are presented in the Appendix, Table 3a[5]. The estimation results show that individual effects are present: the relevant F-statistic, which tests whether all firms dummy coefficients are equal, is significant at the 1% level (F (106,188) = 5.41), thus rejecting the null. This indicates that the firm dummies are jointly significant and the pooled OLS estimates which omit these firms dummies suffer from an omission variables problem rendering them inconsistent. We also compute the Breusch and Pagan's Lagrange multiplier test (1980) and we reject it, thus excluding homogeneity among firms[6].

The results of the Granger causality Wald test suggest the existence of unidirectional causality. In particular, the null hypothesis that profitability does not cause any of the independent variables (i.e. ROA does not cause net interest income) cannot be rejected at the 1% level for all countries, according to the Granger causality reference theory. In contrast, the null hypothesis of non-causality (i.e. net interest income does not cause profitability) can be rejected at the 5% or 10% level for all countries (with the exception of France for the variable other income and Germany and Spain for the variable credit risk)[7].

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5 As suggested by both the specification tests and coefficients, the estimations based on ROE produce inferior results (Appendix, tables 4a-6a). This performance may be related to the explanation given in section 4.2.

6 The Breusch and Pagan test checks for the null hypothesis $H_0 : \sigma_\mu^2 = 0$. The estimation results show that the null can be rejected at the 1% level: χ^2 (1) = 67.74 Prob > χ^2 = 0.0000.

7 These results are available from the authors on request.

Table 5. Consumer credit company data: the Within Estimator (Fixed Effects results)

Variable	Coefficient	Std error	*t*-Statistic	*P* > |*t*|
Size	0.0049	0.0037	1.33	0.184
Capital	–0.0539**	0.0268	–2.01	0.046
Loans	0.0449***	0.0095	4.71	0.000
Net Interest	0.4992***	0.0490	10.20	0.000
Other income	0.5070***	0.0629	8.06	0.000
Operating expenses	–0.1558***	0.0392	–3.97	0.000
Credit risk	–0.6537***	0.0932	–7.08	0.000
Credit diffusion	1.1848***	0.3095	3.83	0.000
Household debt	–0.9469***	0.2415	–3.92	0.000
Per capita income	0.0023***	0.0008	2.89	0.004
Constant	–0.1515***	0.0496	–3.05	0.003
σ_u = 0.0249				
σ_e = 0.0067				
ρ = 0.9333				
F test all u_i = 0 F (106,188) = 5.41 Prob > F = 0.0000				
F zero slopes F (10,188) = 18.35 Prob > F = 0.0000				
Number obs = 305				

The symbols *, **, *** indicate significance at 10%, 5% and 1%.

According to our results, all firm-specific determinants, with the exception of size, affect consumer credit company profitability significantly.

Other income, measured by non-interest income to total assets and included in the model to proxy diversification of product and services within lending to households, is the most influential driver of profit. The coefficient is positive and statistically significant at 1% level: a 1% increase in non-interest income as a share of total assets raises ROA by 0.51%. This result suggests that an improvement in non-interest sources of income arising from the supply of a wider range of products and services related to consumer credit – i.e. loyalty programmes on revolving cards, payment protection insurances, loan consolidation – will have a larger and positive impact on consumer credit companies' accounting profits. Lenders can have access to different market segments, widen potential customer bases, exploit cross-selling opportunities and satisfy more effectively different customer needs. This result is in contrast with part of the empirical literature on bank profitability (Section 2) that finds a negative relationship between diversification and profitability. We argue that this is due to the fact that while for banks diversification is realized by investing in different business activities, for consumer credit companies diversification means heightened customer service level within the traditional lending activity and this is likely to produce positive externalities for consumer credit companies.

Results also highlight that the contribution of *net interest*, which is a proxy for the profitability of traditional lending activities, is statistically significant and positive. In particular, a 1% increase in net interest income as a share of total loans boosts ROA by almost 0.5%. The coefficient of the variable *loans*, which is the size of the loan portfolio to total assets, is also significant and positive. This suggests that a business focused on credit lending generates higher profitability levels, since it increases the possibility to widen the loan portfolio into different market segments and this may raise the opportunity for cross-selling of other financial services.

Concerning the impact of credit risk, as expected, the coefficient of *credit risk* is negative and statistically significant at 1% level. This result may in part be related to the growth of consumer credit and the generally easier access to the market which raises the diffusion of this financial solution also among riskier borrowers (Cavalletti *et al.* 2008) and stresses the need for a continuous improvement in screening and monitoring policies.

Referring to the impact of overhead costs on ROA, we find that the coefficient of the variable *operating expense*, measured by the ratio overhead expenses to total assets, is negative and significant. This result implies that an increase (decrease) in these expenses reduces (increases) the profits of the consumer credit industry, and is consistent with the empirical literature according to which poor expenses management is among the main contributors to poor profitability.

The coefficient of the *capital* explanatory variable is negative and significant at a 5% level; although a lender with a sound capital position has more time and flexibility to deal with problems arising from unexpected losses, thus achieving increased profitability (Athanasoglou 2008), an increase in capital is likely to raise the cost of funding, thus reducing profitability.

The estimated equation also shows that the effect of consumer credit lender *size* on profitability is not significant. This result appears to conflict with the theoretical position which states that size allows for cost reduction due to the economies of scale generated. However, the absence of a statistically significant relation may stem from the fact that demand for consumer credit continues to grow and some companies have yet to reach the size necessary to exploit economies of scale.

As far as market-specific factors, the three explanatory variables, *credit diffusion*, *household debt* and *per capita income*, are statistically and economically significant and work in an opposite direction. The first variable, which is a proxy of the size of the market, is positively related to profitability. As expected, this result suggests that in a more mature market consumer credit companies may boost the development of market segmentation and may benefit from cross-selling and market segmentation. Since the volume of the business is bigger, companies may also benefit from the attempts to optimise asset portfolio sizes in order to generate the economies of scale necessary for the containment of the administrative and management costs associated with the supply of large numbers of small loans as well as to creating adequately diversified loan portfolios.

Household debt, measured by the ratio consumer credit to disposable income, is a proxy of the burden of debt and the coefficient is significant and negative. As expected, this result suggests that as long as individuals increase their debt to income ratio the riskiness of the market increases and this negatively affects the profitability of the market. Our finding is in line with the empirical literature that shows that an increase in debt burden increases the risk of over-indebtedness, which for consumer credit companies, increases the riskiness of their loan portfolios, which, in turn, reduces profitability.

Finally, the coefficient of the variable *per capita income* is positive and significant. In the empirical literature, the variable income is positively related to the demand for debt (Del Rio and Young 2005a). Consequently, a high level of *per capita income* may increase the size of the market and affect positively the lenders' profitability. At the same time, the variable income is found to be negatively related to the risk of over-indebtedness, thus high level of per capita income reduces household default risk, which again has positive externalities on lenders' profit (Del Rio and Young 2005b).

7. Conclusions

In this paper we analyse the effect of firm-specific and market-specific factors on the profitability of a sample of European consumer credit companies.

Empirical results suggest that among firm-specific effects the most influential driver of profitability is represented by non-interest revenues: the supply of increasingly diversified and sophisticated products increase ROA and may benefit the lenders' profitability. With regards to market-specific factors, the profitability of consumer credit companies is positively affected by the size of the market, which is a proxy of the level of maturity of the industry, and negatively determined by the level of household debt burden. This suggests that a more mature market is ready to absorb a wider and more sophisticated supply of products and services, with positive externalities on consumer credit company profitability. At the same time, a wider diffusion of consumer credit increases the debt burden of households, generally measured by the debt to income ratio, and may raise the potential risk of household default, with a negative impact on the profit of lenders.

The findings of this study have considerable policy relevance. It could be argued that the more profitable consumer credit companies may be able to offer a wide range of lending solutions, as well as financial services related to lending. Consequently, strategies to exploit customer segmentation policies linked to the development of a range of lending products targeted and marketed to specific customer types may generate competitive advantages. Moreover, in the light of opportunities for integration and expansion offered by the new Consumer Credit Directive, product diversification may clearly represent a competitive advantage in entering national markets with lower levels of maturity.

Results also show the need for consumer credit companies to focus on credit risk management policies. The increase in household debt burden, due to new spending models, changes in socio-cultural variables that have made personal indebtedness more acceptable, and to generally easier access to consumer credit, raises the risk of household over-indebtedness, with negative effects at individual levels and potentially high costs for the financial system due to worsening of credit quality levels. The effects of household over-indebtedness should be addressed not only by the credit system, but also by policy makers, who will have to address the potential socio-economic repercussions of the phenomenon. To this end it is argued that responsible lending and borrowing solutions need to be designed that are capable of preventing *ex ante* unsustainable levels of indebtedness and managing situations of temporary financial difficulties.

The topic is relevant and suitable for further development in at least two directions. First, a focus on “new” EU Member States from Central and Eastern Europe, where consumer credit diffusion has registered a high growth ratio in the last few years. Second, a deeper analysis of the finding of positive correlation between credit diffusion and profitability of consumer credit companies, since more mature markets are likely to meet rising difficulties in reaching high profitability levels, due to a likely increase in credit risk exposure.

Appendix

Table 1a. Consumer credit to GDP (in %)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
UK	14.12	13.77	15.36	15.49	15.86	16.16	17.06	16.58	14.93
EL	2.97	4.04	5.37	6.19	7.25	9.21	10.50	11.96	12.00
ES	7.47	7.69	7.16	7.37	7.09	7.40	8.49	9.39	9.85
IE	7.51	7.41	7.95	8.03	8.13	9.90	10.29	9.72	9.74
DE	10.72	10.79	10.52	10.47	10.67	10.72	10.42	9.84	9.23
AT	8.20	11.28	10.71	10.13	9.24	10.16	10.98	9.44	8.95
PT	5.93	6.69	6.24	5.81	6.27	6.29	6.31	7.33	8.46
FR	7.57	7.81	7.85	7.77	8.01	8.04	8.19	8.19	8.22
DK	na	7.19	6.83	6.42	6.41	6.56	6.58	7.07	8.17
SI	na	na	na	na	na	6.87	6.97	7.50	8.16
EU	6.32	6.72	6.99	7.05	6.97	7.40	7.76	7.91	7.97
IT	2.87	3.12	3.30	3.56	3.75	4.38	5.09	5.79	6.37
FI	2.50	2.36	4.57	4.66	5.02	5.29	5.97	6.24	6.28
BE	5.03	5.06	5.11	5.05	5.00	4.89	4.90	5.14	5.48
SE	na	na	na	na	3.49	3.65	3.83	4.29	4.29
NL	3.33	3.31	3.08	3.98	4.23	4.72	4.78	4.69	4.18
LU	3.95	3.59	3.77	3.80	4.14	4.10	3.81	3.36	3.18

Source: computations on national statistics (National Central Banks and Eurostat).

Table 2a. Consumer credit growth rate (in %)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
PT	9.35	20.78	–1.26	–2.50	10.40	4.23	3.83	20.98	21.19
SI	Na	Na	Na	Na	Na	Na	7.11	15.99	20.13
DK	Na	Na	–1.88	–3.06	1.88	6.95	5.65	13.92	19.46
UK	29.70	10.78	14.43	4.96	–1.46	10.04	9.18	16.58	14.93
IT	18.79	14.86	10.96	12.03	8.62	21.62	19.23	17.85	14.25
ES	18.21	11.94	0.50	10.25	3.34	12.14	23.86	19.39	12.26
BE	6.96	6.53	3.86	2.07	1.61	3.00	4.78	10.14	11.18
EU	13.09	15.04	14.49	7.63	6.95	12.47	9.79	10.31	8.88
IE	35.14	13.80	19.98	12.49	8.30	29.75	13.04	2.20	8.18
FI	0.29	1.93	104.48	5.01	9.26	9.89	16.73	10.86	7.82
EL	31.00	50.09	42.47	24.24	27.21	37.42	22.26	22.78	7.60
SE	Na	Na	Na	Na	Na	9.06	7.57	19.06	6.17

continued Table 2a

	1999	2000	2001	2002	2003	2004	2005	2006	2007
FR	10.44	8.73	4.30	2.44	6.11	4.53	5.87	4.77	5.06
LU	–5.62	0.45	7.82	7.19	16.67	5.86	1.66	–0.52	2.19
AT	11.55	44.79	–2.59	–3.29	6.52	14.75	12.33	–9.66	0.26
DE	–0.43	3.18	–0.07	0.87	2.93	2.62	–1.25	–2.38	–2.08
NL	4.74	7.65	–0.19	34.07	8.90	15.12	4.80	3.06	-6.47

Source: computations on national statistics (National Central Banks and Eurostat).

Table 3a. Consumer credit company data: the GLS Estimator (Random Effects Results) ROA: dependent variable

Variable	Coefficient	Std error	*z*-Statistic	$P > \|z\|$
Size	0.0015**	0.0007	2.10	0.036
Capital	0.0333***	0.0121	2.75	0.006
Loans	0.0393***	0.0060	6.53	0.000
Net Interest	0.5069***	0.0302	16.78	0.000
Income diversification	0.3726***	0.0349	10.69	0.000
Operating expenses	–0.3017***	0.0342	–8.82	0.000
Credit risk	–0.6808***	0.0742	–9.19	0.000
Credit diffusion	1.2684***	0.3342	3.79	0.000
Household debt	–0.9671***	0.2606	–3.71	0.000
Per capita income	0.0030***	0.0008	3.72	0.000
Dummy captive	–0.0062***	0.0022	–2.78	0.005
Dummy foreign	0.0015	0.0022	0.70	0.484
Dummy France	–0.0259***	0.0103	–3.08	0.002
Dummy Germany	–0.0341***	0.0095	–5.05	0.000
Dummy Italy	–0.0268***	0.0108	–3.20	0.001
Constant	–0.0987***	0.0178	–5.54	0.000
σ_u	0.0077			
σ_e	0.0067			
ρ	0.5738			
Wald chi^2 (16) = 470.67 Prob > chi^2 = 0.0000				

The symbols *, **, *** indicate significance at 10%, 5% and 1%.

Table 4a. Consumer credit company data: the Within Estimator (Fixed Effects results) ROE: dependent variable

Variable	Coefficient	Std error	*t*-Statistic	$P > \|t\|$
Size	–0.0122	0.0401	–0.30	0.762
Capital	–0.9930***	0.2980	–3.33	0.001
Loans	0.3151***	0.1016	3.10	0.002
Net Interest	3.1000***	0.5685	5.45	0.000
Other income	3.2483***	0.7109	4.57	0.000
Operating expenses	–0.6792	0.4349	–1.56	0.120
Credit risk	–4.3088***	0.9822	–4.39	0.000
Credit diffusion	9.3264***	3.3667	2.77	0.006
Household debt	–8.2911***	2.6159	–3.17	0.002
Per capita income	0.0228**	0.0090	2.54	0.012
Constant	–0.3064	0.5314	–0.58	0.565
$\sigma_u = 0.1925$				
$\sigma_e = 0.0705$				
$\rho = 0.8818$				
F test all $u_i = 0$ $F(106,184) = 7.75$ Prob > F = 0.0000				
F zero slopes $F(10,184) = 6.90$ Prob > F = 0.0000				
Number obs = 305				

The symbols *, **, *** indicate significance at 10%, 5% and 1%.

Table 5a. Consumer credit company data: the GLS Estimator (Random Effects Results) ROE: dependent variable

Variable	Coefficient	Std error	*z*-Statistic	$P > \|z\|$
Size	00227**	0.0092	2.46	0.014
Capital	–0.6608***	0.1464	–4.51	0.000
Loans	0.3280***	0.0698	4.70	0.000
Net Interest	3.1992***	0.3628	8.82	0.000
Income diversification	2.4625***	0.4102	6.00	0.000
Operating expenses	–1.4818***	0.3847	–3.85	0.000
Credit risk	–4.1937***	0.8195	–5.12	0.000
Credit diffusion	9.2410***	3.4363	2.69	0.007
Household debt	–8.6000***	2.6754	–3.21	0.001
Per capita income	0.0203**	0.0082	2.48	0.013
Dummy captive	–0.0788***	0.0288	–2.73	0.006
Dummy foreign	–0.0141	0.0289	–0.49	0.624
Dummy France	–0.1644**	0.0895	–1.84	0.066

continued Table 5a

Variable	Coefficient	Std error	*z*-Statistic	*P* > |*z*|
Dummy Germany	–0.2539***	0.0730	–3.48	0.000
Dummy Italy	–0.2417***	0.0885	–2.73	0.006
Constant	–0.5182**	0.1999	–2.59	0.010
σ_u	0.1111			
σ_e	0.0750			
ρ	0.7132			
Wald chi^2 (15) = 149.12 Prob > chi^2 = 0.0000				

The symbols *, **, *** indicate significance at 10%, 5% and 1%.

Table 6a. Consumer credit company data: Hausman Test FE versus RE ROE: dependent variable

Fixed	Random	Difference	S.E.
–0.0122	0.0227	–0.0348	0.0391
–0.9930	–0.6608	–0.3322	0.2596
0.3151	0.3280	–0.0130	0.0737
3.1000	3.1992	–0.0992	0.4376
3.2483	2.4625	0.7858	0.5806
–0.6792	–1.4818	0.8026	0.2029
–4.3088	–4.1938	–0.1150	0.5414
9.3264	9.2410	0.0854	.
–8.2911	–8.5999	0.3088	.
0.0228	0.0203	0.0024	0.0036
Chi^2 (11) = 40.60 Prob > chi^2 = 0.0000			

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Summary

Cândida Ferreira

European Financial Integration and Economic Growth

This paper is a contribution to the empirical analysis of the link between financial intermediation and economic growth, more precisely the real GDP per capita growth, in the context of the European Union and particularly in the context of the recent enlargement to new member-states, however, just before the last financial and economical crisis.
We use panel fixed effects estimates considering two sub-sets of EU countries: the first comprises 11 "old" EU countries, (Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom) for the period between Q1 1980 and Q3 2006; the second panel includes 26 EU countries, excluding only Luxembourg, for the period between Q1 1999 and Q3 2006.
The results obtained allow us to draw conclusions not only on the importance of the considered financial variables to economic growth, but also on the level of integration in the two considered sub-sets. There is evidence of financial integration in the form of the similarities in the behaviour of the different countries, in spite of their different initial conditions.

Mirosław Bojańczyk

The Ineffectiveness of the State as a Regulator in the Global Economy

The global market is largely a game without rules and without an arbitrator able to dispense the necessary medicine. Undoubtedly, the crisis has caused the emergence of new challenges, which require the active role of the state in various areas. States play the role of company owners and market regulators. Unfortunately, governments have not been performing these functions adequately. Those therefore, who themselves committed many mistakes, must improve not just the mis-functioning market, but also a defectively functioning state; or, to put it in other words, they must improve themselves.
The negative experience of state intervention has led many to conclude that the lesser the role of the state, the better. It does not appear, however, that such a conclusion is fully justified. Please note that the absence of state in the economy could be as damaging as an excess of it. In view of the increasing costs and risks associated with globalisation, there is a need to increase the role of the state in order to decrease the adverse effects of this process.
Determination of the adequate role of the state is one of the most difficult problems that arise in the process of globalisation. The macroeconomic policy is a very important issue; it should be shaped so as to foster economic growth. The budget deficit and inflation must be reduced. Whenever a deficit occurs, it is important how it is financed. In constructing the budget, it is of paramount importance to have the share of fixed expenditure not too high. This increases flexibility. A budget should also include

off-budget operations. This will make a better assessment of government finances possible.

As the capital market develops, the state largely loses its ability to act. To attract capital, the state must submit to the requirements of capital. Taking action unfavorable to capital means that capital leaves (this is a kind of punishment). From this point of view we can say that the state loses its significance, because it may not take certain actions at will. Incompleteness of political and economic globalisation promotes the growing strength of the capital market. The flow of labour remains blocked, while capital is on the move. Despite these limitations of the States' ability to act, there are new trends and the impact of new challenges. Without the active role of the State the adverse consequences of development of capital markets cannot be restricted. These measures must however be carefully considered and subject to a certain logic. It is essential to identify the causes of instability.

Anna Dąbrowska, Anna Olejniczuk-Merta

Sustainable Consumption as a Challenge for 21st Century Communities

This article considers the opportunities of developing sustainable consumption, which is an integral part of sustained development and at the same time it is a challenge for the communities of the 21st century. It focuses on the presentation of two contradictory tendencies and objectives in modern consumption: consumerism and sustainable consumption, and which follows the search for methods to ensure the development of sustainable consumption. The problem of sustainable consumption has recently become a major issue raised not only by ecologists but also by politicians, scientists and consumer organisations operating both locally and globally. Despite the flow of time, there is still some discrepancy between the theoretical assumptions and implementation of sustainable consumption in practice. Much depends on the consumers themselves. The style of life needs to be changed to consider consumption together with respect and care for the natural environment, other people and future generations. This should result in more conscious consumption decisions. There is a dilemma though: how to reconcile sustainable consumption and the corresponding higher prices or resignation from a number of products, thus limited satisfaction of needs, especially those artificial ones, with growing consumerism. Consumerism results from the desire to meet newer and newer needs, especially those created artificially. That is why, it is more and more important to accumulate wealth (goods and services) without considering the effects of such decisions: social, ecological or individual costs. Special attention has been paid to the problem of the quality of life from the perspective of sustained development as well as the significance of education in the process of the development of sustained consumption.

Giovani Feretti

Basel II and the consequences of its implementation on the SMEs system

The article discusses the effects that the normative Basel II has had on the SMEs (small and medium-size enterprises) sector.

It shows how the pro-cyclicality of Basel II rules is likely to limit the access to credit for SMEs. Moreover, a categorisation of the possible influence of Basel II on the SMEs is proposed with the focus on the rules defining the bank's capital requirements concerning the access to credit for SMEs. The author's opinions are supported by the views of notable scholars and deep research of the literature on the topic.
The last part of the work describes the influence that the current financial crisis has had on the SMEs sector. After briefly reporting the main actions conducted by the national governments in order to support the SMEs, the issue of the possible exacerbation of Basel II pro-cyclical effects on the SMEs during the current financial turmoil is analysed. In the end, the author presents its further considerations of a possible strategy in order to guarantee a sounder and safer policy for the SMEs activity.

Luisa Anderloni

Consumer Credit Companies: an Empirical Analysis of their Profitability

This paper focuses on the profitability of the consumer credit industry in Europe. Using consumer credit companies' financial statement data, we investigate the effect of firm-specific and market-specific factors on the profitability of a sample of French, German, Italian and Spanish consumer credit companies over the period 2005–07. Results highlight that, among firm-level determinants, diversification of products and services within lending to households is the most influential driver of profit. With regards to market-specific factors, the profitability of consumer credit companies is positively affected by the size of the market, and negatively determined by the level of household debt burden.