

# Political Economy

“We live in a period in which the specialists in macroeconomics come up with new hypotheses on the mechanisms which govern the economy and are look to formulate a new paradigm... Pluralism represents the best solution, its periodic manifestations being unavoidable anyway.”

**Edmund S. Phelps**

Economic research is most often stirred by political ideologies. Just for the fact that it has to search for answers to problems complicated in their evolution by political decision, the research positions the diagnosis at the limits of reality and, more often than not, beyond these. Somewhat symptomatic, economic research is a prisoner in the court of politics.

But there is something more profound and with wider consequences, relating to the gene of economical research, born at the dawn of modernity: the reality it tries to tackle is part of the plethoric phenomenology of politics. The principles to which Economics must conform are the rationality claims of the Prince. The world, with its powers and hopes, with its resources and its needs, has taken each time the appearance of the Prince. Only in the fictions of Athenian academies was the economy a domestic recipe, of household administration. In the Agora, the economy would listen to the orders of the King and Economics, entwined with Philosophy, would fashion algorithms to satisfy the King's ambitions.

In the preamble of modernity, which prepared the triumph of Machiavellian cynicism, Economics has invented its emancipation from the suzerainty of the Prince by proclaiming the market as of immanent reason and universal will. The sui generis secularization and the breaking of personalized dependencies has made the economy the sole adventure of winning, to counteract the impossible: personal happiness and social liberty. Money has completed the illusion of the redemption from the curse of solidarity and has opened instead a rational Eldorado for the confirmation of inequality. The access to power has become a problem with a rational solution called money. The Prince has quickly taken on the vestment of the money fabricant, his divine power being fully secularized.

In its new situation Economics did no longer feel degenerate in its ambition as it had felt when it had to deal with household chores. The altitude of interests has gradually increased, the stakes have risen in importance and the results have sublimed. The market encompasses everything, money produces freedom, close living means efficiency, insurance predetermine metabolism, energy anoints the Prince.

The imprint of rationalization became general. Life can be invented, beings can be replicated. In a rationalizing perspective emotions become an atavism, sentiments alter the sense of life if they cannot be marketed. Morality, by not generating efficient order, is replaced with contextually accepted norms. From the rule of relative majority the transition is made to the absolute truth of the self-legitimizing minority. The expansion of reason and rationality rediscovers the primal cause and the final cause

by the functionalization of political correctness. Hobbes is sanctified through the ritual of reason.

Within these lines, Economics seems to feel comfortable as a science. Its knowledge sustains the reproduction of the artificial to the detriment of the natural. The biological world is replaced in its productivity functions by the virtual world. The absolute efficiency is announced possible. Speculation becomes the royal path towards gain. The soap bubble has the consistency of the nōosphere. The frenzy of productivity justifies rational choices and the rising trend is a consequence of mutual expectations. The state of wellbeing is the profit, unlimited by the undervaluation of human resources. Production migrates so that the cost of labor stays low. The New Economy is irremediably still political. It is the politics of absolute efficiency. Which, no matter how we would try to exorcise partisan passions, excels against human nature.

The highway of modernity represented by rationalization has pushed Social Sciences, including – and maybe especially – Economics in the abyss of self-referentiality. The supreme mark of this failure is the value attributed to man as labor force in the equation of profit. To guard against the perpetuation of failure, Economics must remain entwined with Politics in its Aristotelian sense and not with its representation by the Enlightenment as the final cause of progress – the “Politically Correct”.

The ambition of Smithian regularization through the rationalization of the conflicts of interest in the alchemical melting pot of the Market – a sort of anticipation of paraconsistency – has pushed Economics beyond what was its natural source, meaning beyond what science historians call “the culture of uncultured people”. The attempt of inventing universal problems for Economics was and stays an epistemic failure each time when there was disregard for contextual determinations, experience, tradition, motivation etc. To the extent to which it considers itself a science, Economics solves particular problems, limited in space and time. In its modernity, Economics gains through the “culture of people without an economic education” – which today we call entrepreneurs, investors, developers a.s.o. – rather than through scientific research. The most nimble in finding rational solutions to the interests of Politics are exactly the crusaders of the profit. They are the ones to have intuited that there are gains to be made from Political Economy. They value true contradictions.

Stripped of the “culture of uncultured people”, Economics would lose itself in its illusory project: the rationalization of ideologies.

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# Overtime – whereto?

■

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**Abstract.** *The overtime with respect to the normal working hours determined by law and organization rules are a source of apparent profit, but when exercised without a strict control leads to rapid “depreciation” of human resource, causing alienation and stress. Overtime abuse indicates ignorance of the main vector for growth and organizational and social development. Managers should make efforts to understand these fundamental truths instead of pushing the legal limits to risk rules reinforcements by the control authority.*

**Key words:** aggregate programming; aggregate programming additional costs; overtime additional costs; employ/release; shortsighted managers; economic model; socioeconomic model.

■

**JEL Classification:** A13, J22, J24, M12, M50, O15

## 1. The demand game

The variation of demand at the moment  $t$  ( $Q_t^D$ ), particularly in the highly competitive environments with a system of customers driving the suppliers' behavior, is the free variable of the goods and services processing system. *Matching demand is the essential paradigm of every organization.* Actually this is achievable in three steps: forecast, plan and program. For the organizations in the current context, the *aggregate programming* is added between the later two steps, to improve efficiency. This allow managers to reach a certain processing level based on the estimated demand and using a global representation of the resources.

The decision making rule is as follows:

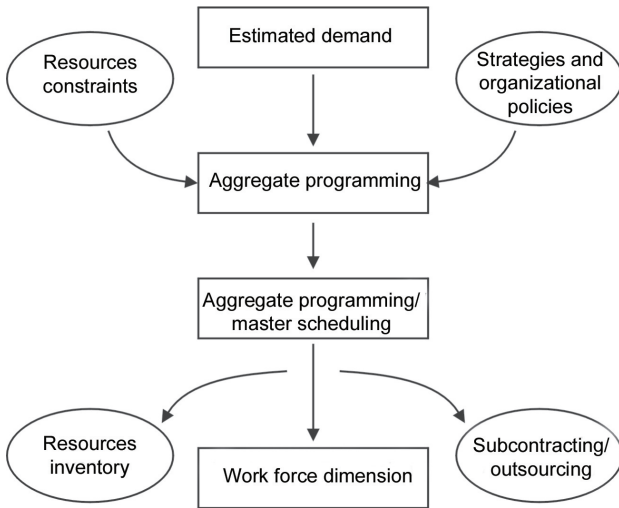
$$Q_t^S = Q_{t-1}^S + A \times (Q_t^D - Q_{t-1}^S)$$

Where:

$Q_t^S, Q_{t-1}^S$  is the level of processing at the moment  $t$  and  $t - 1$ , respectively;

$Q_t^D$  the level of demand from consumers at the moment  $t$ ;

$A$  a constant belonging to the  $[0,1]$  interval.



**Figure 1.** Aggregate programming process synthesis

The case  $A = 0$  corresponds to the uniform constant processing strategy, whereas in the case  $A = 1$ , the strategy is to follow the demand curve, and although the later is the more effective, the question arises whether the organizational resources suffice to achieve this desired goal. The answer is negative more often than not.

### 2. The additional costs of the aggregate programming or a solution

To achieve the dynamic balance between the functions  $Q_t^S$  și  $Q_t^D$ , the aggregate programming offers a system of additional costs, and although they are not represented as such in the accounting of the organizations, they influence or determine their performance. Thus, we may mention:

- the additional cost with the inventory maintenance, the inventory being required to absorb the demand fluctuations;
- the additional cost of employing/releasing work force to follow the demand variations;
- the additional cost of increasing/decreasing the labor hours;
- the additional cost of subcontracting work to other organizations;
- the additional cost of the short supply of goods and services;
- the additional cost of the part-time work etc.

If we use the notation  $C_i$  for each additional cost considered, rational managers pursue the following function of the aggregate programming:

$$\min f = \min \sum_{i=1}^n C_i$$

Where  $n$  represents the number of additional costs used by the decision maker;

### 3. The overtime additional cost

The top theories advance combinations of additional costs (combined strategies), but in practice there is a preference of certain additional costs such as the overtime used with ability, in such a case  $Q_t^S > Q_m$ , where  $Q_m$  quantifies the level of processing according to the internal rules of the organization.

Due to the excessive use of this additional cost, we will analyze it regardless of the others. This additional cost is determined as follows:

$$C_{ms} = c_{ms} \times (Q_t^S - Q_m)$$

Where:

$c_{ms}$  is the unitary overtime additional cost, with respect to the unit of good / service.

Logically:

$$c_{ms} = k \times C_m$$

Where:

$$k \in [1,5 - 2]$$

$C_m$  is the cost of the legal time labor.

If the demand variation is not extreme, a rational managers decision could be:

- i) Keeping the competent workers;
- ii) Investment efforts including employment if the demand stays over capacity for longer; another efficient and effective solution is also the *part-time* work, which usually generates less costs than the *full-time* work;
- iii) Using subcontracting, outsourcing or offshoring of some products or services.

The solutions above should not be taken in absolute terms because they have their shortcomings, as for instance the lack of skill and experience in case of *part-time* work, or reducing profits, lengthening the processing cycle and even stimulating potential competitors in case of subcontracting. Offshoring is a rather new technique to outsource certain services in cheap and qualified labor countries (for instance India, but also Romania). However, this method is usually employed for support activities rather than the main activity, for instance for payrolls and human resources management, lacking relevance for the demand following strategy.

With all shortcomings, the solutions above are useful and keep labor in a normal process economically and socially.

### 4. Other factors which lead to overtime abuse

Besides the demand following strategy, overtime is due to a couple of other factors.

Firstly, we may remind the systematically ineffective time allocation for activities. Norman R. Augustine, ex-president of Lockheed Martin Corporation, demonstrated on a statistic basis that activities are completed in a time interval greater by 1.33 on average than that initially allocated (Augustine, 1997).

This systematic time budget extension leads to time crisis and subsequently to overtime abuse, if the time reserves are not planned and correctly dimensioned. In this context we recommend the allocation of reserve time buffers for each activity based on the Critical Chain Project Management (Goldratt, 1997).

Another factor is psychological, having less to do with managerial decision.

In 1993, a start-up organization employed just 10 people, without hierarchy, specialization or organizational structure. After the first months of activity to prepare market launch, the business owner decided to examine the employees. Each should rank the others on their contribution to the organization's goals. After gathering all papers, the business owner determined an overall ranking for all 10 employees. He was not particularly interested in the ranking itself as in which employee had a perception closest to this "objective" ranking. He explained that objective and accurate assessment of the human performance is the key problem of the management and he nominated this person with the most balanced perception in the job of general manager, over the other nine.

Returning to overtime abuse, we believe that it is driven sometimes by the desire of employees to show off and even out of a sense of guilt. When assessment criteria are strictly based on working hours, we may end up in such a context with overtime abuse.

A remarkable example is a test performed on members of an organization. The test aimed at identifying factors driving to a better impression about the work of a member of the organization. The test consisted of two questions: "Who is in your opinion the most dedicated employee? What is your judgement based on?".

To our surprise, the person indicated by most respondents was a rather ineffective and inefficient director, who spent most of the time in the office. His quality was loyalty, but he was always late with his tasks, and for this reason he was the first to arrive and the last to leave. The results of this director were insignificant as compared to others, and with respect to his willingness and diligence.

We thus identified the mechanism of guilt, which favors the one who seems to sacrifice himself for the firm. Curiously, some much more productive directors were feeling guilty, directors who could take 10 minutes to solve a problem which consumed a whole week to the former director.

The bad organization is yet another key factor to induce overtime. For instance, in Romania all companies are supposed to close the financial year on the 31<sup>st</sup> of December, which puts an enormous pressure on accountants, auditors, asset managers and the like. A more logical approach would be to avoid this assault by using a rotation method, as in other countries: 1/12 of the companies end the year on December 31<sup>st</sup>, 1/12 on January 31<sup>st</sup> etc. The assault is thus avoided.

## 5. Romanian organizational realities

The overtime is constantly used in the organizational strategies, and yet it is limited within the working day and within a time interval according to the master scheduling or the aggregate program. Thus, a limit recommended by managers in developed countries is three months, beyond which, depending on demand fluctuations and internal processing capacity, employment and release decisions are taken.

Managers of certain companies in Romanian (for instance some multinationals) ignore this limit of twelve weeks of overtime extension, claiming the lack of efficacy and ferocious competition. In reality, this is a symptom of lack of organization and of managerial performance.

Moreover, the uncontrolled overtime prevents human development and progress, which is the most valuable strategic reserve for every organization. Shortsighted managers take sides for the "economic" model, which claims that the company is better off with a profit-only oriented approach. In the same time the employees fall in this "trap" without a realistic long-term analysis, but is it possible that an educated young work force to do such an analysis under the circumstances of the hierarchy of needs pyramid and the realities of the prolonged transition economy to the real institutionalization of the market mechanisms?

We believe the answer is negative, and the organizational behavior gets polarized to the extremes. One part resort to primordial needs, but declines individual and ultimately social development, whereas the other part, in excess of 50%, gear up to the profit making machine, pursuing their own financial support to face a turbulent, changing and little predictable environment.

Based on both theory and practice, we would need to reiterate the thesis of the 4E based organizational performance: Economy, Efficiency, Effectiveness, and Equity. The first E (in a sense of low inputs with compliance to the specifications), and also the Efficiency and Effectiveness are applied brilliantly sometimes, whereas the fourth (the Equity), with its forms of discretionary ethical and legal responsibility, gets simulated.

We may question if circulated concepts such as “*corporate responsibility*”, “*community involvement*”, “*social awareness*” and others are really implemented.

Some managers should remember the socio-economic model, based on the idea that business is not founded solely on its own profit, but instead on the impact of the decisions in the society, and in this case rational decisions may lead to a profit margin accepted by all *stakeholders*.

## 6. Conclusions

The business equity applied in the field of labor leaves the employees with some time for their own, for cultural, family and sport activities and through its social desirability turns into a market breakthrough and securing the competitive advantage. Thus, increasing profit is correlated or convergent to a good managerial practice.

Through these conclusions we do not intend to destroy any model, and yet we suggest a wider image than the unilateral economic responsibility, extended to other types of responsibility ignored by the excessive managerial behavior. Otherwise, the future of some organizations will be threatened by flaws in the human resources development. We reiterate the biologic model of the organizations as opposed to the mechanical model.

In conjunction with the overtime, the following ideas and practices are derived from the experience of the authors:

- the overtime would be better viewed as a symptom of bad organization and inefficiency;
- continuous overtime increases risks for work accidents (this theory has been sadly confirmed many times);
- home overtime work should be discouraged (besides respecting rest time, there is a security issue regarding the circulation of the official documents beyond the office building);
- the office hours of the managers should not be subject to accounting (although we recommend

electronic logging), meeting targets is more important; when targets are not met, managers get monitored more closely on terms of effectiveness and efficiency, still not on time spent in the office; is idea is controversial, but we believe an organization is not supposed to rely on managers failing to voluntarily participate as a minimum responsibility level;

- overtime grows when the employee fixes each problem in turn, out of a problem stack; the model we tried to implement is the following: the employee never confronts a single problem, but a class of problems selected from the stack, creating a standard operating procedure (SOP), later implemented in software and automated; thus, productivity increases tenfolds, and in less than a year we end up with 90% of the problems having a standardized solution, leading to a sort of redundancy: the employee sees the things working out by themselves, and develops a sense of guilt and usefulness mentioned earlier; we need to counter this symptom, for instance by stating that “the ideal manager has plenty of time”;
- excessive overtime is sometimes correlated with the lack of understanding of the power of statistics; for instance, in a restaurant opened non-stop we do not need D7H24 supervision; low profile supervision is required in a sample of time intervals only, enough for satisfactory analysis and decision making; for instance, 12 hours a month would suffice, which means a sample base of 1/60
- in many organizations are now implemented high accuracy cost systems, which put pressure on the employees, who are not able to complete all their reports in the working hours and resort to “voluntary” overtime; more often than not, the accuracy of these systems does not pay, they come at an unjustified cost of their own and they sacrifice once again the employees.

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# Disciplinary Accountability in the Financial Area



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***Abstract.** The disciplinary accountability of the personnel from the local public administration is differently regulated, depending on the personnel category. The disciplinary accountability of the civil servants is an administrative-disciplinary accountability regulated by the Law no. 188/1999 concerning the Status of the civil servants and can take place only under the circumstances stipulated by law, while the disciplinary accountability of the persons hired on the basis of the individual work contract is regulated by the Work Law, Law no. 53/2003 and can take place only under the circumstances stipulated by this law. The only basis of the disciplinary responsibility is the disciplinary infringement, that in fact represents a deed related to work, a deed consisting in an action or inaction carried out with guilt by the employee, through which this one broke the legal norms, the internal regulations, the individual work contract or the applicable collective work contract, the orders and the legal dispositions of the hierarchical superiors (Law no. 53/2003, Art. 263, Paragr. 2).*

**Key words:** disciplinary accountability; disciplinary infringement; disciplinary sanction; civil servant.



The *disciplinary sanctions* are those means of compulsion stipulated by law, with highly educative character, that have as purpose defending the disciplinary order, developing the spirit of being responsible for accurately fulfilling the job duties and respecting the norms of conduct, as well as preventing that indiscipline acts are made.

## **1. The administrative-disciplinary accountability of the civil servants that operate in the financial field**

The administrative disciplinary accountability is based on the existence of an administrative law relation, resulted from an administrative act, namely the act of appointing in a public position (Preda, 1999). There is a legal definition of the disciplinary infringement made by the civil servants that influences directly any attempt to define the institution of the administrative disciplinary responsibility. The

legislator showed that „*if the civil servants break with guilt the duties belonging to their public function and the norms of professional and civic conduct stipulated by law, this represents a disciplinary infringement and leads to disciplinary sanctions*”.

The disciplinary responsibility of the civil servants is an important component of the wider area of the administrative accountability. It fundamentally differs from the disciplinary responsibility specific to the work law. The administrative-disciplinary infringement can be committed only by persons with a special quality, that of civil servants. Analyzing the conditions for the existence of any form of administrative accountability, we realize that for the existence of the administrative disciplinary accountability, certain conditions must be fulfilled, there has to exist administrative disciplinary infringements and sanctions with certain characteristics. All these elements are shown in figure 1.

THE ADMINISTRATIVE DISCIPLINARY RESPONSIBILITY	
Conditions	Characteristics
<ul style="list-style-type: none"> <li>- Unlawful deed (disciplinary infringement)</li> <li>- Damaging result</li> <li>- Cause-effect relationship between the disciplinary infringement and damage</li> <li>- The doer is not a company</li> <li>- The guilt takes all the forms</li> </ul>	<ul style="list-style-type: none"> <li>- It is a form of the administrative accountability, it has a marked character of sanction</li> <li>- It is a form of personal accountability</li> <li>- It is based on breaking a relation of administrative law</li> <li>- It is based on the guilt of the subject</li> <li>- The sanctions do not deprive of freedom</li> </ul>
Disciplinary infringements	Disciplinary sanctions
<ul style="list-style-type: none"> <li>- Repeatedly not respecting the work schedule</li> <li>- Systematic delay in doing the works</li> <li>- Unmotivated absences from work</li> <li>- Not respecting the professional secret or the confidentiality</li> <li>- The unjustified refuse to fulfill the job duties</li> <li>- Repeated negligence in solving tasks</li> <li>- Deeds that harm the prestige of the authority or of the public institution where the person works</li> <li>- Breaking the legal provisions concerning incompatibilities, conflicts of interests</li> <li>- Carrying out during the work schedule of activities with political character</li> <li>- The civil servants establish direct relations with the petitioners in order to solve their requests.</li> </ul>	<ul style="list-style-type: none"> <li>- Written reprimand</li> <li>- Diminishing the wage rights with 5-20% during a period of maximum 3 months</li> <li>- Suspending the right of advancing in salary degrees or of promotion over a period of 1-3 years</li> <li>- Passing to an inferior public position over a period of maximum a year, with the appropriate decrease of the salary</li> <li>- Dismiss from the public position</li> </ul>
	Individualization of the sanction
	<ul style="list-style-type: none"> <li>- The causes that determined committing the disciplinary infringement</li> <li>- The seriousness of the disciplinary infringement</li> <li>- The circumstances in which the deed was made</li> <li>- The general conduct of the public servant during work</li> <li>- The consequences of the disciplinary infringement</li> <li>- The existence in the antecedents of the civil servant of other disciplinary sanctions.</li> </ul>

**Figure 1.** *The conditions and the characteristics of the disciplinary responsibility, the disciplinary infringements and sanctions*

Under the aspect of the juridical system of procedures, the administrative disciplinary infringements made by civil servants follow an administrative contentious procedure, while all contraventions follow a jurisdictional procedure regulated by the frame-law concerning contraventions. The administrative disciplinary sanctions applicable to the civil servants (Law no. 188/1999, Art. 65, Paragr. 3), Letters a), b), c), d) and e)). The disciplinary administrative sanctions are measures of compulsion with educative effect. Applying them has as purpose defending the order and the discipline in institutions (Preda, 1999). These are:

- *the written reprimand* is the written notification through which the doer of the administrative disciplinary infringement is warned that he didn't accordingly fulfilled his obligations as civil servant;
- *diminishing the salary with 5-20% over a period of maximum 3 months* is mostly a sanction with patrimonial character. The correction is carried out through diminishing the incomes of the infringer;
- *suspending the right of advancing in salary degrees or of promotion over a period of 1-3 years* is a sanction with a compelling character, addressed to the civil servants;
- *passing to an inferior public position over a period of maximum a year, with the appropriate decrease of the salary* is mostly a compelling sanction, but also a sanction with important patrimonial consequences, that applies to infringements that bring serious damage to the company where the doer carries out his activity;
- *dismiss from the public position* is an extreme measure and has as immediate effect that the work relations of the sanctioned civil servant stop.

*The individualization of the sanction* (Law no. 188/1999, Art. 65, Paragr. 4), that applies after mobilizing the disciplinary accountability of the civil servants, is realized by taking into consideration the causes that determined making the disciplinary infringement, the seriousness of the disciplinary infringement, the circumstances in which the deed was committed, the guilt degree of the doer, the consequences of the disciplinary infringements, the general conduct at work of the doer, the existence in the antecedents of the doer of other disciplinary sanctions that weren't deleted under the conditions of the law. Based on the intimation or on the official finding concerning administrative disciplinary infringements, the management of that company has to order an investigation, according to the Law of the Status of the Civil Servants, according to which the disciplinary sanction is applied only after making the previous investigation of that unlawful deed. Applying the disciplinary sanctions such as the written reprimand can be made directly by the manager of the authority or of the public institution where the sanctioned person works, at the proposal of the chief of the compartment where that person works. If the sanction to be applied is one of the sanctions stipulated by the Law no 188/1999, other than the written reprimand, this can be made only by the manager of the authority or of the public institution, at the proposal of the discipline committee.

*The discipline committees* are organisms built within each public authority; they have the competency to investigate each infringement made by the public servants from the institution or the respective public authority and to propose a way of sanctioning the persons that are guilty of any disciplinary infringement. These organisms have only the right to make proposals concerning the



opportunity of the sanction and the sanction modality, but the decision belongs to the manager of that authority or public institution. Finding the infringement and applying the sanction is made in writing, through an order issued by the manager of the authority or of the public institution, with the exceptions stipulated by the law, at the proposal of the discipline committee. If the civil servant is dissatisfied with the applied sanction, he can address the administrative contentious instance (Law no. 188/1999, Art. 68), he can ask either the cancellation or the modification of the order. The way the discipline committee is built and the way its activity is carried out is regulated by the Government Order no. 1210/2003 concerning the organization and the activity of the discipline committees and the par committees from within the public authorities and institutions. The disciplinary sanctions can be applied to the civil servants only after the previous investigation of the committed deed and after the hearing of the civil servant, which must be noted down (Law no. 188/1999, Art. 66, Paragr. 3).

## 2. The disciplinary accountability of the employees (typical for the work law) who work in the financial field

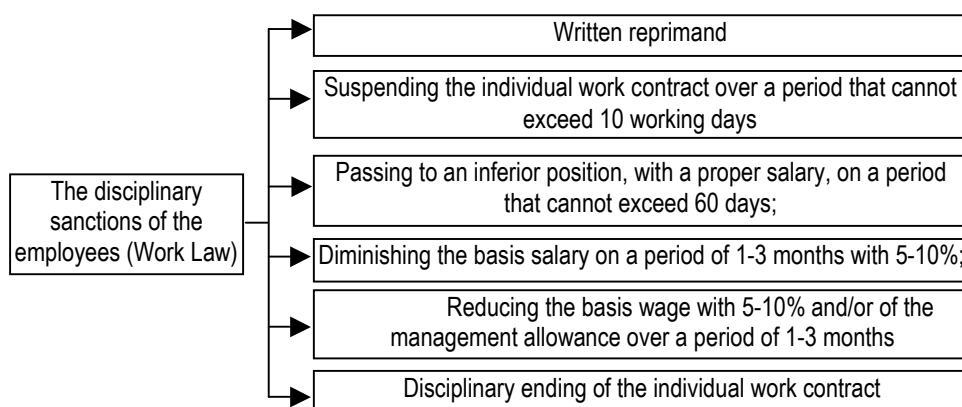
The disciplinary accountability of the employees (the notion of employee defines in this paper the person hired on the basis of an individual work contract) is an institution typical for the work law and consists in a set of legal norms concerning sanctioning the guilty deeds of an employee, no matter the position or job he has, deeds that represent breaking the obligations made through the individual work contract, including the norms of conduct (Ghimpu, 1997). Similar to the civil servants, the disciplinary accountability of the employees has three important functions achieved simultaneously: sanctioning, preventing and educating.

The legal basis of the disciplinary accountability of the employees is the individual work contract. The hierarchical subordination is the consequence of closing the individual work contract and at the same time the legal fundament for the fact that the management is authorized to apply disciplinary sanctions. The disciplinary accountability of the employees defends the internal order from that unit and it can be activated only in the case of the existence of the work relations and not after the ending of the work contract of the guilty person, as it happens in the case of the patrimonial accountability.

The characteristic features of the disciplinary accountability of the employees are similar to the ones of the administrative disciplinary accountability of the civil servants mentioned above. The independence of the forms of juridical accountability, due to differentiating its object of activity from the object of other forms of juridical accountability, has as consequence the possibility of cumulating the accountabilities for a deed unique in its materiality, but that harms several social values protected by law (Ghimpu, 1997). In this way, it is possible to totalize the disciplinary accountability with the material accountability, the criminal accountability, the contravention accountability and with the civil accountability.

In the area of the public finance, the disciplinary sanctions of the persons hired on the basis of an individual work contract do not have special characteristics. These sanctions are (figure 2):

- *the written reprimand;*
- *suspending the individual work contract over a period that cannot exceed 10 working days;*
- *passing to an inferior position, with a proper salary, on a period that cannot exceed 60 days;*
- *diminishing the basis salary on a period of 1-3 months with 5-10%;*
- *reducing the basis salary with 5-10% and/or of the management allowance over a period of 1-3 months*



**Figure 2.** The disciplinary sanctions that can be applied for financial infringements to the persons hired on the basis of the individual work contract

The *disciplinary ending of the individual work contract* is the most serious disciplinary sanction regulated by the Work Law and has as effect the ending of the work relation at the initiative of the unit due to very serious acts of indiscipline. Through professional statuses approved through special laws, another system of sanctions can be established for certain categories of employees.

*Applying disciplinary sanctions.* The disciplinary sanction is applied according to some rules of procedure with the role of guaranteeing the exact establishment of the facts, to guarantee the right of self defense for those persons and to ensure the efficiency of the struggle against the disciplinary infringements that disturb the community of that unit. „The disciplinary action”, as called in the literature (Ghimpu, 1997), is not an action from a jurisdictional perspective, but a privilege of the ones that manage the work process having as ground the individual work contract. For the same disciplinary infringement, one can apply only one disciplinary sanction. The employer establishes the applicable disciplinary sanction, depending on the seriousness of the disciplinary sanction and takes into consideration the following elements: the circumstance in which the deed was made; the guilt degree of the employee; the consequences of the disciplinary infringement; the general conduct of the employee at work; the possible previous disciplinary sanctions. The disciplinary sanctions, except for the written reprimand, can be applied only after carrying out a previous disciplinary investigation. The disciplinary investigation is made by a person appointed by the employer. If the sanction is ordered without a previous disciplinary

investigation, the act that ordered the sanction (sanction decision) is null (Law no. 53/2003, Art. 267). For a correct previous disciplinary investigation, the employee will be convened in writing. The paper will include the object, the date, the hour and the place of the meeting.

*The disciplinary sanction decision.* The disciplinary sanction is found and applied through a sanction decision that is not a jurisdictional paper and therefore can be revoked. The decision of disciplinary sanction is issued under a written form, within 30 calendar days from the information date, but no later than 6 months after the deed. The decision that orders the disciplinary sanction must obligatorily comprise the following elements, otherwise it is null: the description of the deed that represents a disciplinary infringement; mention of the provisions from the personnel status, the internal regulations or the applicable collective work contract that were broken by the employee, the reasons why the defensive arguments brought by the employee during the previous disciplinary investigation were not taken into account or the reasons why the investigation was not carried out; the norm that was broken; the term within which the sanction can be contested. The sanction decision is communicated to the sanctioned persons within maximum 5 calendar days from the issue date and causes effects starting with the communication date. The communication is given in person to the employee, under signature, or, if he refuses to receive the decision, through letter, at the domicile or the residence communicated by the employee. The sanction decision can be contested by the employer in court, within 30 calendar days from the communication date.

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# Assessing Discount Rate for a Project Financed Entirely with Equity Capital

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**Abstract.** *Estimating discount rate for an investment project is one of the most challenging tasks in capital budgeting. In this paper we discuss different kind of models for cost of equity capital proposed in finance literature (static CAPM, conditional CAPM, APT, build-up model), focusing especially on advantages and disadvantages of using each of them. In the final section, we estimate the discount rate for a certain project financed entirely with equity capital, using a version of build-up model.*

**Key words:** capital budgeting; discount rate; cost of equity capital; risk-return models; build-up models.

■

## Introduction

Investment decision has major consequences for the future development of a company. Assessing a project under uncertainty may be an extremely complex task. Uncertain future events which could affect the entire economy, a business or a project, lead to variable cash flows, which have different values than the projected ones under certainty, in a deterministic environment.

An investment assumes a capital expenditure at the present moment, hoping that it will generate income streams that increase the value of the firm. In this respect, investment analysis must be extremely rigorous, to be able to reveal if earnings are big enough to justify the capital expenditure, according to the level of risk assumed by investor.

Risk consists of possibility that an unfavorable state of nature appears and determines variance of future

financial flows. It may be seen from three different perspectives (Halpern, Weston, Brigham, 1998, p. 499):

- *individual risk* – it is the risk induced by the project if this is the only project of the firm and the company equity is the only security owned by investor;
- *firm risk* – it is the supplementary risk generated by a project for the investor who hold the company as a portfolio of projects, each of them having an individual specific risk;
- *market risk* – it is a part of project risk if the firm is a portfolio of projects and investor owns a diversified portfolio of many companies.

Individual risk and firm risk can be diminished through diversification, while market risk is a systematic one. It appears no matter the diversification level and

cannot be decreased. The cost of capital or discount rate catches the risk of a project and it is defined as “the expected rate of return that the market requires in order to attract funds to a particular investment”<sup>(1)</sup>.

Beside cash flows estimation, assessing discount rate is very important for Discounted Cash Flows method (DCF). We concisely depict further on some models for appraisal the cost of equity capital, highlighting the advantages and disadvantages for each of them.

### Growth models

There are three categories of growth models: single-stage, two-stage and three-stage models.

Single-stage growth model (or Gordon model) presumes that investment is expected to produce stable financial streams, which increase from a period to another with a stable rate, for a very long time. Two-stage model separates the time interval into two periods: for the first period, we are not able to forecast stable income streams, while in the second period cash flows will enhance at a constant sustainable rate. The three-stage model establishes three development steps. In the first period, the growth rate of financial flows equals the average growth rate of firm profits. Companies with high growth rates attract new competitors; thus, in the second period, enhancement is limited to the growth level of industry. However, industries with high returns get strong competition, which determines a cut in earnings. Therefore, after the first two stages, the growth rate will stabilize in long run to the level of the growth rate for the whole economy.

These types of models have some disadvantages. First, the result is a cost of equity capital, used as discount rate only for those projects that are all-equity financed. Second, the assumption of constant growth rate in perpetuity in the Gordon model is not reliable. Third, historical growth rates are not stable for long periods, thus they do not equal the current or the projected growth rates.

### Capital asset pricing model and its extensions

Sharpe (1964) and Lintner (1965) developed the standard version of Capital Asset Pricing Model (from now on CAPM), which states a linear relationship between the rate of return required by investors and the specific risk for an asset. Expected return  $E(R_i)$  in CAPM represents in fact the cost of capital for a project entirely financed with equity:  $E(R_i) = R_f + \beta_e \times (E(R_M) - R_f)$ , where:

$\beta_e = \text{cov}(R_i, R_M) / \sigma_M^2$  is the volatility of equity capital,  $R_f$  stands for the risk free rate and  $E(R_M)$  is the expected rate of return for the market portfolio (often assimilated with a market index).

The CAPM presumes some simplified assumptions<sup>(2)</sup> and that is why there are certain limits for using it. Beta estimation is done through a regression of historical returns for the analyzed asset on historical returns of market index. This procedure implies some inconvenient: the period chosen for computing historical returns (a longer period offers more information, but implies more changes in the structure of risk), frequency of data (annual, monthly or daily quotations), market index or other portfolio used for  $R_M$  (for transnational investments, for example, it is difficult to say which is the market index that we must use).

It is well known that CAPM roused many controversies. Does beta represent a good measure of risk and is there in deed a linear relationship between beta and expected return?

Black, Jensen and Scholes (1972) tested CAPM and found that assets with low beta had superior returns than returns assessed through CAPM, while assets with high beta performed worse than expected according to CAPM.

Black (1972) built an alternative to classic CAPM by eliminating one restrictive hypothesis. He presumed that investors do not have access to borrow funds at risk free rate and found that return for a financial asset is better explained by a two-factor CAPM ( $R_M$  and  $R_Z$ ), called CAPM with substitute portfolio. Expected return for portfolio Z (minimum variance zero-beta portfolio Z is uncorrelated with market portfolio  $\sigma_{ZM} = 0$ ) replaces the risk free rate when it can not be identified:  $E(R_i) = E(R_Z) + \beta_i \times [E(R_M) - E(R_Z)]$ . Merton (1973) developed an intertemporal CAPM that succeeded to explain the discrepancies discovered by Black, Jensen and Scholes in their study from 1972. He obtained a simple formula for rate of return, under the assumptions of autocorrelation between cash flows, while interest rate and market price of risk are unchanged. Its author did not test the model.

Roll (1972) said that CAPM is not testable because market portfolio is not observable. The previous tests were not correct or conclusive because the model used an approximation for market portfolio (a market index, but not all assets quoted in a financial market). Even beta, as a measure of risk, depends on how the market portfolio is chosen, which means that the same asset may have different beta for two investors, if they chose two different proxies for market portfolio.

Chan and Chen (1988) concluded in their study done for period 1949 – 1983 that a pricing model with one factor (CAPM) does not describe entirely the risk – return relation, but can not be rejected either for a model with two factors (firm size – ln(MV) beside return for market portfolio).

Starting with these results, Fama and French (1992) performed a new study, for period 1963 – 1990, and they found that linear relationship between average return and beta disappears, while firm size explains an important share of changes in rate of return. The two authors synthesizes in their paper previous results regarding other factors that influence cross-section average return, such as: firm size – Banz (1981), leverage – Bhandari (1983), E/P (price earning ratio) – Basu (1983) or BM (book-to-market value) – Stattman (1980) and Rosenberg, Reid and Lanstein (1985). Fama and French tested some models with various combinations of these factors. They ascertained that only size and BM significantly explain the cross-section average return, while E/P and leverage provide redundant information. They use the following model to asses the rate of return for a financial asset:  $E(R_t) = \gamma_0 + \gamma_1 \times \ln(MV) + \gamma_2 \times \ln(BM)$ .

The model becomes difficult to use for those companies that were recently quoted or are not quoted at all. In this situation, beta for traded companies in the same industry (with a similar structure for economic and financial risk), corrected with leverage, could be used as a proxy for risk assumed by investors in non traded firms. “Bad news” came from Myers and Turnbull (1977). They considered that beta is influenced by many factors: it depends on relation between forecasting errors for cash flows and forecasting errors for market return, it depends on economic life of assets, nature and trend of cash flows, and methodology used for estimation. It is difficult to get beta for a company or industry (taken as reference) that presents the same stream of cash flows, the same life period with the analyzed project. Measurement errors distort results. The observed beta for a company with high opportunities to develop (it owns valuable growth options) is higher than that for a firm with no such opportunities, and the estimated discount rate is higher comparing with the case when company owns only tangible assets.

CAPM has the advantage of a simple and easy to use model. Its “survival” relies on some explanations: others pricing models empirical support is no better than that for CAPM, it has an intuitive theoretic support and tests that disputed the correctness of the model are not so

conclusive and comprehensive to lead to model rejection. The static version of CAPM also has obvious disadvantages: rate of return assessed with CAPM can not be used as discount rate for a project which is not entirely financed with equity capital, because it does not match to forecasted cash flows. Extrapolation of discount rate obtained from historical data presumes time stability of firm structure of risk (historical beta) and of inflation rate (if we use nominal returns). For example, if we analyze a project for developing new products or markets, its risk is higher than the level of risk for this company before adopting the new project.

Hypothesis for static CAPM are not satisfied: investors have a dynamic behavior, they act for many periods and volatility for a security (beta) is changing over time and it depends on information available at any moment.

Jagannathan and Wang (1996) built a pricing model named conditional CAPM. This time, beta is changing from a period to another, while static CAPM holds for each period. Conditional expected rate of return for a security (depending on available information) is a linear function of its conditional volatility.

The two authors said that wealth portfolio is not observable and that is why it is assimilated to a market portfolio, constituted entirely of shares. They identified three more factors that can measure more accurate the return for aggregate wealth portfolio: return on human capital – its volatility is  $\beta_t^{labor} = cov(R_{it}, R_t^{labor})/var(R_t^{labor})$ , market risk premium – with volatility  $\beta_t^{prem} = cov(R_{it}, R_t^{prem})/var(R_t^{prem})$  and a value-weighted portfolio for a significant stock index, with volatility  $\beta_t^{vw} = cov(R_{it}, R_t^{vw})/var(R_t^{vw})$ . This new model, named *P-L Model (Premium Labor Model)* is in fact a multifactorial CAPM:

$$E(R_{it}|I_t) = c_0 + c_{vw} \times \beta_t^{vw} + c_{prem} \times \beta_t^{prem} + c_{labor} \times \beta_t^{labor}.$$

Another empirical study was performed by He, Kan, NG și Zhang (1996). Covariance between stock return and market factors and risk premium are both time variable. Essentially, the model states that the expected return for a large number of stocks is determined by covariance with a small number of market factors. Anyway, said the authors of the model, the macroeconomic factors (such as human capital, identified and used by Jagannathan and Wang in 1996) have greater explanatory power for cross-section of expected returns for securities than firm specific factors (MV or BM).

This model is a discreet time alternative for continuous model developed by Merton (1973), in which return for

financial assets follows the lognormal distribution function. The rates of return are not discreet anymore, but instant values at different moments, into a continuous process. Such a dynamic CAPM could be more realistic, but these considerations are strictly theoretical, because in practice there are many inconveniences for applying it.

Conditional CAPM is more alike arbitrage pricing model build by Ross than CAPM, because there are considered more factors. The most important accomplish of this model is time variation for volatility and establishment of a linear relationship between expected return and two or many betas, instead of single one.

### Arbitrage pricing theory (APT)

Ross (1976) developed the model that also sustains the linear function between expected return and beta. If there are not arbitrage opportunities, an efficient market reaches equilibrium and model becomes:

$$E(R_i) = R_f + \beta_1 \times (E(R_1) - R_f) + \beta_2 \times (E(R_2) - R_f) + \dots + \beta_k \times (E(R_k) - R_f)$$

Its advantage consists of considering many factors (return for market portfolio in CAPM could be one of them), which makes the model more rigorous. The disadvantage of time instability of volatility (beta) remains. More than that, it is difficult to identify the economic factors with high sensitivity for firm. That is why practitioners prefer CAPM to APT.

Statistical methods (such as factorial analysis) provide two categories of information: number of factors that influenced historical returns for stocks, also beta and risk premium for each factor. The disadvantage is that it does not identify the factors that significantly explain the variability for stock return.

We get multifactor risk-return models with economic basis and statistical relevance by replacing unidentified factors, obtained with statistical methodologies, with specific economic factors. Chen, Roll and Ross (1986) emphasized such a range of factors: changes in industrial production, anticipated and unanticipated inflation, changes in risk premium and term structure of interest rates.

Kan and Zhang (1999) said that these kinds of models (with unidentified factors, such as conditional CAPM, APT) are not testable, because we chose the factors for empirical analysis by economic intuition and we do not know if they are the factors with most important influence

on asset pricing. If the model is not correctly specified, null hypothesis and alternative hypothesis are both wrong. It is certain that there are not only entirely good models or entirely bad models. We do not have to test them to examine if they are right or wrong, but find a possibility to compare their performances in explaining the cross-section returns for financial assets.

### Build-up models

This model compounds the rate of return for a security (the discount rate) by adding different risk premiums to risk free rate. The traditional form for this model is:  $E(R_i) = R_f + RP_m + RP_s + RP_u$ , where  $RP_m$  is market risk premium,  $RP_s$  represents size premium and  $RP_u$  stands for unsystematic, firm specific risk. A new alternative for the model<sup>(3)</sup> also includes an industry specific risk premium (+/-  $RP_i$ ).

The build-up model has the important advantage of eliminating beta with all inconvenient that accompanies it. It is a simple model and this is the reason why many practitioners prefer it to other pricing models. Applying it is not such an easy task as we could think, because these risk premiums must be rigorously estimated.

Risk free rate ( $R_f$ ) is represented only by income return gained by investors for 10, 20 or 30-year constant maturity bonds. Total return includes also capital gain return, which implies some risk and it is not appropriate for riskless asset.

Market risk premium ( $RP_m$ ) used for assessing discount rate is a forward looking concept, even if it is estimated from historical data. First, we have to choose a reliable market benchmark, usually a market index with a high coverage in number of industries and market capitalization (for example, S&P 500 is chosen to represent the US capital market). This time, rate of return for market portfolio is represented by total return, provided also by dividends and capital gain.

Methodologically, it is recommended arithmetic, instead of geometric average, because it captures the uncertain nature of return and let it vary over time. Using geometric mean presumes that risk premium will be the same for every future period. Geometric average is more appropriate for historical returns analysis, while arithmetic mean is used especially in forecasting.

Another concerning aspect is how long should be the historical period for estimating market risk premium (for US market, reliable data is available from 1926). A longer period presents the advantage that the analysis includes different past events, that may occur again in the future.

There are also disadvantages: using a longer period, the estimated value for market risk premium is affected with very high or very low values in some periods, because of events such as economic crisis, wars, that are not expected to happen again in the future period.

Annin and Falaschetti (1998) discussed about rolling average approach used in practice to estimate equity risk premium. The appraiser have to choose a significant window of historical data, calculates a risk premium, then moves the window one year forward and determines another premium. There are many disadvantages with this methodology. First, we do not know the exact length of the window for determining the rolling average (for USA, there were usually used 30-year data windows, because of changes in capital market in early '70s). Second, years in the middle of the period are considered in many windows, so they have a higher impact on average premium, while years from the beginning and ending of time period are included in fewer rolling windows, so they have little weight in ultimate equity risk premium.

There are still many controversies and debate about equity risk premium, because of its impact on ultimate value derived under different approaches. The few risk premiums included in a model, the higher the impact of equity risk premium on discount rate (it decreases from CAPM and three-factor Fama-French to APT and build-up model).

It is widely recognized that small capitalization companies have higher expected returns than large companies in the same industry, because investors bear a higher risk. They expect to compensate this kind of risk through a specific risk premium called size premium.

Barad (2002) emphasized two approaches to measure size effect on return: first, there is a *small stock premium*, which captures the excess return for small companies to return expected for large companies; second, there is a *size premium*, focusing on isolating size effect on return of specific risk. The latest approach is used in developing the cost of capital for discounting purposes, in the build-up model, because it is more appropriate to catch return due to size effect and it is removed the possibility of twice capturing the risk, through different premiums.

Martin and Seigneur (2001) determined size premium as a margin between excess return to  $R_f$  (arithmetic average for actual return of a stock minus risk free rate) and excess return to  $R_f$  from CAPM (which is  $\beta \times (R_M - R_f)$ ).

The additional risk captured by beta in CAPM is now integrated in the build-up model with a *company-specific risk premium* ( $RP_u$ ).

To assess industry risk premium, we have to estimate first beta for that industry, which is a complex procedure, because some companies (usually the large capitalization ones) operate in more than one field and that is why their overall risk is lower. These companies are often excluded from analysis when beta is computed. Kaplan and Peterson (1997) performed a study and demonstrated (like other previous studies) that beta calculated with *pure play* method (when there are included in analysis only those companies that operate exclusively in one industry) is higher, because they are, in most cases, small and undiversified companies, and its risk is higher than industry average. The authors developed a *full information* methodology for including in industry beta determination those divisions of large, diversified companies that belong to industry in discussion.

Industry risk premium (+/-  $RP_i$ ) is determined as (beta industry  $\times$  ERP) – ERP, where ERP represents equity risk premium and industry beta is calculated using full-information beta methodology.

If we use cost of capital computed from data for publicly traded companies, most of them held by minority stockholders (it is the case for cost of capital data published by Ibbotson Associates), discount rate have to be adjusted with a risk premium for lack of liquidity (for privately held companies) and also for lack of control for minority shareholders, that can not influence company policies.

No matter what model we use to estimate discount rate, we have to keep in mind some important aspects:

- free cash flows must be discounted with a risk-adjusted discount rate, which is a weighted average cost of capital (not only cost of equity capital);
- each project has a specific risk structure and that is why we are not allowed to use the cost of capital for the company as discount rate for all new projects, but only for those investments that maintain the same pattern of risk like the overall firm;
- cost of capital is in fact an estimation, which is more accurate if we use a cost of capital for entire industry (taking as a proxy firms with similar features) instead of cost of capital for the analyzed company;
- we use nominal discount rate for nominal free cash flows, which means that we have to integrate expected inflation, even if not all components of cash flows are affected by inflation (amortization

and depreciation, for example); we start estimation with a real rate and after that we transform it in a nominal rate, using anticipated inflation rate;

- the disadvantage of extrapolation historical data for future periods maintains for risk free rate too; first we determine a real historical risk premium and then we add it to current risk free rate;
- it is preferable to use arithmetic average than geometric mean for assessing expected returns or risk premiums, because the second is more appropriate for compound rate of return, but not for expected return.

### Case study concerning assessment of discount rate for a project entirely financed with equity capital

The objective of this section is to assess the discount rate for an investment in a leather shoes factory. A detailed analysis of the project regarding estimation of cash flows was performed before and does not constitute the object of this study. A company from textile industry, as unique shareholder of the new firm, fulfills the project. The project is all-equity financed. Therefore, the discount factor for projected cash flows is a cost for equity capital. The estimated annual turnover is about 400 thousands USD and the firm belongs to the segment of small/middle companies in this field.

The new company is privately held and for this industry we do not have enough information about traded companies in Romania, to use them as a proxy to appraise the cost of capital. Under these circumstances, we appeal to a complex procedure, consisting of two stages:

1. assessing discount rate for the project according to its risk category, assuming that it is accomplished in the United States of America (we chose USA because of data accessibility for estimating a proper discount rate);

2. assessing discount rate for the same project implemented in Romania, by adding some supplementary risk premiums to discount factor obtained in the first stage.

We start with risk free rate and then we add a range of risk premiums to reflect the level of risk for the analyzed project, in a build-up model.

#### Stage 1: Assessing discount rate for a similar project operated in USA

Expected rate of return for investor is computed with the following formula:

$$r = R_f + RP_m + RP_s + RP_{i(\text{manufacturing})}$$

$R_f$  is assimilated to yield to maturity for treasury bonds issued by US Treasury, with 10, 20 or even 30 years constant maturity. The rate of return is determined from daily market prices for securities with the same maturity (20 years, for instance) and become public information. Annual average (at 31<sup>st</sup> of December, 2006) for daily quotations of yield to maturity for US Treasury bonds with 20-year constant maturity is approximately 5% (4.9973%)<sup>(4)</sup>.

This average value represents expected return from two sources: income (coupon) and capital gain. The risk free rate corresponds only to the first component, because only debt payments promised by issuer to investor are riskless, while security price variations depend on changes in capital market. An empirical study, performed for a period of 20 years ending at 31<sup>st</sup> of December 2006, revealed that income return had an overwhelming weight in total return: 98% for government bonds, 99% for corporate bonds and 95% for municipal bonds<sup>(5)</sup>. Therefore, we consider that risk free rate is total return for government bonds with 20-year constant maturity, which is 5%.

$RP_m$  stands for risk premium of capital market in USA and it is determined as excess return for market portfolio (S&P 500 index) to risk free rate. Rate of return for market index S&P 500 is calculated as annualized average from average of monthly total return for a period of 120 months (Avg), as follows<sup>(6)</sup>:

$$R = (1 + Avg)^{12} - 1$$

This return is accompanied by risk, quantified through annualized standard deviation, determined with the following formula:

$$\sigma = \sqrt{[SD^2 + (1 + Avg)^2]^{12} - (1 + Avg)^{24}},$$

where SD stands for standard deviation of monthly total return for a period of 120 months.

The annualized average return for S&P 500 for the last 10 years, at 31<sup>st</sup> of December 2006, was 9.64%, and the standard deviation was 16.88%, which means that market risk premium is 4.64%.

$RP_s + RP_{i(\text{manufacturing})}$  stands for size and industry premium and it represents the supplementary risk assumed by an investor in this industry, if the new firm is small or



medium size, with different features compared to average firm from manufacturing field.

Ibbotson Associates publishes annually statistics for each industry regarding cost of capital determined through five different models (we also wrote, in parenthesis, the average values for cost of capital of small/medium size companies in manufacturing industry<sup>(7)</sup>):

- *CAPM* takes into account only the systematic risk, measured by beta (13%);
- *CAPM + Size Premium* establishes a proper discount rate for the risk of small or medium companies (17.01%);
- *3-Factor Fama-French* uses market value of equity (MV), book-to-market ratio (BM) and a capital market factor for calculating expected return (17.9%);
- *1-Stage Discounted Cash Flows* (Gordon model) keeps a constant annual growth rate for dividends in perpetuity (15.19%);
- *3-Stage Discounted Cash Flows* uses three different growth rates, as follows: the growth rate for profits of the firm for the first five years, the growth rate for the whole industry for the next five years and, finally, the growth rate for the entire economy, after the tenth year (6.5%).

The rate of return estimated even with CAPM or a growth model (one or three-stage discounted cash flows) is not a reliable measure for the risk of the analyzed project. We have to choose between the second and the third model. As the two values are close enough, we appreciate that their average reflects more accurately the level of risk assumed by investor. The risk premium for size and industry in this case is 7.82% and the discount rate for a project in manufacturing industry, if it is implemented in USA by a small size firm, is 17.46%.

*Stage 2: Assessing discount rate for the project operated in Romania*

Estimating expected rate of return for investor starts with the rate of return for a similar project accomplished in USA, plus a range of specific risk premiums for Romania and for the new company:

$$r = r_{USA} + RP_{m \text{ (supplementary for Romania)}} + RP_{\text{country risk for Romania}} + RP_{s \text{ (supplementary for Romania)}} + RP_{\text{supplementary for minority shareholders}} + RP_{i \text{ (supplementary for manufacturing industry in Romania)}}$$

$RP_{m \text{ (supplementary for Romania)}}$  catches supplementary risk assumed by an investor on Romanian capital market

besides the case of a similar investment in US financial market. It is determined according to the surplus of risk taken on unit of return gained. We have determined the historical annualized rate of return and the standard deviation for BET from daily prices registered at Bucharest Stock Exchange<sup>(8)</sup>, between 1<sup>st</sup> of January 1998 and 31<sup>st</sup> of December 2006. We used USD quotations for BET and the same formulas for mean and standard deviations (as well as for S&P 500) in order to get comparable results. We preferred the arithmetic mean to geometric mean, because it is thought that the first pictures better the annualized rate. Average return for this period is 27.52% and standard deviation is 49.77%. The quantity of risk on unit return gained is 1.81 (while the same ratio for US capital market is 1.75).

$RP_{\text{capital market in Romania}} = RP_{\text{capital market in USA}} \times \text{risk on unit return for Romania} / \text{risk on unit return for USA} = 4.64\% \times 1.81 / 1.75 = 4.8\%$ , which corresponds to a  $RP_{m \text{ (supplementary for Romania)}}$  of 0.16%. This value may be surprising for someone, but there are a couple of explanations. Bucharest Stock Exchange performed very well for the analyzed period, especially in 2002 and 2004 (annualized rate of return for BET – USD was 80.2%, respectively 87.3%), but also in 2005 (46.7%) and 2006 (59.8%). For the same period, American capital market registered poor returns (for instance, annualized return for S&P 500 was 9.8% in 2004, 4.5% in 2005, or even negative, –6.9% in 2001 or –21.7% in 2002).

Country risk (or sovereign) is not diversifiable because investors hardly can constitute a portfolio of securities issued in different countries. In this respect, a risk premium must pay for the sovereign risk. It could be determined in three different ways:

- As a margin between coupon rate for bonds issued by Romanian government on international financial markets and coupon rate for similar securities issued by US Treasury. The Public Finance Ministry in Romania did not recently issued bonds denominated in USD, therefore this method cannot be used, despite of its simplicity.
- As country default spreads, according to notes granted for the two countries by the main international rating agencies. Romania received for foreign currency bonds the following ratings from these agencies: BBB (Fitch Ratings<sup>(9)</sup>, modified in August 2006), Baa3 (Moody's<sup>(10)</sup>, improved in October 2006) și BBB- (Standard & Poor's<sup>(11)</sup>). USA rating is Aaa or AAA, which is the maximum note for all agencies (investment in US

Treasury bonds is a safe one). According to sovereign ratings provided by Moody's<sup>(12)</sup>, the country risk premium for government bonds noted with Aaa (USA) is zero, for Baa3 (Romania) is 2%, while for Ba1 is 3.25%. We took Moody's as a reference because this agency did the most recent change of rating for Romania and improved its note from Ba1 to Baa3, on 6<sup>th</sup> of October 2006. This alternative method offers a value of 2% for  $RP_{\text{country risk for Romania}}$

- From relative standard deviation of capital market from the analyzed country in comparison with USA<sup>(13)</sup>, we can determine a relative standard deviation for Romanian financial market, as a ratio between  $\sigma(\text{BET})$  and  $\sigma(\text{S\&P 500})$ , that is  $21.23\% / 9.86\% = 2.15$ . For Romania, we used the annualized standard deviation for BET in ROL, for year 2006 ( $\sigma(\text{BET}) = 21.23\%$ ). We did not rely anymore on USD quotations, because the national currency met a strong appreciation in 2006 (from an exchange rate of 3.1078 ROL/USD on 1<sup>st</sup> of January 2006 to 2.5676 ROL/USD on 31<sup>st</sup> of December 2006). Therefore, the variance of returns for BET in USD ( $\sigma(\text{BET}) = 69.7\%$ ) is due in large measure to exchange rate risk and to a certain extent to financial market risk. For USA, we have considered the annualized standard deviation for S&P 500, for year 2006 ( $\sigma(\text{S\&P 500}) = 9.86\%$ ).  $RP_{\text{country risk for Romania}} = RP_{\text{m USA}} \times (\text{relative standard deviation} - 1) = 4.64\% \times 2.15 - 4.64\% = 5.34\%$ .

The value of 2% obtained from the second method is much smaller than this value of 5.34%, determined with the third method. It is happening because the last method includes the influence of financial market risk, which was also reflected before by another risk premium ( $RP_{\text{m}}$ ). The risk premium for capital market in Romania is 0.16%, while the country risk premium, calculated also from performances of capital markets in the two countries – USA and Romania – is 5.34%. We do not trust the second value, because it is obtained using only one-year data (2006). For US capital market, in 2006,  $E(\text{S\&P 500}) = 11.8\%$ ,  $\sigma(\text{S\&P 500}) = 9.86\%$  and ratio  $E(\text{S\&P 500})/\sigma(\text{S\&P 500}) = 0.848$ . The risk free rate is 5% and  $RP_{\text{m}}$  could be 6.8%. For Romania, for the same period (2006),  $E(\text{BET-ROL}) = 18.9\%$ ,  $\sigma(\text{BET-ROL}) = 21.23\%$  and ratio  $E(\text{BET-ROL})/\sigma(\text{BET-ROL}) = 1.124$ , while  $E(\text{BET-USD}) = 55.5\%$ ,  $\sigma(\text{BET-USD}) = 69.7\%$  and ratio  $E(\text{BET-USD})/\sigma(\text{BET-USD}) = 1.256$ . We reassess now  $RP_{\text{m (supplementary for Romania)}}$  and the

new value is 2.21% (for BET in ROL), respectively 3.27% (for BET in USD). These values are significantly different from those calculated with annualized data, for the last 10 years, for BET and S&P 500 (0.16% for BET in USD or -1.24% for BET in ROL).

In this respect, using the third method, we can determine a country risk premium as a spread between 5.34% and the risk premium from the capital market in Romania of 2.21% (hypothetically established, only from quotations for BET in ROL in 2006), that is 3.13%. If we would use values for BET in USD, the component of country risk premium related to capital market (for 2006) would be higher (3.27% instead of 2.21%, because of exchange rate movements). Therefore, we consider the exchange rate risk closer to country risk than to financial market risk. In this situation, we use as a proxy for  $RP_{\text{country risk for Romania}}$  the average of the values from the two methods (2% and 3.13%), that is 2.57%.

Concerning the manufacturing industry, we estimate that for the specific field of producing leather shoes, there is a supplementary risk in Romania beside USA, because of the strong competition of similar products. We refer here to substantial imports of footwear, made of substitute of leather, from China or other countries. These poor quality and low prices products target the category of consumers with low income. As Romanian society will develop and consumer's income will increase, this type of substitute products will "lose field" to quality, but more expensive products. Barriers to entry for this industry are not significant and new competitors could appear anytime. Therefore, we consider that  $RP_{\text{i (supplementary for manufacturing industry in Romania, footwear production)}}$  is 2%. This value is subjectively fixed, without a rigorous appraisal, because of lack of data or detailed analyses concerning this specific industry in Romania.

We mentioned before that the new firm is small size and it must compete with large size national or international producers or importers for well-known brands, similar in quality with products obtained by the company in discussion. We remind that when we assessed discount rate for similar projects in manufacturing industry in USA, we took the data for small composite in this industry. That is why we think that a supplementary size premium for the project operated in Romania is not needed.

The last component of discount rate is  $RP_{\text{supplementary for minority shareholders}}$ . It is needed only if there are many small stockholders that have no control on decisions adopted

by majority shareholders. The new firm has a unique stockholder that decides alone the future strategy. From this perspective, a risk premium for minority shareholders is not necessary for the project.

We conclude that discount rate (in fact, the cost of equity capital) for USD projected cash flows is:  $r = 17.46\% + 0.16\% + 2.57\% + 2\% = 22.2\%$ .

## Conclusions

Estimating discount rate is always a “touch stone” in every valuation process. Cash flows appraisal follows a precise pattern. All we need to do is to focus only on entries required in the free cash flows model. Things become more complicated when assessing discount rate, because there are many valuation models, some of them are unsophisticated but strongly disputed, and some of them are complex but little preferred by users. Choosing a model for estimating discount rate depends on available information and on user’s reasons and preferences.

Estimated discount rate for the project consisting in a footwear production unit must be taken with caution. The build-up model, used in this situation, may lead to estimation errors, because every single risk premium is subjectively assessed. The more risk premiums to estimate, the little reliable the final result. We can say how important these errors for a valuation process are only after we estimate the projected cash flows. Sensitivity analysis of the project reveals such information, because discount rate is one of the investment variables that must be modified (other variables are kept unchanged). The sensitivity of the project to discount rate is given by the response of NPV and IRR to a change with one percentage point of discount factor. If the project is sensitive to  $r$ , it means that a supplementary risk premium of 3% for manufacturing industry in Romania (instead of 2%) may drive to completely different conclusions concerning efficiency of the project or even the decision to adopt or to reject the project. We chose this particular premium as an example because we mentioned before that it is not very well grounded.

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## Notes

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- (1) International Glossary of Business Valuation Terms
- (2) Piață concurențială perfectă (sau cel puțin eficientă), finanțare în totalitate din capitaluri proprii, amortizarea este egală cu investițiile de înlocuire, creșterea provine numai din profitul net, absența fiscalității, transparența și gratuitatea informației, orizont de previziune limitat la o singură perioadă etc.
- (3) Propusă de Ibbotson Associates, care furnizează și date referitoare la primele de risc pe industrii, în cadrul „Ibbotson SBBI Yearbook Valuation Edition”
- (4) Seriile de date au fost preluate de pe site-ul băncii centrale a SUA, [www.federalreserve.gov](http://www.federalreserve.gov)
- (5) Sursa: Lehman Brothers U.S. Government Bond, U.S. Credit and Municipal Bond Indexes, 12/31/06, [www.franklintempleton.com](http://www.franklintempleton.com)
- (6) Modelul de determinare a mediei și dispersiei este preluat din *Cost of Capital Yearbook* - Ibbotson Associates, [www.morningstar.com](http://www.morningstar.com)
- (7) Statistics for SIC Code 3: Manufacturing, Ibbotson Associates, [www.morningstar.com](http://www.morningstar.com)
- (8) Sursa datelor: [www.bvb.ro](http://www.bvb.ro)
- (9) Sursa: [www.fitchratings.com](http://www.fitchratings.com), Fitch Ratings Ltd., New York
- (10) Sursa: [www.moodys.com](http://www.moodys.com), Moody’s Investors Service
- (11) Sursa: [www.standardandpoors.com](http://www.standardandpoors.com), Standard & Poor’s, The McGraw-Hill Companies, New York
- (12) Sursa: [www.sjsu.edu/faculty/watkins/countryrisk](http://www.sjsu.edu/faculty/watkins/countryrisk), conform datelor privind ratingul de țară furnizate de Moody’s
- (13) Metoda este propusă de Aswath Damodaran - [www.performancetrading.it](http://www.performancetrading.it)

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# The Capital Market in the Context of the Integration within the European Union

■

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***Abstract.** This work is focusing on the main aspects concerning the present stage of the capital market as well as on the perspective of its evolution after the adhesion to the European Union.*

*After emphasizing the main characteristics, the material is analyzing the financial instruments market – Bucharest Stock Exchange, Monetary-Financial and Commodities Stock Exchange Sibiu, RASDAQ market as well as the collective placement organisms.*

*Finally, there are the main tendencies of the capital market which are pointed out.*

**Key words:** stock exchange; financial instrument; RASDAQ market; depositary; transaction.

■

## 1. Main characteristics

A modern economy, competitive and capable to line up with the present requirements of the globalization process, is not to be conceived without the existence and functioning of an efficient capital market.

The establishment of the capital market in Romania had, as a starting point, the re-setting in 1995, after a brake of about five decades, of the Bucharest Stock Exchange, as a continuous market whose mechanisms are in the position to secure the price forming for equities under transparency conditions and in conformity with the European standards.

The following steps may be considered as the main moments marking, as from 1994 on, the establishment and the development of the capital market in Romania:

- Enforcement, in 1994, of the first law of the capital market, respectively the Law no. 52/1994 concerning the equities and stock exchanges;
- Re-establishment of the Bucharest Stock Exchange, in 1995, when a number of 24 equities companies, members of the Stock Exchange Association, applied for the right to negotiate shares issued by a number of 6 commercial companies;
- Setting-up, in 1996, of the RASDAQ market, meant to secure transactions on shares issued by a very large number (over 5000) commercial companies, resulting out of the Mass Privatization Program;
- Changing the legislative frame, in 2002, by enforcement of a legislative package including four laws:
  - ◆ The law concerning equities, financial investment services and regulated markets;
  - ◆ The law concerning the organisms of collective placements;
  - ◆ The law concerning the regulated markets of goods and derivatives;
  - ◆ The law concerning the approval of the Statute of the National Commission for Equities;
- Drawing-up, in 2004, an unique law, the Law no. 297/2004, concerning the capital market, in order to implement the community acquis to the financial sector, as well as the adoption, within the period 2004-2006, of the necessary regulations meant to allow the application of this law.

As from 2005 on, the capital market in Romania entered a process of profound reconstruction which represents the very foundation of its future development, in the context of the integration of Romania within the European Union. The Bucharest Stock Exchange changed its juridical form, becoming a shareholding company instead of institution of public interest.

The capital market Authority in Romania is the National Commission of Equities, which is regulating, supervising and controlling the capital market, as well as the specific institutions and operations of this market.

The access of the equities issuers and investors on the capital market is achieved through *intermediaries*. There are the financial investment services companies (SSIF) as well as the crediting institutions authorized by the National Bank of Romania to carry out, directly, financial investment services on the capital market. The intermediaries activities is carried out according to the “*unique passport*” principle, implying the possibility for the financial investment services suppliers to operate on the markets of the member-states on the basis of the authorization granted by the country of origin, as well as the free access of the suppliers of investment services from the other member-states to the national market. As from January 1, 2007, i.e., as from the moment of the adhesion of Romania to the European Union, the intermediaries authorized in Romania may provide services in the member-states of the European Union, without any additional authorization, while intermediaries from other member-states may provide services in Romania on the basis of a simple notification submitted to the market authority.

The capital market in Romania is structured by two main: the financial instruments market and the market of the placements being done through organisms of collective placements.

## 2. The financial instruments market

The transactions on financial instruments are achieved in accordance with the European Union standards on regulated markets and the alternative systems of transactions securing, meantime, the finality of all transactions through only one institution meant to

accomplish the storage, the offsetting-discounting and the recording of the operations on equities.

Presently, there are two regulated markets being authorized and in function, namely: *Bucharest Stock Exchange* and *Sibiu Monetary-Financial and Commodity Exchange*.

The activity of a regulated market is organized and administrated by a *market operator*, set-up as a shareholding company. The regulated market is considered to be a system for transactions on financial instruments which is functioning regularly and operates in an ordered manner, being characterized by the fact that the issued regulations define the conditions of functioning and access on the market as well as the conditions for admittance for transactions of a specific financial instrument. The issuers whose equities are transacted on a regulated market are bound to BVB requirements of reporting and transparency, in order to protect the investors and insure their correct, complete and in due time information.

The transparency requirements are referring to both, the pre-transaction and the post-transaction operations. Thus, under the pre-transaction context, the market operator must put at the disposal of the public, in a continuous manner, all over the duration of the transactions normal program and under reasonable commercial terms, the current prices and quantities for sale or for purchase for the financial instruments being accepted for transactions on the respective market. As to the post-transaction operations, the market operator must transmit, in real time, information regarding the price, the volume and the moment the transaction is executed, according the specific rules governing each financial instrument being accepted for transactions on the respective market.

*Bucharest Stock Exchange (BVB)* is disposing of a performing system of transaction, consistent with the one run by the stock exchanges of the developed countries which allowed the number of investors to increase, along with the diversification of the transacted instruments and types of operations as well as drawing of new issuers of developing potential on medium and long term. Contrary to the beginning, when the stock exchange represented a shares market, presently there are also transactions on bonds issued by both the local public authorities and commercial companies.

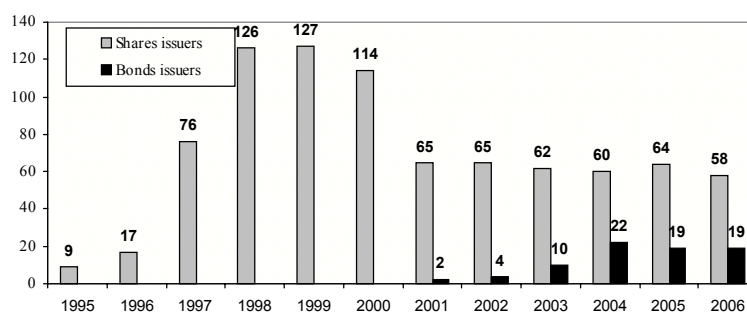


Figure 1. Evolution of the issuers' number listed by the Bucharest Stock Exchange quota within 1995-2006 period

The year 2002 has been considered as the moment of the sudden change for the better of the stock exchange activity, on the ground of the re-launch of the economic activity and a legislation becoming more transparent, more flexible and better adjusted to the national specificity of the capital market.

The following graph is illustrating the evolution of the stock exchange capitalization which, in 2006, counted with 30% higher as comparatively to the previous year, in the context of the increase of shares quotation to the stock exchange as well as the increase of the volume of the transacted stock.

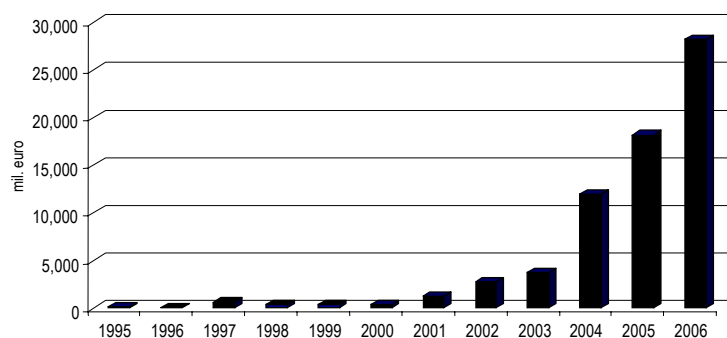


Figure 2. Evolution of the Bucharest Stock Exchange capitalization within 1995 – 2006 period

If one considers its weight in the gross domestic product, the stock exchange capitalization recorded a steadily up-warding evolution during the last six years. If in 2000, it represented 1.37% of GDP, only, in 2004 it reached a weight of 13.86% while in 2006 the stock exchange capitalization exceeded 24% of GDP. The evolution of the ratio stock exchange capitalization/gross domestic product is shown by the following figure.

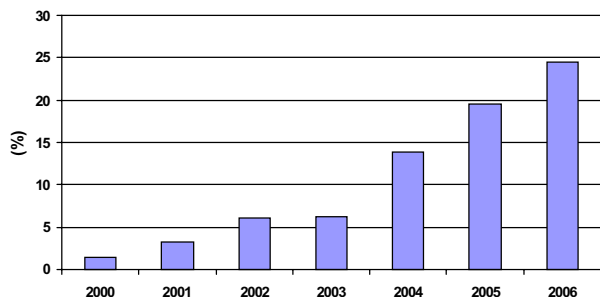


Figure 3. Weight of the stock exchange capitalization within 2000-2006 period

The policy run by CNVM as regards the development of the capital market is targeting for 2007 a stock exchange capitalization amounting 30% of GDP. The target is a realistic one under the circumstances of the increase recorded by the number of transactions and the diversification of the financial instruments being transacted at the stock exchange. Drawing new financial flows from resident and foreign investors, on the ground of a positive evolution of the entire Romanian economy, represents the warranty for an up-warding evolution of all the stock exchange indices. All these statements are confirmed by the fact that during the first quarter 2007 only, the capitalization of the Bucharest Stock Exchange reached an amount of EUR 24,296.6 millions, exceeding by 13% the value recorded all over the entire previous year.

The total amount of the transactions in 2006 counted for EUR 2,756.31 millions, recording thus a daily average of over EUR 10 millions, as well as an increase of over

30% as comparatively the year 2005.

The Bucharest Stock Exchange keeps on remaining, significantly, a shares market. The evolution of the transactions on bonds is relatively limited even if there are record-transactions being concluded, such as those generated in 2006 by the issue of the bonds of the International Bank for Reconstruction and Development. During the year 2006, there were 19 municipal and corporate bonds being transacted, out of which five represented newly listed bonds.

As an opening for the capital market in Romania, starting the year 2005, the investors took the advantage of dealing, at the stock exchange, with preference rights attached to the newly issued shares by the occasion of the increases of the social capitals.

The activity of any stock exchange is evaluated in terms of stock indices, considered as barometers of the market.

Since the moment of launching the first indices BET and BET – C up to middle of the year 2002, their level kept on remaining below 1000 index points. But, these last years, all indices of BVB followed an up-warding trajectory, recording levels which have been historical maxima.

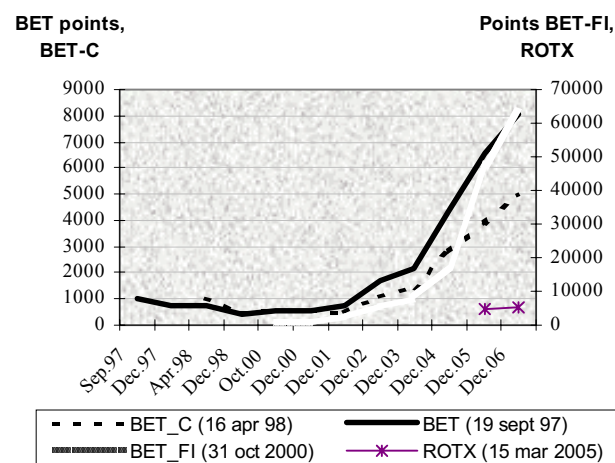


Figure 4. Yearly evolution of the Bucharest Stock Exchange indices

The BET index being computed by the end 2006 counted for 8,050.18 points, 22.23 % over the value recorded during the last day of transactions of the year 2005.

The historical maximum of 5,169.21 points has been reached by the index BET-C in October, being 25.81 % higher than the previous year record.

The most spectacular increase has been recorded by the index BET-FI, the maximum value reached counting for 63,606.97 points in November 2006. Thus, the index BET-FI holds the 21<sup>st</sup> position in the classification of the international stock exchange indices.

The index ROTX reached a maximum value of 18,809.88 point in October 2006.

The increases recorded by all the indices of BVB took place on the ground of the performances of the Romanian economy and the increase of the autochthonous and foreign investors' confidence in the performances of our market, characterized by more transparency and governed by a modern legislation, perfectly adjusted to the European standards. For the year 2007, once the adhesion of Romania to the European Union took place, the expectation is that the up-warding trend of the stock exchange indices keeps on continuing, simultaneously with the introduction of new stock exchange products.

A particular position in the frame of the financial instruments market goes to the *SIBIU MONETARY-FINANCIAL AND COMMODITIES STOCK EXCHANGE (BMFMS)*, as a regulated market, authorized to organize and administrate *transactions on derivatives*. This market has been established as a commercial company, ever since 1994, and launched the first futures contracts in 1997, while the options on futures contracts started to be transacted since 1998, after the setting-up of the Offsetting Romanian House.

The futures contracts and the options are addressing to the investors both as instruments for covering the risk in case there is an unfavorable evolution of the price for the underlying asset and for the purpose of getting profits on the basis of the arbitrage operations between the price on the spot market and the price on the market at term. The underlying assets of the contracts at term are represented by shares belonging to attractive issuers who are transacted at BVB, stock exchange indices as well as foreign exchange rate (RON/EUR, RON/USD, EURO/USD) and the 3 and 6/ months interest rate.

As far as BMFMS is concerned, the year 2006 meant a year of historical maximum, characterized by a high liquidity, with an up-warding volume of the transactions.

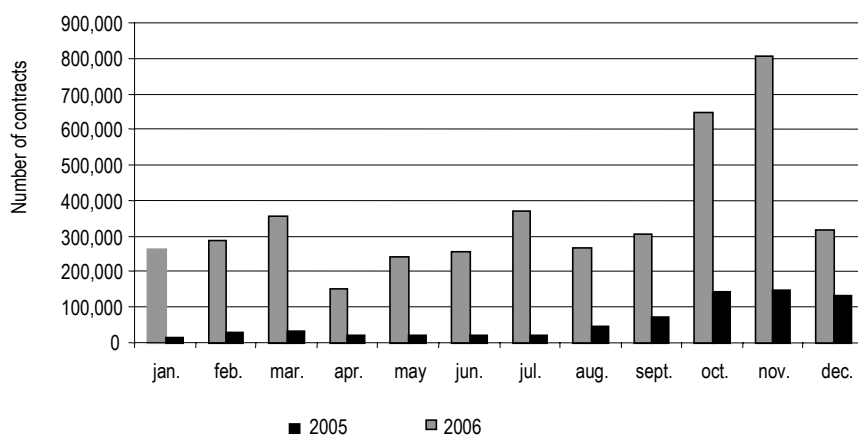


Figure 5. Evolution of the total volume of transacted contracts

In 2006, the total value of the transactions on derivatives counted for EUR 2,770 millions.

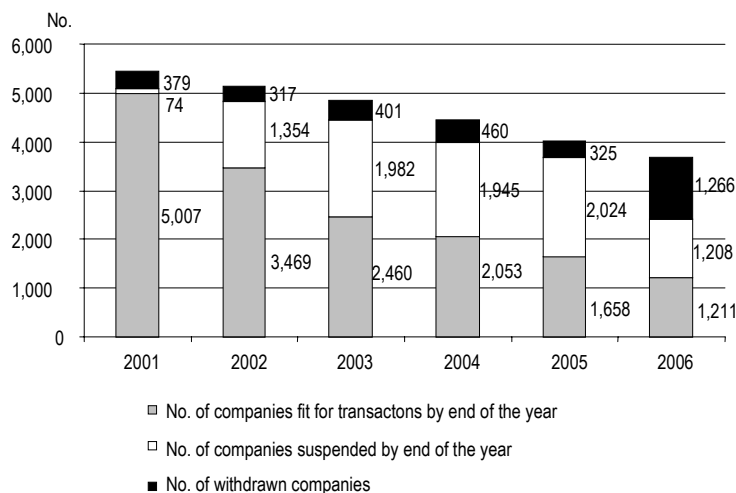
The volume of the transacted futures contracts was 6 times larger in 2006, as comparatively to 2005, while the options contracts doubled within the same period. The year 2006 marked a major difference between the total number of transactions on derivatives having shares as underlying asset (99% of the total) and the one of the transactions on derivatives having foreign currencies as underlying asset (1% of the total).

The derivatives market is subject of a process of development and diversification taking into consideration the increasing need for covering the loss risk run by the portfolio investors.

RASDAQ market recorded a continuous transforming process, since it has been established in 1996, up to 2007

when it started functioning according to the rules of an alternative system of transactions. A significant moment is given by its merge with the Bucharest Stock Exchange, initiated in 2002, when the denomination of RASDAQ Electronic Stock Exchange (BER) has been adopted. This is this context which involved the identification of the most attractive companies, grouped by categories of excellence, as a first step towards promoting them the stock exchange quota. Meantime, the number of listed issuers has been gradually reduced, by withdrawing them from the market, based on the decision of the shareholders as well as in conformity with the degree of meeting the listing requirements, so that the number of companies fit for transactions get reduced from over 5,000 in 1996, to about 1,200 in 2007.

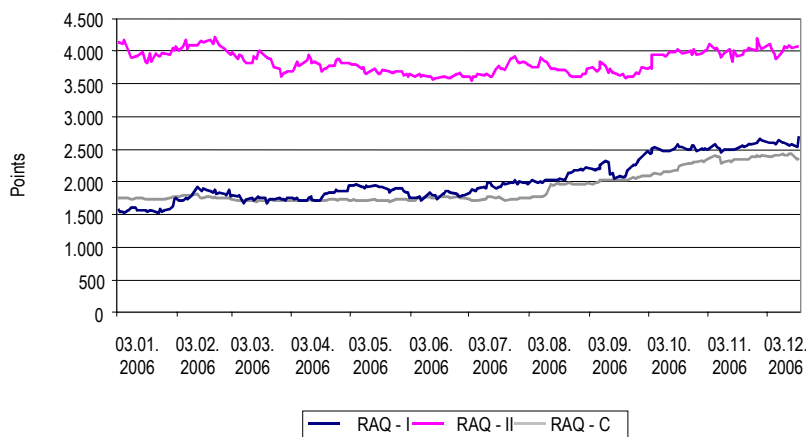




**Figure 6.** Evolution of the number of listed issuers on RASDAQ market

On the ground of the decrease on the number of the listed companies, the capitalization recorded by the RASDAQ Electronic Stock Exchange counted for EUR

3,126.44 millions in 2006, as against EUR 1,943.72 millions in 2003.



**Figure 7.** Evolution of RASDAQ indices

The investors who placed the available resources on stocks transacted on the RASDAQ market recorded, during the year 2006, an average yield counting for 22.74%, measured by the evolution of the index RASDAQ – C.

The year 2007 will represent the transformation of the RASDAQ market into an alternative transactions system, in conformity with the legislation in force and aiming to line up with the requirement of the European Union directives.

*The alternative transactions system (ATS)*, links together several parties who buy and sell financial instruments, in a manner which leads to contracts conclusion, being administrated by a *system operator*. As a system operator, there are the authorized intermediaries or a market operator who can act. In the frame of an alternative transactions system there are, basically, the financial instruments belonging to issuers not complying with the conditions of admittance on a regulated market, which are transacted. The alternative transactions system

is on the way to be authorized. This is set up in order to put at the investors’ disposal an organized and transparent framework, required by transactions on stocks belonging to issuers listed on the RASDAQ market.

*The post-transaction operations* due to both the regulated market being operated by the Bucharest Stock Exchange and the alternative transactions system are carried out through the *Central Depository*, authorized to function as a shareholding company. Thus, in order to carry out, in a centralized manner, the operations on stocks and to secure an unitary recording of these operations, all the classes of equities being transacted at the Bucharest Stock Exchange and in the frame of the alternative transactions system are compulsory deposited to the Central Depository. The main operations carried out by the Central Depository are the following: offsetting-discounting the transactions on stocks, recording the new holders and identifying, by any time, of one issuer’s shareholders and their holdings, allocating serial numbers to the equities issues by setting

up ISIN codes, keeping the equities in custody, providing services for the exercise of the rights due to equities as well as management of the guaranties (the collateral) on the equities.

On the derivatives market from Sibiu, the post-transaction operations are carried out by the Offsetting Romanian House, a distinct entity, having as main part to guarantee the good execution of the transactions, through the intermediate of the compensating members, on the basis of a system of multiple levels of warranty: margins – joint warranty fund – individual warranty fund – warranties of the compensating members.

### 3. Collective placement organisms

The second segment of the capital market is given by the *collective placement organisms*, grouped in two main categories: the *collective placement organisms on equities (OPCVM)*, harmonized with the European Union directives, as well as collective placement organisms, other than those on equities, which are not harmonized, being known as the *other collective placement organisms (AOPC)*.

The category of *collective placement organisms on equities* includes the *investment open funds*, established on the basis of a civil contract and the *investment companies*, established by a constitutive act, organized as shareholding companies with variable capital.

The organisms of collective placement on equities have as an unique purpose to perform collective investments, by placing the money resources in liquid financial instruments and by operating on the principle of risk diversification and prudential management. The issue of

the participation assets is achieved on the basis of a continuous public offer, in conformity with the information included by the issuance prospectus, so that the investors may evaluate, mainly, the risks implied by the proposed investment. The participation assets are re-purchasable in a continuous manner out of the assets of the respective organisms of collective placements on equities.

The organisms of collective placements on equities are administrated by investment administration companies (SAI), which entrust to depositaries (credit institutions) all the assets of the OPCVM, which they are administrating, in order to be kept under security conditions.

Presently, in Romania, there are 34 *investment open funds* in function, which are classified in four types of funds: of shares, diversified, of bonds and of fix income instruments as well as monetary. To note that the number of investors increased as a result of regaining the confidence in this type of investment, after the failures of certain funds in 2000, as well as a result of a favorable evolution of the prices for the equities transacted at the Bucharest Stock Exchange. The number of the participation assets in circulation increased also, quite significantly, which is a positive fact attesting that this segment of the capital market changed for the better.

These favorable tendencies are explained also by the fact that the investment open funds have generated superior gains, in comparison with both the inflation rate and the foreign currency investments, being judged through the angle of the evolution of the exchange rate, leu/dollar și leu/euro. The average net unitary value of the participation assets to the mutual funds increased with over 80% all over the year 2006, while the inflation level reached 4.87% only.

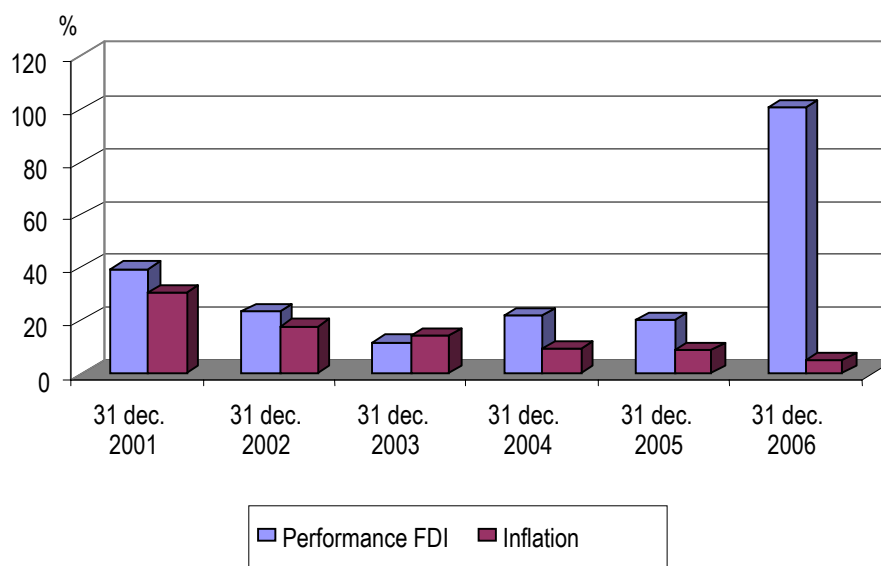


Figure 8. Evolution of the performances of the investment open funds during 2006 against the inflation level

The evolution of the portfolios of the investment open funds, by types of financial instruments, in 2006 against 2005, reflects the orientation of the placements towards equities being transacted on the regulated markets and towards the banking deposits. To underline the fact that the weight of the banking deposits within the structure of the funds assets decreased from 35% in 2005 to 22% in 2006, while the weight of the equities transacted on the regulated markets increased from 25% to over 37% within the same period.

The performance of the investment open funds is evaluated also from the point of view of the evolution of the net assets, which increased in 2006, as comparatively with 2005, by approximately 86%. The net assets have increased significantly as a result of launching new investment open funds and of the increase of the prices for the equities on which the investment was done.

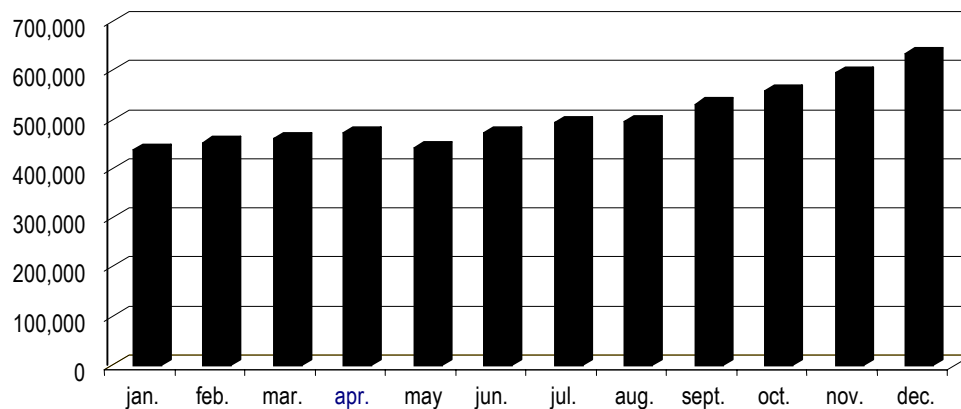


Figure 9. The net assets of the investment open funds in 2006

Out of the 34 investment open funds existing in 2006, the biggest market quota was holds by the diversified funds and by the shares funds.

The non-harmonized collective placements organisms (AOPC) are established as:

- *Investment closed funds*, set-up on the basis of a civil company contract, which are bound to repurchase the participation assets by pre-set intervals of time or by certain dates in conformity with the constitutive documents;
- *Investment companies of closed type*, set-up by a constitutive act, which issue a limited number of shares and are transacted on the market. This category is including the financial investment companies (SIF).

The non-harmonized collective placement organisms are characterized by more permissive legal regulations, they addressing mainly to the investors who accept to undertake the risk generated by a non-diversified portfolio.

The closed investment funds are administrated by an investment administrating company on the basis of specific rules, self-established and may issue funds units of a single kind, registered, dematerialized, which confer equal rights to the holders.

The investment companies of closed type can be administrated by an investment administrating company (such as the case of SIF-Muntenia) or by an administration council (typical for the other four SIFs) and are bound to secure the transactions for the issued shares on a regulated

market, the repurchase of their own shares being also allowed.

The financial investment companies are the sole closed funds being listed at the Bucharest Stock Exchange.

The SIFs management aims to diversify the portfolios by achieving placements of yields as high as possible and low risks, so that the unitary value of the net asset records an up-warding trend.

The price for the shares issued by the five SIFs being transacted at BVB kept on increasing, as a result of the increased interest of the investors for holding this kind of shares bringing in high yield for both the distributed dividends and the gains as difference between the re-selling price and the acquisition price of the respective shares. The performances recorded by the SIFs shares are reflected also by the evolution of the index BET-FI. The diminishing of the difference between the market price of the financial investment companies shares and the unit value of the net assets of these investment funds reflects the fact that the foundation of the investment decision is closely linked to the potential of increasing the assets hold by the portfolios of the five SIFs.

#### 4. Tendencies of the capital market development

In order to achieve the capital market transformation, so that it becomes a viable alternative for financing the national economy, there have been joint steps adopted aiming a correct and complete information of the investors,

the increase of the market transparency, the increase of the investors protection, the insurance of a supervision in real time of the transactions from the regulated markets and the achievement of controlling actions with the purpose to prevent the negative effects and the risks identification. All these steps are meant to secure the consolidation and the development of the capital market.

The Bucharest Stock Exchange is placed on the 4th place within the area, after the stock exchanges from Poland, Czech Republic and Hungary and, as for 2007, it is intended that the gap diminishes. The Bucharest Stock Exchange intends to open a new sector of its activity, by initiating a market section for financial derivative instruments. The first financial derivative instruments which will be transacted on this market administrated by the Bucharest Stock Exchange will consist of futures contracts on stock index BET. Another step meant to improve the market capacities is given by the fact that the shares of the listed companies are possible to be bought by the investors on credit as well, through transaction within the margin, according to the new Stock Exchange Code, entered into force by the end of September 2006.

In 2007, the market of the financial derivative instruments will keep on developing with the same alert rhythm. The number of intermediaries and that of the sophisticated investors who participate to the transactions with derivatives is recording a continuous increase and for 2007 there is a net increase of minimum 20% as to the market participation and minimum 70% as to the volume of transactions to be expected.

As far as the evolution by groups of financial instruments is concerned, there is a more significant increase to note for the futures, which will continue the tendencies already recorded in 2006. The options contracts will have a positive trend as well but the variation of this trend is hard to be predicted presently, as the market is still sophisticated

enough to allow that this financial instruments are used at their full capacity. Nevertheless, taking into account the tendencies of the other European stock exchanges for derivatives, an increase of the transactions on options is to be expected in Romania as well.

On an overall basis, the capital market in Romania will continue the process of development, trying to recover the gap against the European strong markets, this effort being a general and well sustained one. For the year 2007, there is a positive evolution to expect for all the segments of this market. The potential for the future development of the capital market in Romania is a particular one if to consider the fact that, presently, less than 0.05% of the population of Romania is involved in activities on the capital market. It may be estimated that, during the forthcoming years also, Romania will attract significant financial flows, which would be found inclusively in the increase of the weight held by the portfolio foreign investors within the total turn-over of the stock exchange market. On medium and long term, there are conditions already set-up, for increasing the investment belonging to both, residents and non-residents, the participation on the market of the institutional investors being more and more active. As far as the foreign investors are concerned, the opening of the capital market of Romania for the intermediaries registered in other countries members of the European Union might be a good reason for the stock exchange market to become more attractive and more accessible for non-resident individuals. As a result of these possible evolutions, there will be not only liquidity increases to be recorded but also a market volatility more tempered. A better regulated capital market, a correct, complete and operative information of the investing public in respect of the important events, a careful supervising in real time, as well as a more efficient control may offer to the autochthonous and foreign investor the warranty for an attractive and safe placement.

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# Aspects Related to Researching Consumer Preferences

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***Abstract.** Catching the essence of consumer' preferences, a dimension of consumers' behavior through marketing research represents an important aspect in the activity of any organization and, in the same time, an objective very difficult to reach. This paper is meant to bring some light on the importance of knowing the consumer' preferences and on the ways that consumer' preferences are determined.*

**Key words:** consumers' behavior; consumer preferences; marketing research; sample; organizing the research.

“Know your consumer”. This is no simple task, and more so, isolating a single feature, as we do here, the consumers' preference for a certain good or service is particularly difficult. It may happen for them to express their needs and desires and yet act in an entirely different way; at times, it's possible that they aren't even aware of the true motivations behind their buying behavior, or they could react to factors determining last minute changes to their buying decision. Although the consumer decisions are relatively easy to notice and quantify, the psycho-physiological processes behind them are very difficult to take into account (Kotler et al., 1998).

Research related to the consumer behavior looks upon its different dimensions and their relationship. The final aim of these investigations is to foresee and channel the future reactions of the demand agents, for a precise correlation between demand and supply. All dimensions leading to a certain behavior must be determined. Each facet of consumer behavior we wish to analyze in-depth within the marketing research imprints certain specificity, special means of approaching the issue.

## **1. The importance of researching consumer preferences**

We can define consumer preferences as a positive motivation, expressed by the emotional compatibility with a certain merchandise, service or form of sale. We're not

dealing with an internal bodily function, but a quality of objects that aims to fulfill our needs, quality acquired within the connection between man and the merchandise able to fulfill these needs.

Knowledge of consumer preferences is especially important with respect to the various activities carried out at the organizational level, necessary for its survival.

For example, in case an entrepreneur needs to establish the characteristics the product he intends to produce needs to hold, he must interview several potential buyers, asking them to mention the preferred level of each individual characteristic.

The consumer preferences and behavior represent the basis of the pretesting models for the new products (ASSESSOR, COMP, DEMON, NEWS, SPRINTER), which implies determining the functional relationships between the buyer's opinion concerning a product, testing it and the purchase behavior.

The level of preferences is one of the variables that need to be taken into account when identifying the strong and weak points of the competitors.

By measuring the consumer preferences before and after carrying out an advertising campaign, the transmitter may evaluate its success or failure (Kotler, 1999).

The preferences towards certain products or brands may constitute the theme of a survey supplying information concerning the relative non-consumers, since attracting these represents an important means of increasing the sales volume up to the maximum limits of market potential.

The companies constantly increasing the level of reminding and of preference shall attain an inevitable increase in market share and profitability. The size of profits is less important than managing to consolidate consumer preferences towards its products.

Examples concerning the implications of preferences in the organization's activity could continue.

Preferences are the result of a long-term relationship between the brand and the consumer, as the latter learns to associate the brand with a symbol and perceive it as having high quality. Following these deep connections created over the course of time, a strong emotion is developed which lies and the basis of preferences, remaining present even in the absence of the friendly symbol or of any other component feature.

In order to fully understand the coordinates of loyalty towards a brand, it may prove useful to present certain aspects related to measuring preferences.

Preference is a "favorable attitude" towards a brand, often expressed by creating the intent to purchase.

Forming and intensifying preferences towards a brand could be the result of a classic Pavlov-type conditioning, arising from buying repeatedly, from the fact that the individual becomes more and more accustomed to the brand and wishes to avoid unfamiliar situations by choosing other brands or, possibly, the family he/she was born in preferred the respective brand (Catoiu, Teodorescu, 2001).

Preferences towards a certain brand, out of the set of alternative brands available for a product or service, constitute one of the variables of learning, according to the Howard – Sheth pattern of influencing the consumer behavior. As per this pattern, the consumer develops a certain attitude (preference), in accordance with the level of knowledge and the choice criteria he/she has defined which, in turn, constitute an essential determinant of the purchase intent.

The attitude developed exerts its influence as a reactive action over obtaining and processing information.

After determining consumer preferences towards a brand, the producer may take the following measures, with a view to increase preferences for that brand:

- change the product;
- change beliefs concerning the brand;
- change beliefs concerning the competing brands;
- change the importance of features;
- attract attention towards neglected features;
- change the consumers' ideals.

In addition, in order to attract consumers' preferences towards their own brands, producers and retailers may chose the option of "renting" those brands having won the preferences of consumers (names or symbols previously created by other producers, names of celebrities, names of movie characters etc.).

The renowned specialist George S. Day, professor at Wharton School, believes that for a consumer to be truly loyal, he/she must not only repeatedly purchase a certain brand, but he/she must prefer it as well.

## 2. Methods of researching consumer preferences

Researching preferences is not as wide, but more in-depth than studying motivations, being a component of the latter. In evaluating the intensity of preferences, the same instruments are used as in the case of motivations.

Analyzing purchasing preferences as well as motivations may be performed using the *observation method*; ensuring an authentic motivational image, observation imprints an objective feature to the investigation and may prove to be the least expensive and most exact method of gathering behavioral data.

Organizing a research on preferences using the observation method must be performed thoroughly and rigorously, must be systematic in character, and the presence of observers must not be noticed by the subject (Florescu (coordinator), 1992).

*The selective enquiry* based on a written questionnaire is also used in studying consumer preferences even though it determines solely the declared behavior of consumers and not the actual one, as in the case of observation.

Measuring consumer preferences for alternative product concepts may be performed by using technique that is more and more widely known, namely the *conjugate analysis*. This is a method of finding out the value in use consumers attach to various features of an object. The respondents are presented with several hypothetical offers obtained by combining certain features, and the must rank these offers according to their preferences.

The results obtained may be used by the company leadership to identify the most attractive offer as well as the market share and the profit estimated to be attained by the company.

This analysis was used, for instance, in creating car prototypes, in projecting services offered by air-line companies, in creating credit cards.

Testing consumer preferences is based on a variety of techniques such as: simple rank ordering, paired comparisons, appraisal scales, each having specific advantages and disadvantages.

*The method of unitary appraisal* supplies much more information than the method of simple ranking and that of paired comparisons. The subject is required to order on a scale his/her preferences for each product.

By using this method, we can find out not only the order of preferences, but also the qualitative levels of preferences for each product and the distance between the products. At the same time, this method is easy to use, especially when we must evaluate several products.

When the aim is to identify categories of consumers according to their preferences, we may obtain the following types of structures:

- homogenous preferences when all consumers on the market have the same preferences;

- heterogeneous (diffuse) preferences when the preferences of consumers are divided uniformly at market level;
- “grouped” preferences. The market can contain groups having distinct preferences, called natural market segments. A company entering the market has, in this instance, three possibilities:
  - to implement undifferentiated marketing (to attract all groups);
  - to position itself on the largest market segment (concentrated marketing);
  - to create several product brands, each aimed towards a different market segment (differentiated marketing) (Kotler, 1999).

Should the company launch a single product brand, it is obvious that the competition shall launch products aimed at the other market segments.

Investigating preferences may be approached in different combinations with investigations of other dimensions of consumer behavior. The dimensions of consumer behavior may constitute the object of marketing investigations, viewed in their entirety. For this purpose, one can make use of special investigation techniques, such as contextual methods of psychodrama type (Florescu (coordinator), 1992).

### 3. Organizing the consumer preference marketing research

Organizing a selective marketing research is an especially complex process. In order to maximize the contribution of the marketing research to the decision-making process, this complex activity must be organized with most care.

Carrying-out the marketing research involves going through certain successive phases, within a complex process, starting with determining the research aim and objectives and finishing with presenting conclusions and recommendations.

#### *Identifying the issues and defining the research purpose*

Identifying the issues and defining the research purpose is one of the most important phases of the research process, having decisive influences over the subsequent phases.

Even if perfect decisions are taken during the other phases, the research is compromised if the issue to be investigated and the research purpose were not clearly defined, and this can only be attained through a close collaboration between the person conducting the research and its beneficiary. (Balaure (coordinator), 2000)

In order to exemplify such a research, we will assume that the purpose is “studying readers’ preferences for the Formula AS weekly magazine”, with a view to improve it in accordance with the preferences.

#### *Defining the research objectives*

In the process of organizing the marketing research, formulating objectives involves determining on an operational level which information is necessary for grounding the optimal decision alternatives for each dimension of the issue investigated. Each objective must be relevant for the research purpose.

Establishing clearly the research objectives are useful in fundamenting the priorities concerning the necessary information and serves as a standard in evaluating the final results.

The objectives corresponding to the research purpose put forth above may be formulated as follows:

- Determining the importance readers invest in the main characteristics of weekly magazines;
- Identifying the main competitors of “Formula AS”, from the number of readers point of view;
- Identifying readers’ preference for the “Formula AS” weekly magazine;
- Determining how the readers preferring “Formula AS” appraise its main characteristics;
- Identifying how the readers preferring “Formula AS” appraise its topics;
- Identifying the main sections preferred by the readers of “Formula AS”, by age groups;
- Determining how the readers preferring “Formula AS” appraise its main sections;
- Identifying the main reader segments by age groups, sex, employment and income.

#### *Defining the research hypotheses*

Once the research objectives are set, it is necessary to decide on the hypotheses to be tested within the research.

Based on a logical analysis of all possible hypotheses related to the issue under research, those hypotheses that can be tested by the research conducted are selected.

Stating a valid hypothesis may have as a starting point the theory of a discipline, the experience acquired by certain specialists, the results of previous researches or the results of an exploratory research conducted in advance.

For our example, the corresponding hypotheses may include:

- The main weekly magazines competing with “Formula AS” are “Magazin” and “Acasă Magazin”;
- The weekly magazine “Formula AS” is on top of weekly magazines readers’ preferences;
- The preferences for the sections of “Formula AS” are varied:
  - the main sections preferred by persons under 35 are: “Romanian world”, “Stars gallery”, “Bizarre chronicles” and “Enigmas” ;
  - the main sections preferred by persons over 35 are: “Health”, “Spirituality”, “Top Shape”;
- The topics covered by “Formula AS” are appraised by readers as extremely varied and detailed;

- The frequency of reading the “Formula AS” weekly magazine differs significantly according to age and sex.

#### *The research sample*

It is essential in carrying out a marketing research to determine the elements concerning the research sample.

Sampling relates to establishing the sample size and structure, so that one basic condition is fulfilled, for the sample to be representative with respect to the population researched.

The sampling base is to be determined (general population, population of selection and unit of observation) and the sample size, size which is to produce optimal results with minimum costs (it does not necessarily ensure representativeness of information).

The sample size, apart from its theoretic foundations, must answer to the concrete objectives associated to the study under scrutiny. In practice, while it is possible to determine a sample size ensuring representativeness of all information to be gathered, is very seldom used, due to the costs involved. A compromise is usually accepted between objectives and costs, by choosing that sample size producing the best results (Anghelache et al., 1995).

#### *The research questionnaire*

The questionnaire is the instrument most frequently used in obtaining primary data and consists in a set of questions the respondents must reply to. The flexibility of such instrument lies in the fact that a question may be asked in countless different ways (Kotler, 1999).

The questionnaire is one of the most important elements the success of a selective research depends upon. Concerning the methodology of elaborating the questionnaire, it is believed it is more of answer art than a science.

Specialists agree that, in order for the questionnaire to be an efficient tool, it must fulfill the following functions:

- to ensure the cooperation and involvement of the respondents;
- to communicate correctly to the respondents what is expected from them;

- to aid the respondents in formulating answers to questions;
- to avoid possible distortions of replies;
- to facilitate the interview operator to carry out his/her task;
- to generate the base necessary for processing the data gathered.

Upon elaborating the questionnaire, aspects such as the following needs to be addressed:

- identifying the characteristics comprised in the survey objectives and program, and their logical ordering;
- formulating the questions the respondent is to be asked. With this respect, one must take into account:
  - the type of questions that are to be used (closed, open or mixed questions; factual or opinion questions etc.);
  - the quality of questions (to be specific, simple, to avoid ambiguity, vague and tendentious wording, to avoid presumptions or hypotheses etc.);
  - the order of questions (the questionnaire must be elaborated using the “funnel” principle, starting with general questions and continuing with more and more specific questions, or using the “inverted funnel” approach);
- choosing the proper sizing, page layout and general aspect of the questionnaire;
- using the proper coding and elaborating the code list.

After applying the questionnaire and processing the data collected, we proceed to analyzing and interpreting the data in order to reach the research conclusions. The research conclusions aim at answering to the objectives and hypotheses set out in the preliminary phase of the research, and shall constitute an important source of data for the decision-maker.

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# Two Different Views On Monetary Policy Impact: The New Consensus and Post-Keynesian Economics

■

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**Abstract.** *The objective of this study is to make a synthesis of the differences between two new macroeconomic views. A New Consensus has arisen among neoclassical and New-Keynesian economists, such as Romer, Taylor and Walsh. This new view seeks to redefine the application of monetary policy by re-specifying the most appropriate monetary rule, which is used for inflation targeting. The framework of the monetary policy impact requires the usage of a expectations augmented Phillips curve, characterized through the lack of trade-off inflation-unemployment in the long-run. Post-keynesian macroeconomic critical, whose promoters are Arestis, Lavoie and Satterfield, argues that for most of the production levels obtained output change has no effect on inflation. This is a re-formulation of the Keynesian aggregate supply curve, which is entirely horizontal.*

**Key words:** New Consensus macroeconomic; monetary policy rule; Phillips curve; potential GDP; post-Keynesian

■

## The “New Consensus macroeconomics”

According to the New Consensus, long-term inflation is the result of excess aggregate demand. Supply shocks are random, and their average tends to zero, so that they will have a lasting impact on inflation. In the short term there is a trade-off between inflation and unemployment, but will disappear in the long run, in a neutral monetary policy. This can be illustrated by the Phillips curve equation:

$$\Delta\Pi = \alpha_1\Delta Y + \varepsilon_1,$$

Where:  $\Delta\Pi$  – difference between the actual inflation rate and its expectation level;

$\Delta Y$  – output-gap;

$\alpha_1 > 0$ ;  $\varepsilon_1$  – non-recurrent inflation shock

If there is an output above potential ( $\Delta Y > 0$ ), inflation will accelerate, and otherwise it will generate a decrease of the inflation.

Like Friedman, supporters of the New Consensus believes that monetary policy can influence the real economy in the short term issue reflected by the IS curve. According to this, investment and production capacity are inversely correlated with changes in real interest rate (Lavoie and Kriesler, 2005).

$$Y_a = Y_0 - \alpha_2 i_R.$$

Where:  $Y_a$  – current output;

$Y_0$  – autonomous components of output;

$i_R$  – real interest rate.

To target an optimal inflation rate, were proposed two types of the monetary rules. Friedman proposed the adoption of a rule based by optimal money supply growth. In contrast, for New Consensus economists the interest rate is effective tool in achieving the inflation target. The Central Bank establishes an interest rate for guiding monetary policy, which will influence the monetary supply in economy. This is a nominal variable that affect the real interest rate through anticipated inflation. For representing the monetary policy rule (MPR) in the case of a central bank with inflation targeting strategy, I will consider IS curve, the reference interest rate and short-run, long-run Phillips curves ( $PC_s$ ,  $PC_l$ ) such in model described by Carlin and Soskice (2005).

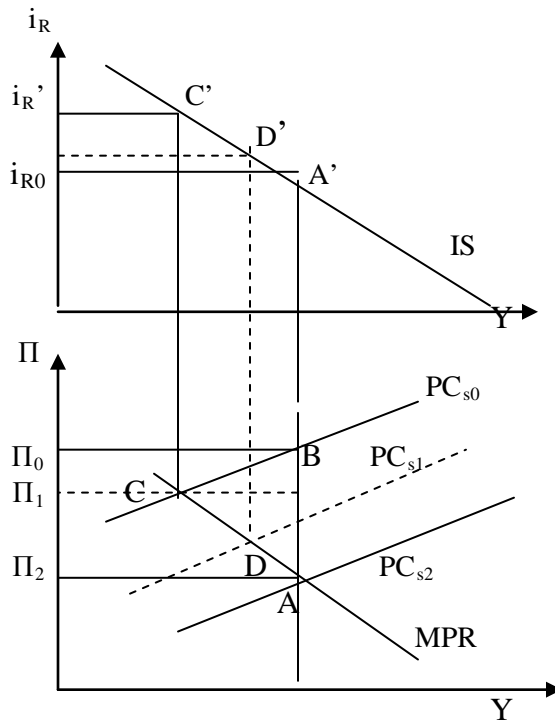


Figure 1. Monetary policy rule of the central bank

According to figure 1, it can be supposed that Central Bank aim to reducing inflation from  $\Pi_2$  to  $\Pi_0$ . Initially the economy produces at potential GDP (point B), which corresponds to equilibrium real interest rate ( $i_{R0}$ ) from IS curve. To reduce inflation the central bank will increase the benchmark interest rate, which will directly influence the real interest rate. Economy will face short-term trade-off between inflation and unemployment, shown by Phillips Curve on short term ( $PC_s$ ). The decrease of the inflation rate at level  $\Pi_1$  leads to lower aggregate demand and a lower GDP, corresponding to point C. Thus, it registers a recessionary gap which will reduce the inflationary expectations in the economy and the short-term Phillips curve become  $PC_{s1}$ . The registered disinflation leads to decrease of the monetary policy interest rate, the economy moving along IS curve from point C' to A', along a line called monetary rule (MPR), from C to A. This line shows the output level chosen by a central bank, given the Phillips curve constraint that it faces. To achieve this, a central bank sets the interest rate instrument, according to IS curve.

The monetary policy rule shows central bank's reactions in context of output-gap or inflation rate deviation from its target. For look into this rule, may be use a model with three equations, which represent a synthesis of New Consensus' approach (McCallum, 2001):

- $\Delta Y_t = a_0 + a_1 \Delta Y_{t-1} + a_2 \Delta Y_{t-1}^a - a_3(i_t - \Pi_{t+1}^a) + s_1$
- $\Pi_t = b_1 \Delta Y_t + b_2 \Pi_{t-1} + b_3 \Pi_{t+1}^a + s_2$  (unde  $b_2 + b_3 = 1$ )
- $i_t = i_R^* + \Pi_{t+1}^a + c_1 \Delta Y_{t-1} + c_2 (\Pi_{t-1} - \Pi^T)$ .

Where,  $\Delta Y$  – output-gap;  $i$  – nominal interest rate;  $i_R^*$  – equilibrium real rate of interest;

$\Pi$  – inflation rate;  $\Pi^T$  – inflation rate target;  $\Pi^a$  – anticipated inflation rate;

$a_0$  – autonomous components of aggregate demand;

$s_1, s_2$  – stochastic shocks.

The first equation corresponds to aggregate demand (IS curve), the level of output being influenced by past and future levels, respectively by real interest rate. The second equation refers to the Phillips curve backward and forward-looking. The coefficient  $b_1$  refers to flexibility degree of prices. Last equation refers to a monetary policy rule, similar to that of

Taylor, in which the interest rate requires knowledge of reference variables: equilibrium real rate of interest, anticipated inflation rate, lagged output gap and the deviation of the inflation rate from the target.

Establishing the natural rate of interest is consistent with adopting a neutral monetary policy, determining compliance with the inflation target without deviation of the output. If the output gap is zero, then there is a constant rate of inflation, according to second equation. Knowing that  $i_R^*$  corresponds to the potential GDP, then it should be equal to the ratio of the coefficients  $a_0$  and  $a_3$  (in first equation  $\Delta Y = 0$ ).

Thus, the New Consensus advocates argue that inflation can therefore be reduced by the interest rate instrument. This affects aggregate demand and output gap (according to first equation), which in turn influences current inflation (according to second equation). Natural rate of interest, estimated by the Central Bank, means equalizing demand and aggregate supply at level of potential GDP (with zero output-gap).

According to model proposed by McCallum (2001) it results that economists belonging to the New Consensus have the following five arguments:

- **the money is neutral in the long run.** It results that there is a vertical long-run Phillips curve which coincides with potential output (consistent with the NAIRU), i.e. there is no long-run trade-off between inflation and unemployment. It results that increase of money offer does not affect real variables, but only nominal ones (such inflation rate);
- **the aggregate demand changes cause an expansionary or recessionary output gap.** The changes of the fiscal or monetary instruments lead to aggregate demand changes and to short-run deviations from potential output.
- **the economic growth process is influenced by potential GDP.** Production capacity of the economy is influenced by long-run aggregate supply which is the results of the capital stock, employment and technical progress.
- **the inflation rate is influenced largely by inflation expectations.** These lead to increase of the Phillips curve on short run

(PC<sub>s</sub>), affecting output and inflation and requiring an adjustment of the monetary policy rule (figure 1).

- **the interest rate is exogenous in relation with money offer, but endogenous in relation with other variables, such inflation rate or output gap (monetary policy rule).** It results that traditionally LM curve no longer describe the relationship between money supply from monetary market and interest rate.

## The Post-Keynesian critique

The objective of this section is to present an alternative to orthodox approaches of the New Consensus about monetary policy management. I have used some arguments summarized by Post-Keynesian advocates, such as these being formulated by Lavoie and Kriesler, 2005. Generally, post-Keynesian critique aims to investigate the validity of the relations sustained by New Consensus approach and to explain the major challenges for a central bank which targets an inflation rate level. There are three major differences between the two approaches, inspired by equations of the McCallum model:

- **the relationship between interest rate and investment is not a linear one, such in first equation of the McCallum model** (2001). The first reason is that the monetary policy interest rate does not always influence the long term interest rate or the lending rates, whose changes affect the aggregate demand. The interest rate pass-through can be an ineffective process and it is possible that the monetary policy decision do not influence the real economy, i.e. output and employment. The second reason is that the economy may be in a “liquidity trap”, situation in which the interest rate reduction does not increase the investment, due to lower business confidence in an economy. Therefore, the inverse relationship between interest rate and investment is not available in any situations.
- **the money is not neutral in the long run and the long-run Phillips curve is not vertical one** (second equation in

**McCallum model).** It results that increase of the aggregate demand influence output and employment on long-term. Also, some economists are even skeptical about the existence of short-term compromise between inflation and unemployment, i.e. reject the form of the short run Phillips curve. The first reason is that short-run aggregate supply is horizontal one, according to Keynesian view, and the employment can increase at constant level of the prices. The second reason refers to stability of wages as a result of collective bargaining, which does not induce additional pressure on inflation.

- **the monetary policy rule (third equation in McCallum model) is affected by lags of transmission of the central bank interest rate upon the inflation rate.** Arestis (2004) has explain that increase of the interest rate with 1 percentage point in euro area led to a decrease of the inflation rate only with 0.2 percentage points. The first reason is that a central bank has difficulties to better approximate the inflation rate over several month when the current monetary policy decisions can influence it. The second reason is that the inflation process may be the consequence of the cost push in the economy on which the central bank has a lower influence. Therefore, high interest rates can coexist with higher inflation rate (Gibson paradox). The third reason refers to difficulties of the central bank in calculating an equilibrium real interest rates, which must be equal to the ratio of the coefficients  $a_0$  and  $a_3$  (the first equation of the McCallum model). Changing propensity to save, to investment or demand for exports could influence the coefficient  $a_0$  and consequently the neutral rate of interest.

Based on the above reasons of the Post-Keynesian approach in literature have proposed several ways of amending the New Consensus macroeconomics. Thus, Lavoie (2005) argues the necessity of a fourth equation in the McCallum model, according to which the target inflation rate should match the natural rate of growth maximization. Therefore, deviations from optimal inflation rate would induce a decline in a potential growth rate. Satterfield (2004) argues that the potential growth is

affected by the path of actual rate of economic growth. Thus, a reduction of aggregate demand will generate an increase of structural unemployment and a decrease of potential GDP. Not surprising in times of recession it registers a lower real GDP and a lower potential GDP. Also, the author has proposed another variable in the second equation of the model – a variable which explain the cost push inflation, neglected by New Consensus approach. According to this relationship, only a part of the previous inflation ( $\alpha_3$ , positive and lower than one) is transmitted to the current inflation and increasing production lead to an increase in inflation:

$$\Pi_t = \alpha_3 \Pi_{t-1} + \alpha_4 Y_t + \Pi_c,$$

Where:

$\alpha_4 > 0$ ;  $\Pi_c$  – a vector of institutional variables that affect aggregate wage and price setting behavior.

Other economists (Freedman, Harcourt and Kriesler, 2004) believe that there is not a positive relationship between the output and inflation, such in the above equation. They argue that in the case of the most production levels, the impact on inflation rate is low. Therefore, changes in output lead to inflationary pressures only at levels near full utilization. Similarly, only at very low levels of capacity the inflation rate will register a reduction. Consequently, there is a short-run tradeoff between inflation and unemployment only at very low/high output levels, while in the other cases, inflation will be constant (figure 2). In the situation described by the three economists, Phillips curve equation becomes:

$$\Pi - \Pi^T = \alpha_5(Y - Y_0) + \alpha_6(Y - Y_p)$$

where:

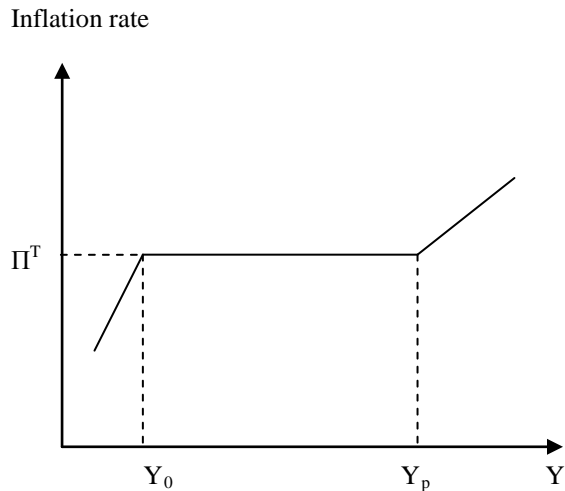
$\Pi$  – actual inflation;  $\Pi^T$  – inflation target (corresponds to  $Y_p$ );

$Y_0$  – lowest level of output, below which the inflation rate falls

$Y$  – actual output ;  $Y_p$  –potential output;

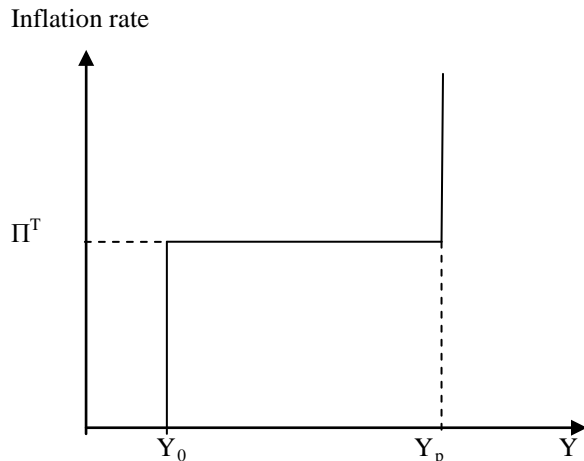
$\alpha_5 = 0$ , for  $Y > Y_0$  și  $\alpha_5 > 0$ , for  $Y < Y_0$ ;

$\alpha_6 = 0$ , for  $Y < Y_p$  și  $\alpha_6 > 0$ , for  $Y > Y_p$ .



**Figure 2.** *Post-Keynesian short-run Phillips curve*

If the current level of production is situated between  $Y_0$  and  $Y_p$ , the change in inflation is zero and it is identical with the target. According to the new form of the short-run Phillips curve (figure 2), the central bank can promote an expansionary monetary policy, if the production is below the potential. The consequence is a fall in employment for a higher production than level  $Y_0$ . Because inflation rate does not deviate from the target, then inflation expectations will not change, which is a reason to keep it steady and long term. Based on these correlations can be established that form long-term Phillips curve is horizontal level of production located between  $Y_0$  and  $Y_p$  and vertical for  $Y_0$  and  $Y_p$  levels (figure 3).



**Figure 3.** *Post-Keynesian long-run Phillips curve*

These new forms of the short/long-run Phillips curves were proposed by Lavoie and Kriesler, 2005. These authors have offered some arguments to sustain the post-Keynesian critique, based on empirical estimations of the three economists. Thus, Eisner (1996) showed that the U.S. economy was characterized by the short term compromise between inflation and unemployment only for high rates of unemployment (for output levels below  $Y_0$ , Figure 2). Filardo (1998) estimated the under a limited output gap any negative deviation from potential output has no inflationary effect. Recently, Wang (2004) noted that most data available for the American economy from 1970 to 2003 suggest a production level between 78% and 85% of maximum capacity with a constant rate of inflation. For represent this situation in the figure 2, I will consider that  $Y_0$  is 78% and  $Y_p$  85%. The main factor that could generate inflationary pressures and therefore a change in post-Keynesian Phillips curve is the price of primary resources, extremely price sensitive global demand.

According to post-Keynesian arguments, it can be concluded that promoting a restrictive monetary policy is not necessary for most levels of production achieved. The cost of this policy involves a reduced rate of labor participation, which could lead to lower growth rates and a slowdown in potential GDP increase.

## Note

<sup>(1)</sup> Taylor recognized that if the central bank acts on an incorrect estimate of the natural rate of interest, “then the steady state inflation rate will not equal the target inflation rate”. “The rate of capacity utilization can converge to its normal level without the steady state inflation rate converging to the target rate set by the central bank. If the implicit real interest rate estimate is too high, the actual steady state rate of inflation will be too low relative to the target, and hence the central bank will need to revise downwards its estimate of the natural rate of interest”. (Lavoie and Kriesler, 2005).

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# Systems of Enterprise Governance and their Effects on the Economic Performance



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***Abstract.** The systems presented by the world managerial theory and practice display the concern for finding solutions adapted to the permanent changes taking place in the external environment or inside the economic organizations. In the following, we will focus on the concept of enterprise governance, highlighting the ideas on which the functioning of this managerial system is based and its effects on organizational performance and on the stakeholders' satisfaction. The analysis of the more or less recent evolutions in various European countries, of the success and failures registered by now, allows us to draw out useful principles on which we could substantiate the managerial actions meant to sustain the immediate and future performance of the economic organizations.*

**Key words:** enterprise governance; economic performance; partnership approach; cognitive approach; organizational perennality.



## 1. The concept of enterprise governance and the context of its emergence

The emergence of the concept of *enterprise governance* is associated, first of all, with the shareholders' need to control the decisions adopted by the managers.

In this context, the choice of the governance forms and of the mechanisms used to regulate the managers' action aimed at a double objective:

- a. providing the perennality of the organization and,
- b. maximizing its performance, according to the criteria defined by the shareholders.

a. This first objective shows that the concept of *enterprise governance* is not limited to taking into account the interests of the shareholders: the concern for the perennality of the organization includes, even if it does not have the same intensity, the aspirations of other

parties involved (stakeholders), first of all of the employees, but also of the banks, suppliers, clients or other institutions more or less connected to the enterprise activity. In other words, the concept of *enterprise governance* raises more fundamental questions: those regarding the efficiency, the value creation, the repartition of the richness created in a context in which the interests of the managers and of other involved parties are not necessarily convergent.

b. The concern for maximizing the enterprise performance regards the search for an optimal system of governance and for some tools able to regulate the actions of the managers according to the interests of the stakeholders and shareholders.

However, the problem regarding the control of the managerial decisions is not recent: it is associated with the

separation between property and management and with the owners' awareness of the risk of spoliation represented by the absence of certain regulations that should empower the managers with the mission of optimizing the enterprise performances.

Nowadays, the problem of the managerial control and of the *enterprise governance* reached a new dimension and entered the heart of the debates regarding the managerial performance, for two main reasons:

- The increased role of the financial investors in the corporate development and,
- The managerial inefficient or fraudulent practices that marked the recent activity of more economic organizations.

In the following, we will discuss the two reasons:

■ *The role of the financial dimension in the economic growth*

The end of the '90s was characterized by a wave of activities oriented towards external growth by means of mergers, absorptions, acquisitions, first of all in the field of information and communication technology, but also in more traditional activity fields.

Financial investors oriented their capital towards the western economies and brought about specific practices. This way it appeared and spread the model of *enterprise governance* that modifies the structure of power and imposes the request of transparency and rigor in the relationship between the managers and the shareholders.

In the centre of this model lays the imperative request for profitability and exigency towards the managerial performance, measured especially on the basis of several financial indicators (the action value, the added value). These aspects made the above model be called the "stock model of *enterprise governance*", with the financial investors being oriented mainly towards the action value.

■ *The inefficient and/or fraudulent practices*

The existent governance system encountered strong turbulences caused by financial reasons, by the events of September 11<sup>th</sup>, 2001 and by the multiplication of the scandals that followed the discovery of the fraudulent accounting practices leading to the bankrupt of companies famous at that moment (ENRON – SUA, Parmalat – Italia). The shareholders began, more and more, to be afraid of:

- the risk of manipulation of financial information;
- the correctness of the financial analyses;
- the limits of the control operations and, naturally, the debate around the theme of *enterprise governance* was launched again.

The speculative deviations of the economic environment and the accounting maneuvers of many companies highlighted enough the risks of the *enterprise governance* oriented

exclusively towards the financial objectives. Therefore, other aspects were also introduced in the model framework regarding the organization, especially those connected to the human resources and to the management of the environment.

## 2. The relationship between performance and enterprise governance

The theoretic framework treating the relationship between performance and *enterprise governance* reflects the concern (however old) for conceiving a system for regulating the managerial behavior in order to allow the maintenance, the defense or the strengthening of the shareholders' interests. An extensive agreement was made between those who considered the limitation of the managers' power useful and necessary, the restriction of their area of action and the control of their decisions. All these views can be grouped in two main theoretic orientations:

*a. a theory that favors the stakeholders' point of view and that aims at impeding the managers to affect negatively the incomes of the capital owners.*

The adepts of this point of view consider that:

- the shareholders are less informed, not having a direct access to management;
- most frequently, the contract binding the shareholders and the managers is incomplete (not all the situations likely to appear can be anticipated);
- there is a moral risk for the shareholders (the manager can take advantage of the asymmetry of information and of the incomplete character of the contract in order to optimize the utility to the prejudice of the shareholders' interests);
- it is necessary to conceive and to implement control systems that should monitor and control the managers' behavior;
- the efficiency of an enterprise is influenced by the disciplinary power imposed by its governance mechanisms, as they join the interests of the managers to those of the financial investors.
- among the mechanisms used to limit the decisional power of the managers we identify *internal solutions* (creating an active Council of Administration, a General Assembly of the Shareholders or using proper systems of remunerating the managers) or *external solutions* (using the labor market for managers, using the stock market, cooperating with the banks or with the financial analysts)

The analysis of all these mechanisms reveals the fact that the creation of the Council of Administration and the proper definition of its role, its structure and its power are essential, especially if we take into account the fact that this body applies systems of manager motivation in order to increase the performance.



The risk of getting fired can determine a manager to make himself/herself difficult to be replaced or to make sure that his elimination will make the shareholders pay an important cost. There are multiple situations when the manager chooses complex strategies for the company, strategies that only he/she is able to apply or he/she makes decisions of investments, the efficiency of which depends on his/ her presence.

Taking into account all these aspects, the *enterprise governance* allows the shareholders to perform an exigent control and to make the managers search for ways of actions that are not likely to be sanctioned.

*b. a theory less debatable that regards the relationship between the shareholders and the managers, that is based on the analysis of value creation and that takes into account the cognitive theories of the company*

The main limit of the above mentioned theory is the fact that it takes into account exclusively the shareholders' point of view. Yet, obtaining a profit in a company involves several factors and, consequently, its repartition has to be fair in order to stimulate the efficiency. In this case, the system of *enterprise governance* (partnership governance) regards exactly such a repartition that can influence its long term existence. The main concern regards the optimization of "the value of the partnership" (not only the value of the shareholders status) and the setting up of functioning rules that could eliminate the potential conflicts.

According to this partnership view concerning the *enterprise governance*, there are various conflicts that can be avoided between:

- shareholders – managers (the shareholders bring the financial funds, the managers contribute with competence);
- employees – managers (the employees create value, the managers are interested in developing and valorizing the human factor);
- enterprise and various partners: clients, suppliers, banks or other organizations.

This extended theory interconnects the stakeholders and their satisfaction to the possibility that an enterprise survives on a long term.

### 3. Cognitive approaches regarding the enterprise governance

The traditional approaches are too normative and too static, so that the interest in the cognitive model regarding the *enterprise governance* is being justified. Unlike the former theories based on information, the cognitive model is based on "knowledge" (deriving from joining information and reasoning) and is interested in the process of adding value. Under these circumstances, the cognitive approaches focus on the competence and on the ability of the enterprise to innovate, to create investment opportunities and to modify the environment.

The need to harmonize the parties' interests is not so obvious anymore and the role of the manager is to anticipate and create new opportunities for his organization, to adapt permanently to the environment in order to provide a sustainable profitability. The systems of governance based on the cognitive model use the cognitive diversity, the debate, the organizational learning in the process of preparation and implementation of the proposed solutions in order to solve certain problems of mutual interest.

### 4. Mechanisms of regulation used in the enterprise governance

The models of *enterprise governance* use, in different contexts, specific mechanisms of regulation that correspond to the need of increasing the economic performance. These can enter two main categories:

- From the point of view of their affiliation to the enterprise, we can identify *internal mechanisms*, specific to the company (the Council of Administration), and *external mechanisms* (the labor market, the stock market, crediting bodies).
- From the point of view of their creation, we identify *deliberate mechanisms*, aimed at the control and limitation of the manager's autonomy area (disciplinary mechanisms), and *spontaneous mechanisms*, based exclusively on the "natural" game of market and institutions functioning.

If we intersect these two classifying criteria we get the table of possible mechanisms of *enterprise governance*:

**Possible enterprise governance mechanisms**

Table 1

	Mechanisms specific to the enterprise	Mechanisms non-specific to the enterprise
<b>Deliberate mechanisms</b>	Formal control systems Remuneration systems	The legal environment and its binding regulation
<b>Spontaneous mechanisms</b>	Informal surveillance mechanisms (implicit control systems already existent in the organization)	The managerial market, the financial market, the market of goods and services

**Source:** Depret et al., Gouvernement d'entreprise, De Bocck, Paris, 2005.

Among all the mechanisms presented above, the Council of Administration is obviously the key structure and the most analyzed structure of *enterprise governance*, taking into account the fact that it is the body that solves the potential conflicts between the managers and the shareholders. Firstly conceived as a body meant to control the managers (in the context in which the governance favors exclusively the point of view of the shareholders), the Council of Administration proved to be the guarantor of the interests of various stakeholders (the model of partnership governance mentioned above). In the cognitive model, the Council of Administration can become a "social

network” helping the manager to accede to new resources, to privileged information, vital for drawing up the strategy.

The structure of the Council of Administration often reflects its role in the activity of the enterprise. We can thus see the place of the employees’ representatives, of the financial bodies or of other important partners.

An interesting question regarding the structure of the Council of Administration is the following: is the presence of external independent administrators (they are not shareholders and often managers of other companies) in the Council of Administration of an enterprise justified?

The most common answer was positive: the existence in the Council of Administration of people coming from various geographical areas, bringing about information and experiences from various types of organizations, helps to avoid non-profitable strategies, to avoid taking unjustified risks, to diminish the tendency of managers’ domination, guaranteeing thus the shareholders’ interests.

Among the mechanisms non-specific to the enterprise, we retain the important role of various markets:

- First of all the financial markets, as they allow the quick checking of the possible inefficiency of the managers (reflected to a certain extent in the share price);
- Then, the labor market (here considered as the managers’ market) also plays the role of regulator. Even if the replacement of a manager has a cost (research, recruitment, selection, training, remuneration...), the threat of going for an external manager can reduce the risk for the shareholders, except for the case when the current manager succeeded into “getting so strong roots” that can destabilize the enterprise.

## 5. The systems of governance of the European enterprise

According to their history and their culture, to their greater or smaller approach to the North-American economy, the European countries can display hybrid systems of governance that borrow various elements from the models already presented:

- the stock model, based on the financial markets;
- the partnership model, based on the interests of the parties involved;
- the network model, based on the interpersonal and social relationships between the various actors of the governance;
- the administrated model, based on the State intervention.

Probably it is not surprising the fact that we frequently meet the stock model in the Anglo-Saxon Europe (N-V), geographically closer to the American economy (especially

in Great Britain and the Netherlands). In these countries, characterized by the presence of big multinationals, the financial and the managerial markets are the main mechanisms of enterprise governance.

Germany, which has economic characteristics closer by tradition to the partnership model, focuses on the important participation of the employees’ representatives to the act of management and on maintaining old and strong cooperation, especially between the banks and the industry.

Many economic difficulties that Germany encountered in the last years made numerous analysts express their doubt regarding the viability of certain models of *enterprise governance* in which the Union plays an important role.

In Italy and Spain, a dominant model is difficult to identify because the differences of development from one region to another were (and still are) strong. However, despite the diversity, we could notice that, from various cultural reasons, the systems of *enterprise governance* are strongly influenced by the interpersonal relationships.

## Conclusions

Discussing the theory and the practice in the field of the enterprise governance was aimed at highlighting an extremely important feature for the corporate management and for the economic performance.

On the basis of the observations registered by now, the fact that we will not be able to talk is obvious, at least not for a long time, about a *universal system* that could facilitate the good performance of the enterprise. As long as the capital moves to various geographic areas, the governance systems will adapt according to the local regulations and they will probably be less connected to the cultural factor. The whole formation process of the European Union is based on the intention of creating a unitary institutional framework, but it is far from favoring a European model of governance able to sustain the need of economic performance.

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# Evaluation of the Risk and of the Opportunities in Launching the New Banking Services

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**Abstract.** *The creation of new products and services is acknowledged as being a necessity for the development of a company. Furthermore, due to the changes occurred in the banking field, the introduction of new services became for institutions a condition to remain competitive.*

*The banking institutions which intend to be leaders in a domain should take the initiative and introduce new services. In the same measure, there are companies for which the cost of a potential failure is too high and they cannot allow it. They limit to introduce in their offer the products that have been tested on the market and have success among the consumers. This option in the marketing policy of the firm depends on several factors, such as the mission of the organisation, the intended objectives, the dimension and the resources of which it disposes and last but not least the nature of the new proposed service.*

**Key words:** development of new financial services; management of existing products; product elimination.

■

## Introduction

The product is, undoubtedly, the main component of the marketing mix. However competitive the price shall be, however effective the distribution and inspired the promotion is, if the product does not meet the qualities required by market, the organisation won't register a success on long term.

As much as, in case of the financial products, the high degree of intangibility has as consequence the difficulty of "isolation" of the service by the price and its manner of distribution.

The banks must ensure certain aspects related of the tangibility of the services offered, so as they may be effectively sold. The banks shall use the marketing elements which may allow them the promotion of these services. As result, to any service or group of services must be attached tangible characteristics which may be used in marketing. Also, a bank shall create products from an entire portfolio of services. For instance, the banks shall "spoke" about their products: credits, investments, economies.

This is an usual element in the industry of financial-banking services. In fact, it was previously stated that what the banks offer to the consumers are services. In this case, the totality of these services represents an offer on the market of the respective institution. For instance, the card VISA GOLD is the tangible product which is accessible to the client, and the service represents the totality of benefices associated to such a card, for instance: higher limits of credit, the statute of preferential client, potential benefits of use, transfers of funds.

In the banking institution, the notions of product and service became interdependent and interchangeable, being used to describe what is offered to the consumer.

### Typology of banking services

More of the offered services involve the bank and the client alike, since there are forms to be filled up, cash to be deposited and withdrawn. Some products, due to their nature, shall need the presence of the bank staff.

As a result of the necessity of consolidating these relations, the fact that each has a role to play and that the quality of the offered service must be at the highest standard with a view to ensure the continuity of the relations becomes more and more obvious for banks. Subsequently, we shall see the necessities of the clients and the qualities of the services, as well as their importance for the bank. The organisations and their employees must be capable to deal with these changes and to ensure the services and the products that the clients need and want.

In general, the banks offer two types of services to their clients: sole transactions and services with a continuity character.

*The sole transactions* form when the client comes to a bank, buys the service, not having another contact subsequently (for instance, buying currency or cashing a cheque in currency). These sole services must be sold to the client any time he needs them.

The services with continuity character appear in the case when the client has a long relationship with the bank (for instance, a client who opens a deposit at term).

The marketing department must adopt a strategy which shall encourage the client and, based on the relationship with the bank, to resort, naturally, to sole transactions as well. This shall determine the increase of the transaction volume with expenses as reduced as possible and small effort.

Anyway, for a bank, all the clients are important, even though they visit it once or several times. Any client

must have a satisfaction feeling which, ultimately, shall determine him use several services and, if he does it, he may become loyal client on long term.

At the same time, we shall take into account that the banking services address to:

- physical persons, but differentiated to the youth, pupils, students, workers and pensioners;
- trading companies, but differentiated to the small and middle enterprises, big plants and factories, transnational societies, societies of commerce;
- other banks; there are banks of the banks (en gross), there are banks that offer collaboration services with similar banks, mandate operations, on the behalf of other banks. In Romania for instance, Transylvania Bank issues cheques Tomas Cook;
- the financial societies, within theses being the brokering societies (in Romania, approximately 15-20 banks attend to societies of movable values), the insuring societies (many banks have their own insuring societies and impose the clients to insure their credits and mortgaged goods to these – ASIT, OMNIASIG, AGRAS), the leasing societies, etc.;
- the state, such as collecting taxes, crediting the budget under the form of state titles, financing the infrastructure projects etc.

The products and the banking services modify and adapt permanently, with a view to satisfy the necessities of consume and the environment conditions in continuous change.

No matter if it is selected the extension, the diversification or the renewal of the products, the decision is being influenced by a high number of internal and external factors. We state further on four of the factors with high impact on the strategic alternatives in the banking field, the internal factors following to be detailed in a future chapter.

*The consumers.* A financial institution may have different segments of consumers (clients): physical persons, trading companies, financial companies, the state. No matter the segmentation criterion used, the satisfaction of the necessities, of the desires, of the aspirations of the consumer remains the main point of the marketing activity. One of the issues associated to the financial services is that the consumers do not experience the necessity of acquisition of a service, but they perceive the legal obligation to do it (such as in the case of some insurance services). Consequently, it is not always relevant to identify the necessities for a product, but to create demands for different services.

Also, there must be taken into account the current products of the banking institution which continue to satisfy the basic necessity of the consumer, but which became used morally, being necessary their modernization. But, if the resources of the bank do not allow realising the satisfaction of a need new-identified on the market, especially in the conditions when this thing is also followed by the competition, it is better to give up the idea. It is more important to identify the more critical demands of the consumers that the bank may satisfy, realising therefore a balance between the client's satisfaction and the profitability of the bank.

*The competition* represents an important source of information that may be used not only in the decisions referring to the product policy. For instance, the actions of some concurrent institutions prove how they perceive the evolution (or the changes in the evolution) of the environment. This may confirm or refute the individual assumptions referring to the market tendencies. Last but not least, a significant part of the new products comes from the imitation of the competition. Indeed, the one who "imitates" benefits from the results of the marketing research made by the competition, of their putting into practice. If the competition evaluated erroneously the necessities, the mistake is less costly for the one who took over the new services.

*The technological environment* has an influence both on the development of the products and on the strategies of distribution. The development of the technology allowed the use of the banking card and automatic teller machines. In order to be implemented with success, any modification in the technological system must take into account the changes that occur in the conduit of the consumer.

*The legislation and the judicial frame* have a decisive impact, ultimately, in the development of the financial products. Many financial products are influenced and even controlled through the system of taxes imposed by the enforced judicial norms. Also, the central banks interfere through mechanisms and levers which favour or redirection, during certain intervals, different actions of the financial institutions.

### **Launching and developing the banking services**

In general, the financial companies may be classified according to the degree of introduction of the new

services in proactive and adaptive (Cowell, 1988, pp. 296-312) institutions. The proactive ones initiate major changes on the financial market. The market leaders have usually a strong conduit of marketing and, implicitly, a clear orientation towards the necessities of the consumer.

An adaptive strategy implies that the institution shall wait the market reaction, according to which it shall introduce the same type of service, with the same characteristics or an "identical", but "superior" service (with certain improvements in comparison with the initial service).

The degree of novelty of the financial products may result from (Edgett, 1993, pp. 35-43):

- changes in the technological domain (bancomats, cards);
- changes in the demands of the consumers (different types of insurances, new credits etc.);
- changes in the strategies of the competition (introduction of new financial services, adopted fast by the consumers).

At their turn, the changes in the technological field and in the necessities of the consumers may be proactive and adaptive.

Usually, the financial societies of reduced dimensions choose to offer new services on the market after the competition, whereas those which dispose of high resources assume the risk to introduce and adapt the services at the level of the technological and informational development in the financial field.

The majority of the new financial services occurred in the last years proves that the financial institution have the tendency to react rather to the concurrence than to the market. The conclusion would be that, in case of the financial companies, the advantage of the "first came" is not applied.

The measure in which a new financial service shall be accepted and adapted by the market depends on a series of factors, a part of them being attributed to the consumer, another part to the product or service. The financial institution must know the reasons for which a segment of consumers is willing to try a new service, whereas another prefers to wait a period and, at the same time, to understand (the causes) of his rejection. While the conduit of the consumer may be less influenced, the companies possess the control over their own products and services.

The process of adapting the new services depends on several factors among which (Rogers, 1982, p. 187):

- *the relative advantage*. The product or the service must, first of all, offer to the consumer a package of benefits which may emphasize its superiority in comparison with similar products. The variability of services, in general, and of the financial ones, in particular, implies differences in the process of carrying out, whereas the heterogeneity may have a positive impact in terms of personalisation and creation of a concurrent advantage. The financial institution must identify the level of tolerance of the new service variability and, at the same time, to evaluate the new service after launching it in order to ensure the satisfaction of the consumer;
- *the compatibility* with the necessities and with the system of values of the aimed segment of consumers. Within the new services occurred as a consequence of developing a new necessity, this factor is understood. In case of the services developed as a consequence of perfecting the technological and informational system or following the imitation of the competition, it is risky not to check up a current necessity of the consumers;
- *the marketing testability* – is more difficult to apply (if not impossible) in case of the financial services. The difficulty is accrued as well by the inseparability of the consumer carrier out. Consequently, the financial institutions which launch a new service must orientate both on the process of carrying out and on the existence that the consumer shall have (the degree of implication of the consumer, the level of understanding of the service complexity, changes in the consume conduit etc.);
- *the communication* – refers to a higher or lower measure in which the new service may be effectively and efficiently promoted (methods, techniques, programs). It shall be stated the fact that some aspects of the financial services' communication are judicially regulated fact which increases the attention offered to this important factor in the launching of a new service.

The systematic development of the new services involves the pass of some stages:

1. The analyse of the existing services and the definition of the strategic roles

2. The exploitation of some varieties of new services
3. The evaluation of the perspectives of these varieties
4. The exhaustive analysis
5. The proper creation and the acceptability testing
6. Post-launch evaluation.

*1. The analysis of the existing services and the definition of the strategic roles*

A first crucial step in the development of the new services is the definition of the strategic roles that the new services could play and of the priority market segments that these may attract. This shall be performed in parallel with the analysis of the situation of the existing services, of each contribution to the profitability of the bank, of the existing environment conditions.

*2. The exploitation of some varieties of new services*

The following stage is the exploitation, with a view to find some varieties of new services, the exploitation which shall be formalised and proactive, since for the insurance of its success is necessary to assume responsibilities.

The varieties of new services with the highest potential are those which determine an important or unique demand on the markets-target. Therefore, a key source of the ideas is the “target”-market, and a key method to use this source is the marketing research.

The outline of specific “target”-markets and the knowing the desires of these current and potential clients may represent an important source of ideas concerning the new service which may be developed, and the old services, which may be improved.

Also, the internal sources, requiring the direct contribution of the bank's employees, may represent a rich potential of ideas, especially in the conditions in which these realise that it worth making suggestions, and the suggestions are appreciated.

The personal contact with the clients, the periodical completion of the questionnaires, the profound interviews number among the techniques which may be used in the realisation of the feedback related with the existing services and the unknown needs of the consumers.

It shall not be ignored the solution “to take a look in the neighbour's garden”, to be practically inspired by what the competition does or to document oneself abroad. The warm water shall not be invented.

### *3. The evaluation of the perspectives of these varieties*

This stage consists in determining which of these guarantees the accomplishment of some complex conditions. Each variety is evaluated in terms of some predominant criteria.

### *4. The exhaustive analysis*

The next step refers to an intrinsic analysis of the idea of service. This stage involves a detailed examination of the financial, marketing and operational feasibility of the bank.

### *5. The proper creation and the acceptability testing*

This stage involves the effective “production” of the service, the test on a restricted circle of users and the acquirement of the market feedback.

In the process of realising the testing, there must be selected areas of the market where the consumers are not warned that they are submitted to a test and they response to the services simulates the conditions of the real world.

The market testing delivers possibilities to experiment the marketing tactics and to evaluate the entire marketing strategy whereas the service is still in the phase of limited distribution.

### *6. Post-launch evaluation*

The previous stages passed by the bank before launching condition this stage, in the sense that the acceptability testing has success when the product shall be launched. This process includes the employees from the Department of Marketing and Strategies, and the staff of public contact, of relations with the client shall be trained how to sell the product.

The launching implies solving the following issues:

1. Establishment of the launching period
2. Selecting the territorial area for launching depending on the strategy of distribution
3. Preparation of the distribution network
4. Preparation of the market
5. Establishing forth the volume of new services which are brought for sale, the organisation of the promotional actions

The launch is an operation which must be well prepared, on it depending to a great extent the success or the failure of the respective product, as well as the expenses performed for its creation.

## **Opportunities on new markets**

It is very probable that the banks shall search to exploit markets which are new for them, or new for anyone in the next dozens of years. Those who shall “make their homework faster” and shall act quicker, will gain from this tendency.

But not everything resumes to speculating on this theme, there must be discussed the criteria according to which it shall be decided the entrance or not on the new markets.

It is probably that a criterion shall be that, if the aimed market is national or even international in a higher proportion than the local one. This is for instance the dilemma of the Swiss banks which number among the first banks in the world as dimension in the conditions that Switzerland is far to be a great market.

It is also probable that the managers shall want to have as qualified staff more men than women, relying on the fact that in the '90 the fluctuation of the feminine staff was much higher. Other criteria are probably those of preferring the banking services generators of incomes from commissions, according to the present style of management and know-how and not the realisation of incomes resulted from credit interests, due to the adversity with respect to the risks, as well as to the existing “elements of endowment” in the totality of the resources.

New opportunities, “new” in fact for anyone, may occur be determined by the legal (judicial) changes or following other incentives.

When we refer to new markets, we do not necessarily think of new countries or new locations. Certainly, Central and East Europe, Russia, Asia of South-East are areas of investment interest and with a huge potential for the development and evolution of the banking services, since the level of these in the respective areas is still very low.

But, new markets mean as well new products and even new concepts to build financial services: INTERNET Banking is an obvious case of market which barely shows its potential, the sole currency created the configuration of a banking market completely new for all the banks from the countries of the European Community as well as in its extension.

The marketing intends to discover these new opportunities through the thorough study of the markets, of the products, of the consume customs, and of the competition such that the strategic decisions of development and positioning to be taken in time.

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