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Theme editor

Romuald N. Hanisz
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Foreword

I am honoured to present you with the first edition of our scientific journal “Forum Scientiae Oeconomia”. The journal has been established by the Faculty of Management, Informatics and Social Sciences of the Academy of Business in Dąbrowa Górnicza. The journal aims at publishing scientific papers in the field of Economics with a special emphasis on management sciences.

The main topic of the first edition is the crisis in the euro zone and the ways of overcoming it. Most of the papers discuss this issue, and others refer to the main topic in a large extent. The authors representing domestic and foreign scientific centres as well as the Scientific Council guarantee the high level of papers published in the journal.

The authors are warmly invited to publish their own papers in our journal which is co-created with scholars and practitioners of open and creative minds. Therefore I am convinced that through our joint efforts the journal will be our mutual success.

Yours sincerely,

Editor-in-Chief

Włodzimierz Sroka
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WORLD IN CRISIS. THE ROLE OF BANKS IN REDUCING THE EFFECTS OF THE GLOBAL ECONOMIC AND FINANCIAL CRISIS 2008-2013

Romuald N. Hanisz, Prof.

rhanisz@wsb.edu.pl

Academy of Business in Dąbrowa Górnicza

Abstract

The subject of this article is to present the economic and financial crisis, and the instruments implemented, mainly monetary, to overcome the negative effects on the global economy. The financial crisis that struck the United States quickly became real and moved to the social area, and affected the condition of the economies in the European Union. Governments affected by the crisis have developed special programs to save the global financial systems and restore the economy to growth. The battle on crisis, however, would be impossible without the participation of the largest central banks that have used unconventional tools aimed at restoring the balance in the global markets, not only financial.

Key words: financial crisis, mortgages, securitization, credit derivatives, monetary policy, liberalization of financial markets, quantitative easing.

1. Introduction

Economy has been accompanied by crises for a long time, but globalization has made them more frequent and easy to spread quickly. The current economic and financial crisis that began in 2007 in the United States is compared to the Great Depression of the late 20s and 30s and basically affected the whole world. The main reason for its emergence was the overheating of the economic situation especially in the credit market. The result of a spec-
ulative bubble in the U.S. mortgage market was the chaos in the financial market. In addition, the crisis that initially was mainly related to financial institutions, also affected state budgets (the debt crisis) and entered into the real area of the economy. Governments affected by the crisis, including Europe, have developed special programs to save the financial systems and restore the economy to growth. However, without the participation of banks, mainly central ones, especially without the Federal Reserve and the European Central Bank the fight with the crisis would be of little effects.

The purpose of this article is to present the economic and financial crisis, and the instruments implemented, mainly monetary, to overcome the negative effects on the global economy.

2. **Is the liberalization of financial markets the main premise of the occurrence of the financial crisis in 2007?**

Capitalist economy has been accompanied by crises for a long time. However, the effects of the crisis which began in the U.S. in 2007 – in the center of the global financial system – turned out to be much broader in its scope and impact than one might initially expect. It was not caused by external factors, but it was a “child” of the system as a whole (Flejterski 2011: 105). The current financial crisis, which has caused serious disturbances in the sphere of real processes in the United States and European countries, has many causes. Within the conditions of the global economy (Kowalik 2011: 58)¹, the crisis quickly spread to European countries, including the developed ones. According to Wojtyna, “the transfer effects” currently occur primarily through financial channels rather than trade ones (Wojtyna 2011: 9). It is not easy to make a distinction between the transfer effect of shock from one country to the other, and a common shock affecting at the same time all those countries in the case of financial channel. It follows that, contrary to the product and labor market, adjustments in the financial market are made with virtually no delays. Studies show that liberalization, including financial liberalization, on the one hand has a positive effect on long-term economic growth, on the other hand increases the risk of crises (Kawa 2011: 45).

Economists have divergent opinions on the causes of the current crisis. Wielecki thinks that there has been a great crisis of civilization taking place

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¹ T. Kowalik believes that the term “globalization” is a hoax equivalent term of neo-colonialism and imperialism, and the former Secretary of State Henry Kissinger said that globalization is another name for the “Americanization” (Kowalik 2011: 58).
for thirty years, and the current economic crisis is only a side effect. (Wiel-
lecki 2010: 35). Kaczmarek believes that the current crisis is rooted in the
lack of trust and lack of social responsibility as well as consumption, which
has reached monstrous and pathological dimensions. “Reasonable limits of
the growth of the global economy have been exceeded.” (Kaczmarek 2009:
142). However, Bootle believes that the current crisis is the result of in-
teractions of eight strong factors: “banks” in the property market, the debt
explosion, the financial weakness of banks, improper risk valuation, errone-
ous monetary policy, excessive tendency to save money in some countries
(e.g China), indulgence and incompetence of the governing bodies and the
submissiveness of credit rating agencies (Bootle 2009: 9).

Kołodko claims that the current crisis is fundamental and systemic.
This is a systemic crisis of contemporary capitalism, its liberal mutation.
The reasons for the crisis are to be found in the structural changes that ac-
crued in the global economy, especially in the U.S., and with the correlated
neo-liberal ideology. Neo-liberalism made a state and its regulations a spe-
cific enemy number one (Kołodko 2010: 92 and 95), (Kołodko 2013: 35).

The event which led to the crisis in U.S. in 2007 and the disaster in 2008
was the gradual deregulation of the financial system, mainly in banks.
Among others, the Interstate Banking and Branching Efficiency Act was en-
acted in 1994, which resulted in a creation of a national banking system and
then in November 1999, the Financial Services Modernization Act – Gramm
– Leach – Bliley Act (GLBA), which abolished restrictions on the conduct
of the various categories of financial services and speculation limitations
imposed on banks in 1933 by Glass – Steagall Act (GSA), (Mishkin 2002:
348-350). GSA regulated the financial system by separating the banking
sector /deposit and loan/ from the investment and public sector – securities.
GLBA was enacted primarily to legally remove any barriers that were sepa-
rating GSA investment banks from public savings and deposits, and to allow
banks to carry out operations characteristic for insurance companies. While
signing GLBA, President Bill said: “This is a historic change. The fact is
that the Glass – Steagall Act no longer corresponds to the economy in which
we operate”, and U.S. Secretary of Finance Larry Summers promised: “With
the new law, the U.S. financial system is entering the twenty-first century”

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2 Neo-liberalism cannot be confused with liberalism. According to Kołodko “A better fu-
ture can be built on values such as freedom, including economic freedom. Ideas such as
liberty, freedom of choice, democracy, pluralism, private property, entrepreneurship, market
competition are positives worthy of treatment. Neoliberalism, however, in a cynical and ef-
cmpactive way, exploits these liberal values to transfer income from the mediocre and poor
people to the rich and wealthy minority” (Kołodko 2013: 35).
Deregulation was a single, but at the same time very important, factor in the rise of modern investment banks and new financial market instruments, including the derivatives. While searching for the causes of the current crisis, one cannot overlook the factors that contribute to the emergence and development of the crisis:

- Modern IT technologies, whose implementation by the financial market institutions has resulted in the increase of information asymmetry in the economic system and the quick increase of money circulation;
- The emergence of the global market of derivative financial instruments (derivatives) as a result of deregulation and information technologies;
- An increase in currency speculation;
- Imbalances in trade and income distribution expressed in the statements like: “The West consumes and Asia produces” or “The poor saves (China) and the rich consumes (USA)”;
- The increasing dominance of the financial sector in the overall economic activity. The process of financialisation of the U.S. economy has the following characteristics: Revenues of the financial markets in the U.S. in 2000 totaled 508,456 billion and were higher than in 1990 at 123.5%. In 2000 the financial market revenue exceeded the U.S. GDP 51 times while in 1980 – six times, in 1990 – 42 times. The U.S. GDP in 1980 was 15.7%, in 1990 – 2.6%, in 2000 – 1.9% of the financial revenues (Żyżyński 2010: 29).

At the outbreak of the current crisis, the scale of the detachment of the financial sector from the real economy was so great that the necessary adaptations could have been accomplished only by the crisis shock adjustment (Kołodko 2010: 93).

From the point of view of this chapter, it is worth talking about the reasons related to the functioning of the financial system, especially the banking system. The immediate cause of the crisis was the collapse of the mortgage market – the speculative bubble burst. The bubble was generated in the real estate market as an effect of a very rapid growth in mortgage lending, resulting from the softening in financial capacity assessment, and particular institutional and legal solutions making the access to loans for a wide range of customers much easier, often not having a job or an adequate income – NINJA (No Income, No Job, No Assets). In 2000-2007, the debt of households with mortgage loans increased in relation to U.S. GDP from about 49 to 76%. The relaxation of credit criteria was reflected
in the deterioration of credit quality and an increase in the risk of insolvency. The value of substandard mortgages, the so-called subprime, increased from $190 billion in 2001 to $600 billion in 2006, and their share in the total value of mortgage loans in these years changed from 8.6% to 20.1% (Kacprzyk 2009: 85). It is believed that the crisis in 2007 did not result from the collapse of the mortgage market substandard because it was “only an ignition of a bomb whose strength was accumulated through pathological relationships characteristic for neo-liberalism... “ (Kołodko 2010: 97). Other sources may include the unprecedented development in the securitization of assets and the monetary policy of the Federal Reserve System.


The deregulation of financial markets has enabled the change from a traditional model of financing the purchase of real estate to the securitization of mortgages, i.e. the sale and issue of securities, collateralized by the real estate financed by the loan. In the process of securitization, credit derivatives have been used, including collateralized debt obligations – CDOs (Rawski 2011: 9 and onwards) and CDS – Credit Default Swap (Demko 2011: 30 and onwards), which transferred risk, including credit, from one financial institution to another3.

A new model of mortgage financing was born (Rosati 2010: 105 and onwards). The most obvious reason why banks and other lenders, including mortgage lenders, decided on securitization was to quickly obtain financing /cash/ and to get rid of the medium – and long-term assets /receivables/ at risk, particularly credit risk. Loans, especially mortgage, are paid in installments over the period of many years, while in the case of a bond issue, initiator has cash on their emissions through a broker. In the case of investors, which included the investment banks, insurance companies and banks possessing the funds, higher rates of return and risk diversification worked encouragingly to buy bonds. Relatively homogeneous mortgage packages were sold by banks to intermediate entities, including Freddie Mac and Fannie Mae, which had the status of being sponsored by U.S. government. These institutions, on the basis of the “packages”, issued MBS (Mortgage

Based Securities) and sold them to other institutions, particularly financial, not only in the U.S., but also in Europe and Asia. The pursuit of profits generated a situation where new financial institutions offering increasingly complex financial products joined the process of securitization. This meant that “the securitized assets were becoming diverse and consequently, the basic type of the instrument, on which the structured product was protected, became difficult or even impossible to identify” (Glinka 2011: 149). As a result of the dispersion of risk and difficulty of the correct valuation, new investors were not aware of the risks held on derivatives. Reputable agencies and financial market supervision, while using the traditional methods of assets valuation, were not able to properly assess the risks associated with the increasingly complex securities which were based on mortgage loans, including subprime. Symptoms of the looming crisis appeared in the second half of 2005, when a slowdown in house price growth and a gradual increase in the number of homes available for sale occurred in many areas of the U.S. Those trends were intensified in 2006 and early 2007 when the bonds collateralised by subprime securities turned out to be without coverage. First financial institutions began to bankrupt. And banks experienced multibillion-dollar losses.

The deterioration of the mortgage loan portfolio, with serious decline in property prices, has led to the deterioration in the quality of credit derivatives, thereby deepening the problems of banks and other financial institutions in the field of financial liquidity and economic activity. It has turned out that the credit derivatives did not secure mortgage banks and other financial institutions against risks, they served only for the purpose of withdrawing bank charges of various risks and for speculators. It is believed that the insurance debt resulted in increased losses caused by poor risk assessment. Given that the value of securitized investment totaled 25 billion U.S. dollars, when the speculative bubble of subprime loans burst and the value of the credit risk transfer contracts was estimated for 58 billion U.S. dollars in 2008 (which was almost the value of global GDP), the initial losses were evaluated at three trillion dollars (Mason 2010: 110-111).

The powerful growth in mortgage lending, as a result of i.a. securitization, would be impossible without the participation of the Federal Reserve System (FRS). During the economic downturn in the early years of the twenty-first century, the FRS aggressively lowered interest rates as an attempt to prevent a recession resulting from the collapse of the new technologies market. From the beginning of 2001 to the third quarter of 2003, it lowered the interest rates on federal funds /reference rate/ from 6.5% to 1%, which, obviously, resulted in the reduction of the discount rate at which funds are lent to banks. Along with the ongoing economic recovery, i.a. in
the real estate market, there has been a crucial change in the interest rates policy. From 30 July 2004, the SFR slowly but steadily raised the reference rate from 1.00% to 5.25% (29 June 2006). As expected, the increase in the value of money contributed to the decline in GDP growth from 3.6% in 2004 to 2.0% in 2007, and a major increase in the cost of mortgages which led to a bursting of the speculative bubble in this market. Banks and other financial institutions began to have problems with maintaining liquidity and started to incur losses. The assistance from the State proved to be necessary.

4. The activities of the federal reserve system alleviating the consequences of financial crisis

The financial assistance of the central bank and the federal government of the United States aimed at rescuing banks and other institutions from bankruptcy resulted only in a temporary tranquility amongst the distressed financial markets. The announcement of the bankruptcy of Lehman Brothers Holdings Inc. on 15 September 2008 (UKNF-2010 – p. 7) – one of the largest investment banks with a 158-year tradition – led to a global crisis of confidence, and thus to a significant changes in the mindset of bankers and the conduct of banks and other subjects of the financial market that supply the economy with money. The refusal to grant financial support by the federal government to such a huge investment bank as Lehman Brothers Holdings Inc. resulted in the paralysis of the financial market with its negative consequences for the real economy (Hanisz 2011: 144-145). Banks being afraid that their existing strong partners in the banking sector may also fall, stopped lending each other money. The crisis of confidence among the banks generated in turn the crisis of public confidence in banks and financial institutions, banks stopped trusting private companies, and companies stopped trusting each other. At the end of 2008, the crisis afflicted the automotive industry that was cooperatively linked with thousands of businesses. The car companies like Ford, and General Motors announced mass dismissals of workers, withheld production for a period of time and did not prolong the employment of temporary workers. The signs of recession appearing in 2008 deepened the concern about the liquidity of the financial market entities, including banks, people’s lending capacity, and non-financial companies. Rating agencies – complicit in the crisis – reduced the position of a number of major financial market subjects (Wieprzowski 2010: 92).

Initially, it was not expected that the collapse of the mortgage market in the U.S. could result in the entire wave of consequences and uncover the imperfections among the operations in derivatives, and even abuses/frauds and failures within the whole financial market. It quickly became clear that the crisis was not just a problem of one country or market, but it was a global crisis of a systemic nature. This fact caused the situation that individual countries and central banks, starting with the U.S., decided to intervene in order to prevent further escalation of the phenomenon and continuation of the increase in systemic risk.

On 6 February 2006, after A. Grenspan’s 18-year career, Ben Bernanke, an expert of the Great Depression of 1929-1933, became the head of the Federal Reserve System by the choice of President Bush. The new head of the Fed began his career during the threat of inflation, and the overall defeat in economy, especially within the real estate market, and the credit sector (Harris 2009: 18). In this situation, he continued the activities of his predecessor by raising the value of money. The first actions of the U.S. government and the Fed were aimed mainly at providing banks with money to improve the situation of current liquidity.

The catastrophe in the financial market which appeared after (probably not very well thought over) the activities leading to the collapse of Lehman Brothers Holdings Inc. forced the federal government and the Federal Reserve to direct huge funds for rescuing banks and other financial institutions, and to support the real economy. By the initiative of the Federal Government, the Troubled Assets Relief Program (purchasing risky government debt) — /TARP/ was designed. The amount of money involved in this program was 700 billion dollars. Due to its controversial nature, it was not approved until December 2008. The amount of money the banks were provided was only a half of the sum — $ 350 billion. They counted that TARP 2 or a “bank of bad debts” would be created.

To kick-start the economy throttled by the crisis, the fastest in its actions, for obvious reasons, was the Fed. By the end of October 2008, The Fed stated that it would finance the purchase of short-term debt from the money market funds by the total of 540 billion dollars. The founding of the Money Market Investor Founding Facility (MMIFF) was complementary to the previously created Commercial Paper Funding Facility (CPFF), which, starting from 27 October 2008, was financing the purchase of highly reliable, denominated in U.S. dollars, three-month, unsecured and asset-based short-term bonds issued by the American subjects, and also complementary to Asset Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF), created on 19 September 2008, which offered loans to banking organizations allowing the purchase of asset-backed short-term bonds from
money market funds. AMLF, CPFF and MMIFF were designed to increase liquidity in the market for short-term bonds, and thus, the availability of credit (Politi, Mackenzie 2008). Despite the steps taken by the government and The Fed, the recession occurred, and it has cost the economy millions of jobs. The unemployment stabilization rate – NAIRU (non-accelerating inflation rate of unemployment) has been disturbed. It sets a maximum level of unemployment that does not accelerate the inflation. (Harris 2009: 35-40).

The fight with the recession and restoring the economy on the path of growth is a challenging task for any central bank. Based on previous experiences, the basic tools in this area can include, among others:

- the reduction of interest rates of refinanced loans/funds/, preferably to zero – ZIRP (Zero Interest Rate Policy). Such actions were undertaken by the end of 1990s by the Bank of Japan. Thanks to this operation, on one hand the liquidity of the banking sector is protected, and on the other, the economy is provided with money at the lowest cost. The lowering of the interest rate by the central bank will reduce the profitability of the securities not laden with risk – especially treasury risk;
- purchasing unlimited amounts of free-risk debt securities, in the first wave – treasury securities;
- interventions in foreign exchange markets aimed at weakening the national currency and the increase in prices of imported goods and services;
- increasing the money issue/reprint/ by the central bank.

The Fed seriously eased monetary policy. Since 2007, the interest rate on federal funds has been sharply lowered, virtually to zero. As a result of such action, the real funds rate since 2008 has been placed below zero (-2,1% in 2008).

The lack of positive reaction of the U.S. economy on such a substantial reduction in interest rates made it necessary to implement a very controversial operation in November 2008, which involved the introduction to the market a huge amount of dollars. The operation was called “quantitative easing” (QE), in the jargon of financiers: “quantitative money easing” or “the reprint of money” – virtual dollars were added as entries in the accounts (Prusek 2011; Siemiończyk 2011). In simple terms, the central bank buys various assets in the secondary market, mainly debt securities, for reprinted money. Within QE 1 and 2, until the end of the first half of 2011, The Fed bought assets for more than 2.3 trillion dollars, including about $ 1 trillion of treasury securities. Pumping such huge amounts of money did not result in the expected growth in the U.S. economy, but it also did not
cause the increase in inflation (Maciejewicz, Prusek, Matusiak 2012). In this situation, the Fed decided to reprint additional money in the QE3 program (Kaminska, Koziel 2012). In December 2012, the U.S. central bank adopted a stimulus program – from the beginning of January 2013, bonds worth 45 billion dollars have been bought every month. The new buy-back program is being carried out at the same time with the covered bond purchase program of mortgage-backed MBS, worth $ 40 billion per month. Thus, the Fed buys assets worth 85 billion USD a month (Saxo Bank, PAP). Taking into consideration the increasingly better data coming from the U.S. economy, a great number of investors is still confident to launch QE3 program restrictions as early as September 2013. The key question that remains is the scale of the reduction program, chosen by the Fed. Initially, the program was expected to be reduced by 10-15 billion USD. At the moment, the amount of money taken into consideration is $ 5 billion, which would be the signal for the market to maintain super-loose policy. It is believed that there could be a change in the structure of bonds bought: the increase in the purchase of MBS covered mortgages bonds, the decrease in treasury bonds. The Fed intends to maintain the current low interest rates, at least as long as the inflation projection for the next 1-2 years will remain below 2.5%, and unemployment between 6.0-6.5%. Currently, the unemployment rate is above 7.2%. The new head of The Fed will decide about the monetary policy of United States in 2014. Ben Bernanke probably will leave at the end of his term in January 2014. However, speculations about his successor do not subside. The first in line is Janet Yellen, the current deputy head of Reserves, and the second in the race for the seat of the head is Larry Summers, former U.S. Secretary of State (Nurczyk 2013).

5. The actions of the European banks aimed at overcoming the effects of the economic crisis

Since February 2009, Europe has begun to fall into recession. However, some symptoms were evident as early as at the end of 2008 (Kuk 2009). The crisis, which at the beginning was mainly related to banks and other financial institutions, quickly affected budgets of states (the debt crisis) and entered into the real economy. A quite rapid inhibition of economic growth occurred, even in the richest countries. European governments, realizing the seriousness of the situation and the effects of the crisis in the U.S., were launching programs designed to improve the current liquidity of banks and

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5 Saxo Bank, „Niejednoznaczny komunikat Fedu” 22.08.2013; PAP, „Fed: Polityka mone-
tarna bez zmian.” 19 June 2013.
to reduce the negative effects associated with the emerging recession, the bankruptcy of enterprises of the real economy and the rising unemployment, especially among the youth. In November 2008, The Swiss government announced a stimulation plan – 1.55 billion francs (1.31 billion U.S. dollars) to support the economy during the worsening economic climate in the world. It was also stated that, if necessary, it could still set aside an additional 1 billion francs (PAP 2008). Germany allocated 80 billion Euro to the banking industry, Sweden 155 billion Euro, and France 40 billion Euro. The governments of Belgium, the Netherlands and Luxembourg decided to transfer 11 billion Euro to Fortis bank, which was on the verge of collapse. The sum of 6.4 billion Euro was allocated by the governments of Belgium, France and Luxembourg to Dexia. Central Bank of Portugal powered the banking sector with the amount of EUR 20 billion. The Irish government guaranteed the deposits for two years in all banks with Irish capital, and Iceland nationalized all major banks. The help for the banks during the financial crisis meant that a large proportion of them started to be controlled by the governments, and the state became one of the main shareholders. This situation, in addition to recapitalize the institutions, was to increase their stability by their control and the state guarantees (Walewska, Więclaw 2009).

Independently from the government’s programs to decrease the negative effects of the crisis, the central banks have undertaken dynamic actions: the European Central Bank, the Bank of England and the national central banks of the countries belonging to the European Union. The governments and central banks of Europe with the leading European Central Bank (ECB) basically copied the actions of the U.S. monetary institutions. However, they modified them significantly including the characteristics of the economy and the crisis in Europe. The changes were implemented in the field of public finance of the 27 countries making up the European Union and the 17 countries of The Economic and Monetary Union (EMU). The ECB also raised interest rates before the crisis and then quickly lowered them. From March to July 2007, ECB raised the base rate of the MRO (Main Refinancing Operations) from 3.50 to 4.25%, the credit operations to 5.25%, and the deposit operations to 3.25% in order to, after the paralysis of the financial market in USA following the collapse of Lehman Brothers, lower them from October to December respectively to 2.5%, 30%, and 2.0%. In the face of the already apparent recession in the European market, the ECB cut main refinancing rate to 1.0%, credit operations to 1.75%, and the deposit operations to 0.25%. The operations took place from January to May 2009. 

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6  PAP, 12 November 2008.
7  Due to the variety of the implemented tools, the monetary policy of EBC will be presented in a shortened form.
2008). At the same time, the providing operations and the purchase of treasury and private bonds on the secondary market designed to calm the panic that began to engulf European financial market were declared (Kochaniak 2012: 80-83; Matuszewicz 2012: 20 and onwards). On July 11 2012, the ECB again lowered the rate on the main refinancing operations. Lending and deposit rates at the end of the day were reduced by 25 basis points, respectively to 0.75%, 1.50% and 0.00%. The price rate remained at 150 basis points: – 75 basis points on either side of a fixed rate of MRO (EBC2013 – Part 2)8.

With the decreasing effectiveness of the standard tools of monetary policy, especially in terms of interest rates with the spread of the crisis in the money market, the European Central Bank implemented an intervention program. Among others, it included (Kochaniak 2012: 74-75):

- Enhanced credit support – a package of instruments increasing liquidity and improving the performance of banks and financial markets;
- Securities Markets Programme – a program stabilizing the secondary markets in debt securities

The most important step was to extend the maturity of long-term operation of the open market firstly from 3 to 6, and later to 12 months. In this way, an attempt to reduce the uncertainty about the availability of bank loans for longer periods of time and to keep the money market interest rates at a low level was made. As a result, the banks have received funds at the lowest cost in history.

Regarding the actions taken for a long period of time, the scale of LTRO operations (Long – Term Refinancing Operations) was increased from 150 billion in June 2007 to over 600 billion Euro at the end of 2008. In July 2009, the ECB started buying covered euro-denominated and issued in the euro-area bonds, which was to additionally support LTRO operations.

Europe in crisis needs “fresh” money. The main task of the European Central Bank is to stabilize the purchasing power of the euro and thus the level of prices in the euro area. It was thought that for treaty reasons, the ECB cannot print more Euro, as does The Fed and the Bank of England, the Bank of Japan, and the Bank of Canada. The idea of printing money by the banks was treated in terms of the highest irresponsibility, because it was thought that it would spin hyperinflation, similar to that prevailing in Germany in the years 1922-1923 (Hongbing 2011: 175 and onwards). However, the replacement of the head of the ECB J.C. Trichet, the declared enemy of inflation, by a pragmatist M. Draghi resulted in the change of how the financial market was provided with money. New European Central Bank

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World in crisis. The role of banks in reducing the effects of the global

President Mario Draghi said that in the fight against the crisis and to save the single currency, the ECB will buy the domestic bonds on the secondary market with a maturity of three years without any restrictions. The program was designed to reduce the record cost of debt service in Southern Europe and Southern Euro zone, especially Italy and Spain, and to improve the situation of the whole Euro area (PAP – 2012)9. The program was designed to reduce the profitability of debt in countries with financial trouble and having difficulty obtaining financing on the market.

Within the LTRO operation conducted in December 2011, the ECB offered EUR 489.2 billion to 523 banks. As a result of the first round of these operations, there was a significant decrease in investors’ aversion towards risk, which led to the increased demand for emerging market assets and the bonds issued by peripheral euro zone countries. In the second long-term refinancing operation (LTRO), the European Central Bank lent in March 2012 EUR 529.5 billion to commercial banks. 800 institutions signed up for the loans (euro www.biznes.onet)10. Carrying two operations for an amount exceeding 1 trillion in such a short time led to excessive liquidity in the money market. Banks in the first period deposited their money in overnight deposits at the ECB, which exceeded EUR 700 billion (Fairless, Feher 2012). In the subsequent period, the borrowed funds were partly used to finance lending and the purchase of bonds, which resulted in, i.a., profitability of Italian two-year bonds fell to its lowest level in half a year, and the rate on ten-year securities became the lowest since September 2011. The reaction of other countries at the risk of fiscal problems in the field of profitability was similar.

In September 2012, the ECB informed about Outright Monetary Transactions (OMT). Its purpose is to ensure the proper transmission of monetary policy and the unitary character of the policy in the euro area (ECB – Part 2)11. In May 2013, the ECB cut interest rates again. The main interest rate of refinanced credit fell to 0.5% against the previous 0.75%. The interest rate on loans was set at 1.00% against the previous 1.50%. The interest rate on deposits remained at 0.0%. Thus, the interest rates in the euro area are the lowest in the history (Draghi 2013)12. At the same time the ECB announced the extension of LTRO.

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9 PAP, „Plan skupowania obligacji przez EBC dobry, ale nie wystarczy”, 06 September 2012.
10 The European Central Bank gives banks three-year loans with a value of 529.5 billion, available at www.biznes.onet, accessed on 29 February 2012.
12 ECB cuts interest rates, Draghi: Mild monetary policy will be carried into effect, available at bankier.pl, (accessed 02 May 2013).
The ECB’s monetary policy includes such instruments: main refinancing operations (MROs), longer-term refinancing operations (LTRO), fine-tuning operations, central bank deposit and credit operations, and intervention operations. It is difficult to assess the effectiveness of these operations. The arduous recovery occurs in most euro area countries of the European Union. The banks borrowing money at a price well below the rate of inflation and investing them in the purchase of bonds, including treasury bonds exceeding 4% profitability – earning much without risking excessively, have benefited the most form the ECB programs. Countries with high public debt have also benefited. A large supply of money created by the ECB (as well as The Fed, the Bank of England and the Bank of Japan, which eliminated interest rates at all) led to lower profitability of the newly issued treasury debt securities, thereby reducing the cost of debt servicing.

6. Summary

While trying to make some assessment of the causes of the current crisis, one should take a look through the prism of its impact on the global economy. The crisis has been going on for six years and it is difficult to predict its end. One should agree with the view expressed by G.W. Kołodko that the current crisis is a systemic crisis of capitalism, its neoliberal mutation, and the causes must be sought in the structural changes that have accrued in the global economy, especially in the U.S, and which are linked with neoliberal ideology (Kołodko 2010: 92 and onwards). The systematic deregulation of the financial system in the United States meant that the state, acting through the supervisor institutions, lost control on the functioning of the financial market. The effects were devastating not only for the U.S. economy but also caused the European paralysis in the financial markets, the financial collapse of banks and enterprises of the real economy, the recession, the sharp increase in unemployment, especially among young people. The multi-billion dollar government anti-crisis programs of countries affected by the crisis have been insufficient to overcome the crisis – they were mainly of temporary nature intended to save banks from bankruptcy. The fight with the crisis in the financial market would have been impossible without the participation of the largest central banks that used unconventional tools aimed at restoring the balance in the global markets, including financial markets.

However, despite the injections of trillion dollars and Euro, both in the U.S. and Europe, the reduction the interest rates to almost zero, and other large-scale activities, it has still not been managed to direct the economy of the U.S. and Europe to the target level. The crisis has demonstrated the
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importance of efficient regulation and adequate supervision for the proper functioning of the financial markets. It highlighted the strong interdependence between the credit market and the derivatives market, the capital resources of banks and the size of the undertaken investments. Despite the six years since the outbreak of the crisis, the key issue for systemic risk in the banking sector remains unsolved – the problem of large banks “too big to fail” (TBTF). In the U.S., the Glass-Steagall Act of 1933 was not reverted to, despite the fact that banks in result of the acquisitions have become even more powerful. In Europe, hopes is placed with a creation of a banking union, which would incorporate three elements: a single European banking supervision system, the European system of deposit guarantees, the European system of restructuring and orderly liquidation of banks. It is hoped that the experience related to the causes of the current crisis will be used by governments and institutions of the banking system, and the crisis in such form and on such a scale will not happen again.

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Abstract

The European Union, due to the intensive impact of globalization and the achieved level of socio-economic development, is an important element of the global economy. The economic and financial crisis that started in 2008, affects the situation of the economies around the world. Despite the similarities of the crisis, different countries in various regions of the world should make individual analyses of the weaknesses of their economies and social models. The weakness of the European Union, as a group which comprises 28 countries with diverse potential, includes the difficulty in formulating and expressing its unified standpoint in the international forum. The growing importance of the relationship between the international parties contributes to the fact that the role of clear communication with the environment is steadily increasing. The intensive development of the Common Foreign and Security Policy is a chance of the European Union. This should be done both through institutional changes and increased awareness of the society and the political class in different countries on the need for closer cooperation in the field of foreign policy groups. The danger of this process is the existence of differences in national interests and poor skills in a constructive international dialogue between EU Member States. The Foreign and Security Policy of the EU enables to speak – and act – as one in world affairs.

Key words: foreign policy, the EU Common Foreign and Security Policy.
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Introduction

The European Union is on a peculiar stage of development. On the one hand, it represents the most advanced international integration model in the world. Geographically, it covers most of the European continent territory, and its constituent countries are among the most advanced in terms of economic and social development. On the other hand, despite these successes and strengths, the further dynamic development of the group encounters a strong barrier. Further avoidance of effective structural reforms in the EU will lead to the gradual marginalization of this part of the world, as the values represented by the Community, will be in a deep defensive, mainly due to the weakening of the competitive position in relation to other countries such as China or Brazil. The weakening position of the EU in the world is caused by the occurrence of the adverse economic effects. The difficulty in ensuring the unity of the political group in the international arena is equally significant. This paper is devoted to the analysis of the functioning of the Common Foreign and Security Policy (CFSP). The analysis of the activity of the EU is to identify the tasks and the mechanisms in the CFSP. It is also useful to identify the shortcomings and deficiencies of the solutions adopted in the framework of this particular policy. On this basis, it will be possible to identify the desired direction in which the CFSP should be developed so that it can be helpful for the maintaining and even strengthening the EU’s position in the modern world.

1. Foreign policy of the European Union and its determinants

The basic policies of the European Union include foreign policy, its full name is: Common Foreign and Security Policy. The Common Foreign and Security Policy is one of the most comprehensive policies pursued by the European Union.

The European Union is a complex integration grouping with institutional structures and rich acquis. The law created by the Community in the field of international affairs affects all Member States and their assumptions will lead to far-reaching unification of the European continent in many dimensions, including economic, political, and social life. The European Union in its actions, before the Lisbon Treaty came into force, was based on three pillars1.

The first pillar was an economic one, based on the European Communities, the European Coal and Steel Community and the Euratom. It included the Economic and Monetary Union, the Customs Union, the Internal

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Market, the Common Agricultural Policy and structural policies. The main objective of the first pillar was to allow the harmonious economic development, which was achieved by ensuring a single market, effective structural policies, social and monetary cooperation.

The European Union, over time, has developed the common foreign and security policy, which falls within the scope of the second pillar. The second pillar of the EU was to safeguard the common values, fundamental interests and independence of the Union. Under this pillar, the European Council and the Council of the European Union took care of raising the security of the Union and its members, as well as maintaining peace in the region and in the whole world.

Due to the fact that the European Union, as a subject of international relations, is not a country, one cannot make a simple comparison of an EU foreign policy with a typical activity that a sovereign state performs in the international arena. However, the foreign policy of a sovereign state and the integration group has a set of similar characteristics and properties.

The foreign policy is the activity of the specialized bodies directed to the international environment. It is not only the submission of internal policies, because (Przybylski 1996: 342-343):

- it is an external activity, e.g. of a state in the poliarchic, decentralized environment, where there is no central authority, but a large number of entities with formally equivalent validity,
- the goals, methods and programs of outside activities must deal with a particular stage in the development of international relations, the international situation, the activities, objectives and programs of other sovereign entities, as well as the current state of their abilities,
- it reflects the fundamental interests, which are known as the “reason of state”,
- the formulation, adoption and implementation of these basic interests require specialized methods and approaches, which imposes the need to safeguard the institution (including specialized bodies, staff, foreign service),
- its mechanism can be divided into two parts: performing strategic tasks and performing tactical tasks (e.g. diplomacy is considered to be a tactical one).

The conduct of foreign policy is dependent on the adoption of an appropriate set of policy objectives. They can be used as unchanging signposts directing current actions. The choice of the objectives determines the interaction with other international actors. Foreign policies are always inspired by the internal situation in which they exist. In other words, international relations are the direct derivative of the internal state of social relations. In
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addition, it is assumed that communities seek fulfilment of their needs in the international space, because they perceive it in a better position to meet their particular interests and needs, than would be possible only in the stacking of social relations only within their own country (group of countries).

Since the beginning of the twentieth century, there has been the dynamic process of increasing the role of foreign policy. The reason underlying it is that more and more advanced technology and the fast flow of information is at the society’s disposal and it gives a real chance to benefit from the international cooperation in all areas of life. The organized effort of the state is aimed at the implementation of relevant interests. This is done through peaceful cooperation with other countries or, in exceptional cases, the need for confrontation. Running external actions is not possible without competent human resources that make up the diplomatic service. The foreign policy of the state is mostly carried out by the Ministry of Foreign Affairs, or by the executive branch of a sovereign state. The external actions that the state may undertake often have the form of multilateral or bilateral cooperation (if they are directed to a single entity). In this case, it requires the involvement of a larger number of international actors. The objectives of the foreign policy include: existential, functional and co-existent. To achieve the objectives of the foreign policy decision-making centre is able to use a wide range of measures. The measures have taken their own characteristics of usability. Among them, there are those that have their own choices and can be applied interchangeably (some of them are even unique). These include, for example, a measure of the declaration of war. However, on the other hand, the vast majority of foreign policy measures have much more conventional specificity. In addition to the vast majority of them, they are peaceful in nature and are based on diplomatic activities. The measures used in foreign policy can be divided into groups: economic, cultural, military, regulatory and propaganda ones. The foreign policy can take the character of passive or active one. The passive foreign policy is carried out when the entity responsible for it sees the external international environment as a set of factors that are independent of the form of this policy. The active foreign policy implies acceptance of the assumptions on which there is a real chance to influence the external environment and shaping it according to its own hierarchy of values. If the purpose of a foreign policy is to preserve the status quo ambient, then this policy is called the defensive one. The offensive foreign policy is pursued through active involvement, with the intent to implement its own vision of international relations (Przybylski 1996: 344-345).

In the case of a group of countries, grouped together on a voluntary basis, with a lot of common interests, as it is in the case in the European Union, there is both a need and an opportunity to influence the common external environment and the state of international relations or foreign policy. The
main complicating factor is that the entity, including an entity group, having ambitions contribute to shape the external environment, must have legal personality. The Lisbon Treaty gives the EU a legal personality. Thanks to it, most of the pre-existing problems disappear. For example, it is easier to join the international organizations or to acquire rights and incur liabilities in the international sphere\(^2\). The Treaty of Lisbon (its full name is: The Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community) was officially signed on 13 December 2007, and the ratification process unfolded in the years 2008 and 2009. The Treaty entered into force on the 1 December 2009 as one of the last treaties ratified by Germany, Ireland (where, on October 23, 2009, the referendum was held) and the Czech Republic\(^3\).

The Lisbon Treaty, according to its proponents, solves lots of the issues relating to the following areas\(^4\):

- it raises the level of democratization and provides greater transparency of the activities of the European Union,
- it increases the operational efficiency of the EU institutions through a clear division of responsibility of each of them,
- it incorporates the Charter of Fundamental Rights into a set of primary laws, it introduces new solidarity mechanisms,
- it raises the importance of the European Union on the international stage.

After the adoption of the Lisbon Treaty the implementation of the European Union Common Foreign and Security\(^5\) improved because, from this moment onwards, it became practically possible to act unanimously and adopt unified standpoints. This idea is effective by creating the office of High Representative of the Union for Foreign Affairs and Security Policy. Holding this position is done through election and lasts five years.

Despite the fact that the Common Foreign and Security Policy has been officially operating since the early 1990s, because it was launched with the adoption of the Maastricht Treaty, the need to give a united Europe unified voice was already expressed in the first years of the integration. The

\(^2\) Article 10b of the Treaty defines “Decisions of the European Council on the strategic interests and objectives of the Union common foreign and security policy and to other areas of the external action of the Union. Such decisions may concern the relations of the Union with a specific country or region or a specific topic. They define their duration, and the means to be made available by the Union and the Member States”.


\(^5\) WPZiB (Eng. Common Foreign and Security Policy) has been founded on the basis of the Maastricht Treaty.
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founding members of the European Coal and Steel Community, the first positive experience encouraged the integration process, they mentioned in the common external action possible additional benefits for themselves. The position that Europe occupied internationally after the Second World War, visibly weakened, and the leaders of the major Western European countries realized that by not acting alone it would restore the importance of the Old Continent (Zięba 2007: 16). The area that would stand up to the fore in terms of needs was to provide external security. During this period, security was handled in three ways. It was essential to prepare for the possibility of an armed strike by the Soviet Union, which would require coordination between various defence systems and the development of military plans. The second aspect of the need for cooperation on the European continent was dictated by the desire to reduce dependence on the U.S. military matters. The NATO’s Pact politically and militarily operated since 1949, and one of the reasons for its establishment was the need to link policy pursued by the U.S. military to the defence of Western Europe (Łastawski 2004: 128).

Europe, however, wanted to create an own, parallel defence system. The desire to prevent the revival of German militarism and to find a formula that would guarantee a form of control over the forces of the Federal Republic of Germany was considerably important. The first major initiative which involved this cooperation area, was the concept of the creation of the EDC (European Defence Community) in 1952. Member countries of the European Coal and Steel conducted the debate on the creation of an European army, which would be put under the command of one European minister. The project was not implemented because the French National Assembly did not ratify it. In parallel to the establishment of the EDC close cooperation with the European Political Community (EPC) was planned to be initiated, which was to focus on cooperation of high level diplomatic services of western European countries. As the French blocked the establishment of the EDC, the project to create the EPC was abandoned as well. It can be assumed that these two concepts (EDC and EPC) were too revolutionary for their times and therefore they were never in the implementation phase. The idea of integrating in the political dimension was abandoned for some time. Western Europe increasingly focused on economic issues, which led to the creation of the European Economic Community (EEC) and the European Atomic En-

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*France saw the EDC as danger to it as it somehow limited their sovereignty in foreign policy. At that time, the international situation in the world was tense in the world because of the war in Korea. In mid-1954, after losing the battle, France lost control in Indochina. One of the main reasons why France did not ratify the establishment of the European Defence Community was the refusal of the UK to participate in this project. The UK’s participation was to neutralize and weaken the position of the Federal Republic of Germany.*
ergy Community (Euratom)7 in 1958. Revival of the idea of cooperation in the field of foreign policy could be observed in the late 1960s. The decisive moment was the change in the position of President of France. Charles de Gaulle’s successor, Georges Pompidou (during his rule Great Britain joined the EEC8) was more willing to coordinate foreign policy of EEC countries at ministerial level. At the conference in The Hague in December 1969, during the EEC summit, the so-called Davignon report was presented, and a Belgian diplomat, Viscount Davignon, became a head of the committee whose task was to deepen integration of the political sphere. The Davignon’s report was finally adopted in October 1970, during the summit in Luxembourg9. As a result, the European Political Cooperation was of an intergovernmental nature because no permission was granted to institutionalize it. Twice a year, meetings of the foreign ministers were held. The meetings were chaired by the Foreign Minister of the country, which held presidency. EPC in the approved form did not provide a consensus between EEC countries, but its major achievement was the collaboration achieved through consultations, exchange of information and observations, which led to the unification of positions.

In 1985 the content of the Single European Act (SEA) was accepted, which introduced the actual reform of the existing European cooperation. This act confirmed the will to create the European Union, and that it must base on the European Communities and the developed EPC. In the treaty the instrument of EPC included the joint actions and the common positions. The document also specified that the external policy of the European Community would be in accordance with the arrangements under the EPC. In addition, the SEA established a permanent secretariat of EPC, which was located in Brussels. The competence of the Secretariat mainly concerned administrative matters. The Single European Act was a significant breakthrough in the policy of the Communities (Łastawski 2004: 245). The solutions used in the EPC proposals were a combination of the UK’s proposal, which preferred the idea of intergovernmental cooperation, and of French and German projects of granting primacy to Heads of State and Government, as well as of other government initiatives, strengthening the integration within the Communities (Zięba 2007: 40-41).

The Treaty on European Union (entered into force on 1. November 1993), signed in 1992 was a milestone in the cooperation between the Member States in the area of common foreign policy. The Treaty set out the

7 European Atomic Energy Community – (EAEC).
8 On the 1st January 1973, after the referendum, the United Kingdom, along with Denmark and Ireland joined the European Economic Community.
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objectives of this policy, for which institutional framework and legal instruments were created. According to the Maastricht Treaty, Common Foreign and Security Policy was to be pursued by means of intergovernmental decisions, which means that a different approach than the one regulating the first pillar of the European Union was adopted. The Treaty of Lisbon improved the functioning of the common foreign policy by appointing the High Representative of the Union for Foreign Affairs and Security.

2. The purpose and instruments of the Common Foreign and Security Policy

The objectives of the Maastricht Treaty, which relate to the Common Foreign and Security Policy were already mentioned generally in Article B (Title I). The Union’s objectives include: “assert its identity on the international scene, in particular through the implementation of a common foreign and security policy, including the progressive framing of a common defence policy, which might lead to a common defence”. Title V of the Treaty was devoted to Common Foreign and Security Policy. When defining the objectives of CFSP, the general wording was used and the area of its application was not narrowed only to the European territory. The following objectives of the common foreign and security policy were identified:

- “to safeguard the common values, fundamental interests and independence of the Union,
- to strengthen security of the Union and its Member States in all its forms,
- to preserve peace and strengthen international security, in accordance with the principles of the UN Charter and the Helsinki Final Act and objectives of the Paris Charter,
- to promote international cooperation,
- to develop and strengthen democracy and the rule of law and respect for human rights and fundamental freedoms”.

Additional issues related to safety and the defence policy were identified in the Treaty as an integral part of the Common Foreign and Security Policy. The common foreign and security policy comprises all issues related to the Union’s security, including the progressive framing of a common defence policy, which might lead to a common defence.

10 The Treaty on European Union (Maastricht Treaty).
11 The provisions on the Common Foreign and Security Policy.
12 The Treaty on European Union (Maastricht Treaty), Article J.1 section 2.
13 Ibidem, Article J 4.
The European Union seeks to achieve the objectives:\(^{14}\):
- “by establishing regular cooperation between Member States in pursuing the policy, in accordance with Article J.2,
- through progressive implementation, in accordance with Article J.3, of joint action in areas where the Member States have important interests in common”.

The instruments of the Common Foreign and Security Policy before the Lisbon Treaty was enforced included:
- principles of and general guidelines of the common foreign and security policy,
- common strategies,
- joint actions,
- common positions.

The Lisbon Treaty made changes in CFSP instruments. Currently, the European Council and the Council of the EU take decisions solely in relation to:\(^{15}\):
- “interests and strategic objectives of the Union,
- measures that the Union should take,
- stances that EU should take,
- conditions of implementing the actions and stances of the Union”.

The Common Foreign and Security Policy envisages the development and the use of rules and guidelines. It is included in the prerogatives of the European Council. The European Council, which consists of the heads of states, has broad powers to develop relations in the international sphere, hence its preparation to determine priorities of the foreign policy. The regular meetings of the European Council even force its participants to conduct ongoing dialogue and consultation. Therefore, it should not be difficult not to infringe the provision of Article J.2. The full text reads:\(^{16}\):
- “Member States shall inform and consult one another within the Council on any matter of foreign and security policy of general interest in order to ensure that the Union’s influence is exerted as effectively as possible by means of concerted and convergent action,
- The Council shall determine a common position, if it considers this necessary. Member States shall ensure that their national policies conform to the common positions;
- Member States shall coordinate their action in international organizations and at international conferences. Then the common

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\(^{14}\) Ibidem, Article J.1 section 3.

\(^{15}\) http://europa.eu/legislation_summaries/institutional_affairs/treaties/lisbon_treaty/ai0025_pl.htm [received: 01.08.2012].

\(^{16}\) The Treaty on European Union (Maastricht Treaty)..., Article J.2 point 1-3.
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positions will be upheld. If in international organizations and at international conferences not all the Member States are represented, the participating Member States shall defend the common positions”.

Another tool of the Common Foreign and Security Policy are so-called common strategies. Their history goes back to the Amsterdam Treaty\textsuperscript{17}, which entered into force on 1 May 1999. The body making decisions about adopting common strategies is the European Council. Strategies define the objectives that the European Union wants to achieve. On the basis of developed strategies, common positions and common tasks are adopted. Common strategies are characterized by a higher level of specificity, compared to the principles and general guidelines of the CFSP. So far three, strategies have been developed. They relate to Russia, Ukraine\textsuperscript{18} and the Mediterranean region.

An important novelty, which the Treaty of Amsterdam sanctioned, was the possibility of performing so-called Petersburg tasks or missions\textsuperscript{19}. These missions are normalized in Article J.7 in sections 2 and 3\textsuperscript{20}. The CFSP also includes the Common Security and Defence Policy that provides the possibility of taking action using both civilian and military forces. The CFSP, which is a kind of successor to the WEU project\textsuperscript{21}, envisages the perfor-

\begin{itemize}
\item \textsuperscript{17} The Treaty of Amsterdam was concluded after the European Union’s diplomatic failures during the conflict in the Balkans in the 1990s and was intended, in its part relating to the Common Foreign and Security Policy, to improve the efficiency of international activities of the Community, for example, in the event of any future conflict.
\item \textsuperscript{18} In the Common Strategy of the European Council of 11 December 1999 on Ukraine (1999/877/CFSP) in Part I, Section 5 strategic objectives of the European Union with regard to Ukraine were precisely defined: “to contribute to the emergence of a stable, open and pluralistic democracy in Ukraine, governed by the rule of law and underpinning a stable functioning market economy, which will benefit all the people of Ukraine, cooperation with Ukraine in the maintenance of stability and security in Europe and in the world, and in finding effective responses to common challenges facing the continent; increasing economic, political and cultural with Ukraine, as well as cooperation in the field of justice and home affairs”.
\item \textsuperscript{19} Petersburg tasks are a result of the work of the WEU in 1992. The Western European Union was finally dissolved and its tangible assets and competence were contributed to the European Union in the area of the Common Security Defence Policy (CSDP).
\item \textsuperscript{20} The Treaty of Amsterdam, Article J.7 paragraph 2 reads: “Questions referred to in this Article shall include humanitarian and rescue tasks, peacekeeping tasks and tasks of combat forces in crisis management, including peace-making.
\item \textsuperscript{21} The Western European Union was dissolved on 31 March 2010 as the Treaty of Lisbon entered into force. In fact, the organization ceased operations on 30 June 2011 Statement of the Presidency of the Permanent Council of the WEU on behalf of the High Contracting Parties to the Modified Brussels Treaty – Belgium, France, Germany, Greece, Italy, Luxembourg, The Netherlands, Portugal, Spain and the United Kingdom, http://www.weu.int/Declaration_E.pdf (received: 11.06.2012).
\end{itemize}
mance of the Petersburg tasks. The concept of the missions refers to the possibility of initiating humanitarian, rescue, and peacekeeping tasks and to deal with the crisis, or even to restore peace (Ruszkowski 2003: 413).

The joint activities are part of the instruments that the Council of the European Union apply in situations when operational actions are taken. The instrument that is called: the unified standpoint can be used in the case of problems of objective or geographical nature. Political declarations and statements, although they do not have the treaty settlements, are included in CFSP instruments. The Common Foreign and Security Policy is pursued by concludeing and implementing international agreements.22

It should be noted that the Treaty of Nice decided on setting up the Political and Security Committee. In addition, the treaty has enlarged the possibility of taking decisions by qualified voting majority. The issues of appointing special representatives and entering into international agreements in the framework of the CFSP (Pietraś 2006: 72-73; Mościcka 2005: 455-456) are the main fields of applying this procedure.

Special Representatives (EUSR), in accordance with the Article 33 of the Treaty on European Union can be appointed by the Council23 at the request of the Top Representative of the Union for Foreign Affairs and Security Policy. A special representative is entrusted with a mandate in connection with particular political issues. The representatives, who have been entrusted a mandate, report to the Top Representative. The main task of special representatives, who are sent to the troubled regions of the world, is looking for methods of solving current political problems. During the missions, the officers represent interests of the Community, try to promote European Union countries values effectively. The representatives’ importance is marked with their presence there and they also create the European Union’s image on the international arena.24 The representatives are involved in strengthening the relations between the European Union and the selected regions of the world. In special representatives’ actions, the particularly underlined aspects are: respecting human rights, democracy and stability in the region.

At the moment when the Lisbon Treaty, which introduced the External Action Service of the European Union – the supporting diplomatic body of the Top Representative – came into force, many doubts concerning the further functioning of Special Representatives have appeared.

The objections were caused by the fact that some of the permanent representatives were dismissed (e.g. on 11. August 2010 the EU Council decided

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to abandon the positions of the EUSR for the South Caucasus, Moldova, Macedonia, and for the Middle East Peace Process by the end of February 2011). According to some analysts’ opinions, it was a mistake which caused the lack of continuity of EU diplomatic missions in those regions where new structures (EEAS) had not begun to operate effectively yet (Liszczyk 2010). The conflict of objectives could have occurred because the reason for founding the European External Action Service was the necessity for obtaining better coherence of the European Union foreign policy. The policy was expected to eliminate the tension between the Community’s external policy and intergovernmental CFSP. The intention of the Service was to contribute to avoiding the duplication of administrative structures of the Council and the Commission. The aim was also to de-politicize the Commission delegations, to locate them in different parts of the world, so that they might serve as diplomatic representations in future (Osica, Trzaskowski 2009: 28). In the middle of 2012, the European Union had its Special Representative for the Central Asia.

CFSP financing can sometimes be very expensive. This is caused by the possibility of financing the participation of the armed forces, police, or technical experts in foreign missions. Such activities may be covered from the budget of the European Union, as well as from additional contributions made by the member states. The EU budget is not charged with the operation costs when the Council establishes, by means of a unanimous vote, different rules of financing particular activities in the framework of the CFSP activities (Dinan 2005: 595).

The achievements of the CFSP integration include: formation of the European Top Representative for the Common Foreign and Security Policy whose responsibilities shall include:

25 Through the Community’s external policy, it should be taken into account the trade, developmental aid and relations with the countries applying for EU membership or those that are in EU neighbourhood.


27 When selecting the newly created positions nomenclatures, the term “EU Foreign Minister” was not used, because this could be badly received by those who conducting foreign policy match with the prerogatives of the nation. It was tried not to make a mistake which was the establishment of a “foreign minister” in the rejected Constitutional Treaty in a referendum. Some member states treated it as a kind of an attack on their sovereignty. According to. http://eup.wse.krakow.pl/?page_id=104 (received: 03.07.2011); http://www.e-finance.com/artykuly_eng/70.pdf, (accessed on 04 July 2011).

– pursuing the European Union Common Foreign and Security Policy,
– submitting own proposals for that policy preparation,
– pursuing foreign policy, in the framework of activities under the authority of the Council,
– watching the implementation of decisions taken,
– chairing the Foreign Affairs Council,
– co-chairing the Commission,
– watching the consistency of the Union’s external actions,
– taking the responsibility for duties in the field of foreign relations,
– coordinating other aspects of the Union’s external actions,
– representing the Union in matters relating to the Common Foreign and Security Policy,
– conducting the political dialogue with third parties on behalf of the European Union,
– expressing the Union’s position in international organizations and at international conferences,
– conducting the European External Action Service and leading the Union delegations in third countries and in international organizations.

The novelty of solutions of the Lisbon Treaty is connected with authorising one person (the Top Representative of the Union for the Common Foreign and Security Policy) competences in the scope of the CFSP. The previous model authorised to two persons, and they are as follows29:
– Top Representative for the Common Foreign and Security Policy (CFSP),
– Commissioner for Foreign Affairs.

This solution reinforces the recognition of the Top Representative internationally, and it raises its importance.

In conclusion, it can be said that the European Union has been observing the need for external activities for a long time. The barrier that hinders conducting effective and adequate to the present geopolitical situation activities in the scope of foreign policy on behalf of the European Union has been the weakness of international representation and the strength of a political mandate for initiatives undertaken. Still there is not single and strong voice of the European Union in the world. In addition, the EU’s foreign partners have got used to the fact that Europe is not decisive and firm in taking its unified standpoint as big powers like Russia, the USA and China do. This

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happens despite the fact that still the possessed economic potential of the European Union authorises it the take the world top position.

The confirmation of the fact that the European Union now sees itself as a player of global importance, is the change of names in the records of budget items that relate to the Common Foreign and Security Policy. At present, the notion: “a global partner” (Czubocha, Paszkowska) exists in the budget description. It should be expected that pursuing the CFSP in future will be connected with the significant increase in costs. The international activity on a large scale is inseparably connected with the need of making quick decisions, as well as earmarking substantial amounts to fulfil the declarations with intense political content. There should not be any problems with the last postulate because expenditures spent on effective CFSP can be treated as an investment and such a solution finds understanding among elites and member countries societies, but there will be a great problem in guaranteeing the fast decision making – it requires achieving internal unity inside the integration group.

3. Summary

The CFSP has developed its specific and characteristic institutions and broad legal instruments. However, together with its development, there are many controversies about its functioning. Most of them are connected with the fundamental question of real possibility of developing a common and unified a standpoint by all European Union members, who often possess different particular aspirations. On the other hand, in the contemporary world, the discrepancies do not concern absolutely all matters and many times the desire to speak unanimously – “one voice” – is highly desirable. All of these are very pragmatic.

At the present stage of the development it is difficult to talk about the high efficiency of the applied solution of a common foreign policy. The changes that occur in the area of CFSP are evolutionary. This is because the European societies have time and opportunity to familiarize with new democratic mechanisms in this important area. The European Union is forced to negotiate successfully with strong political and economic partners. Taking actions, for example, in the scope of counteracting the global financial and economic crisis requires interactions, among others, with Members of the BRICS and the USA. The effective dialogue is possible only in a situation when the European Union members take a unified standpoint and it will not be possible without the continued improvement of mechanisms in the Common Foreign and Security Policy.
References

4. Traktat o Unii Europejskiej (Traktat z Maastricht), Artykuł J.1 punkt 2.
Abstract

The article brings up problems of public finance importance in the period of a financial crisis. The growing role of the state in the process of alleviating the economic cycle as well as consequences of such policy have been presented by showing a budget as a main stabilizing instrument of public finance. The next problems that caused the crisis on the territory of European Union have been mentioned in this paper. The final part of the article presents reforms propositions in the system of economic management suggested by the European Commission in order to limit possibilities of further getting into debts of member countries.

Key words: crisis, economics, public finance, euro zone, budget, fiscal treaty.

1. Introduction

The end of the first decade of the XXI century is associated with the crisis èpoque although its first symptoms were noticed at the turn of centuries. The first wave of the present crisis started in 2007 in the United States of America where the breakdown of mortgage loans market happened. The economy responded to crisis phenomena dynamically. This recession influenced the condition of public finance hence this article’s objective is to analyze reasons of the public sector crisis. It constitutes the article’s format where in the first part the essence and the importance of public finance are presented taking into account the significance of a budget as a main instrument in the system of public finance. In the second part the condition of public finance in European Union countries in years 1998-2007 is presented
– before the Economic and Monetary Union /UGiW/ formation and before qualifying countries that met the convergence criteria until the moment of the crisis beginning. In the third part the author presents how the crisis influenced the condition of public finance. The fourth part presents new postulated by the EU institutional solutions that were to improve the condition of public finance of member countries in the context of their harmonization.

2. State budget – stabilizing instrument of public finance

The theory of economics has always had problems with defining the public sector that means, with identifying the rules of its functioning, presenting aims and objectives that the public sector is obliged to fulfill. It results mainly from the fact that the theory of economics is not the only one and it is divided into different trends that differ in modified paradigms (Kleer 2005: 9). According to P.J. Gaudemet, economics deals with financial phenomena research in the macroeconomics perspective analyzing the financial flow. Economics concentrates on examining consequences of budget imbalance for the economy as well as it examines the results of public investment expenditures for the economic growth. Next, public finance examine the mechanisms of particular financial phenomena searching for rules of imposing taxes on taxpayers and at the same time specifying techniques of expenditures control (Gaudement, Molinier 2000: 17-18). It is difficult to understand financial operations when they are not “located” in economic environment that gives them the full and proper meaning.

Economic factors influence the financial phenomena and vice versa – financial phenomena influence the economics. If assumed that the economics is the science on wealth, public finance, being the part of this wealth, are conditioned economically (Gaudement, Molinier 2000: 18).

The basic definition of public finance underlines the aspect of public means management. The instrument that serves the process is the budget. According to S. Owsiak, the present definition of a budget describes it as a centralized public fund that is used to collect financial resources associated with the state functions. So, a budget is nothing else but a financial plan that constitutes a base for public entities activities in a budget year. Thanks to this plan, the state’s objectives and tasks are achieved (Owsiak 2013: 102).

A contemporary budget, its functions and accompanying rules have caused discussions and debates for years. Commodity and money market has influenced significantly the development of a budget. The economic growth has contributed not only to the increase of societies well-being but it has caused also the budget development and the increase of “the na-
tion’s consumption”, what is mirrored in the rise of the state’s fiscal needs (Owsiak 2013: 105).

The next reason that contributed to the increase of a budget importance, not only in a quantitative dimension but also its functioning in social and political mechanisms, was the increase of the nation’s role in the social sphere. Provided that fulfilling social functions happened gradually, the nation’s entering the economic sphere processed very rapidly. It is no doubt that in VIIth century a state started to implement fiscal instruments in a form of duties protecting the domestic market from the foreign goods flow. Hence till the moment of the great economic crisis in 1929-1933, the role of a nation in n
economic sphere was not significant (Owsiak 2013: 106-108). Until the end of the 1920’s of XX century, a nations activity directed to mitigate the fluctuation of an economic cycle increased. The appearance of the state intervention meant the automatic development of a state budget. Next, it influenced the increase of budget instruments such as: taxes, expenditures, subsidies or transfers. It also caused that, to a larger extent, fiscal objectives and tasks were determined by the Nation’s economic goals (Owsiak 2013: 109).

Over a span of XX and XXI centuries, the development of economic and financial relations happened and at the same time the integration pro-
cesses gathered strength what affected the new budget quality. On one hand, we deal with the process of limiting the national fiscal authorities’ sovereignty to international organizations and on the other hand, decisions concerning a budget in particular countries are controlled and evaluated – the example of the European Union (Owsiak 2013: 111).

Awarding the public finance a crucial role in a contemporary society and economy functioning, it is necessary to mention issues of the stability of sources that supply a public sector as a reasonable condition of using available financial means managed in such a way in order to avoid financial crises (Owsiak 2011: 28).

A state disposes two types of financial supply: the money revenue that comes from public donations – a basic source of a public income – and money loans that come from loans or from sales of securities. The size of a public income is a derivation of a tax system as well as real economic processes that generate this income. A contemporary nation is a tax nation where the intensity of the money flow to a budget is decided by the intensity of public donations. The money loans is different money from the point of view of its quality because it is return money and using it requires avoiding the idea of budget balance (Owsiak 2011: 30).

Real economic processes are cyclic what causes the drop or increase of a public income. A breakdown of economy brings about the decrease of an income to a budget and the necessity of cuts in public spending. It implies
the necessity of creating such a mechanism that would depreciate results of system changes as well as changes in the economic cycle (Owsiak 2011: 32). As a result of the present crisis, the European Union countries focus on creating such a mechanism.

3. Public finance status in countries of the euro zone before the financial crisis

The existence of a budget deficit and in consequence, a public debt is recognized as a rule, not an exception in capitalist countries. In Great Britain a debt has been occurring continuously since the end of XVII century. In the period of the Napoleon Wars and at the end of the II World War, a public debt exceeded 200% in relation to the Gross Domestic Product GDP. The situation is similar in the United States where only one time, at the end of the II World war, the ratio of a public debt to the Gross Domestic Product GDP exceeded 100%. Merely at the end of the first half of XIX century there was a short period when the debt was completely repaid.

In capitalist countries the indebtedness of a public sector is a constant phenomenon. However, the occurrence of a balanced budget or even a budget surplus is classified as a very rare phenomena (Łaski 2011: 7-8). The object of analysis is the period of 2001-2007, the time of creating and forming the Economic and Monetary Union /UGiW/ to which initially 11 countries were qualified (Austria, Belgium, Finland, France, Spain, Holland, Ireland, Luxemburg, Germany, Portugal and Italy: in 2001 Greece joined the euro zone and in 2007 – Slovenia did) till the moment of the financial crisis beginning. The Table No 1 presents the deficit/surplus of the public financial sector of the euro zone countries as a percentage of GDP in mentioned above years.

Table 1. Deficit/surplus of the public finance sector of the euro zone countries as a percentage of GDP in 2001-2007

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Belgium</td>
<td>0,4</td>
<td>-0,1</td>
<td>-0,1</td>
<td>-0,1</td>
<td>-2,5</td>
<td>0,4</td>
<td>-0,1</td>
</tr>
<tr>
<td>2.</td>
<td>Germany</td>
<td>-3,1</td>
<td>-3,8</td>
<td>-4,2</td>
<td>-3,8</td>
<td>-3,3</td>
<td>-1,6</td>
<td>0,2</td>
</tr>
<tr>
<td>3.</td>
<td>Ireland</td>
<td>0,9</td>
<td>-0,4</td>
<td>0,4</td>
<td>1,4</td>
<td>1,7</td>
<td>2,9</td>
<td>0,1</td>
</tr>
<tr>
<td>4.</td>
<td>Greece</td>
<td>-4,5</td>
<td>-4,8</td>
<td>-5,6</td>
<td>-7,5</td>
<td>-5,2</td>
<td>-5,7</td>
<td>-6,5</td>
</tr>
<tr>
<td>5.</td>
<td>Spain</td>
<td>-0,5</td>
<td>-0,2</td>
<td>-0,3</td>
<td>-0,1</td>
<td>1,3</td>
<td>2,4</td>
<td>1,9</td>
</tr>
<tr>
<td>6.</td>
<td>France</td>
<td>-1,5</td>
<td>-3,1</td>
<td>-4,1</td>
<td>-3,6</td>
<td>-2,9</td>
<td>-2,3</td>
<td>-2,7</td>
</tr>
<tr>
<td>7.</td>
<td>Italy</td>
<td>-3,1</td>
<td>-3,1</td>
<td>-3,6</td>
<td>-3,5</td>
<td>-4,4</td>
<td>-3,4</td>
<td>-1,6</td>
</tr>
<tr>
<td>8.</td>
<td>Luxemburg</td>
<td>6,1</td>
<td>2,1</td>
<td>0,5</td>
<td>-1,1</td>
<td>0,0</td>
<td>1,4</td>
<td>3,7</td>
</tr>
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</table>
Increase of public finance importance in conditions of financial crisis...

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
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<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.</td>
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<td>-2,1</td>
<td>-3,1</td>
<td>-1,7</td>
<td>-0,3</td>
<td>0,5</td>
<td>0,2</td>
</tr>
<tr>
<td>10.</td>
<td>Austria</td>
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<td>-0,7</td>
<td>-1,5</td>
<td>-4,4</td>
<td>-1,7</td>
<td>-1,5</td>
<td>-0,9</td>
</tr>
<tr>
<td>11.</td>
<td>Portugal</td>
<td>-4,8</td>
<td>-3,4</td>
<td>-3,7</td>
<td>-4,0</td>
<td>-6,5</td>
<td>-4,6</td>
<td>-3,1</td>
</tr>
<tr>
<td>12.</td>
<td>Slovenia</td>
<td>-4,0</td>
<td>-2,4</td>
<td>-2,7</td>
<td>-2,3</td>
<td>-1,5</td>
<td>-1,4</td>
<td>0,0</td>
</tr>
<tr>
<td>13.</td>
<td>Finland</td>
<td>5,1</td>
<td>4,2</td>
<td>2,6</td>
<td>2,5</td>
<td>2,9</td>
<td>4,2</td>
<td>5,3</td>
</tr>
</tbody>
</table>


Deficits accompanied the foundation of the Economic and Monetary Union. The permissible deficit threshold of 3% of GDP, established in the Maastricht Treaty, was exceeded in big and leading countries of the EU such as: Germany, Italy or Portugal and of course in Greece. Violating the threshold values happened in 2001-2005 – the crisis period. The improvement of such a situation resulted from the EU enlargement by 10 new members. The revenue amount of the public sector in the euro zone countries’ budgets is presented in the Table 2.

Table 2. The revenue amount of the public sector in the euro zone countries as a percentage of GDP in 2001-2007

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Belgium</td>
<td>49,5</td>
<td>49,6</td>
<td>50,9</td>
<td>48,9</td>
<td>49,3</td>
<td>48,8</td>
<td>48,1</td>
</tr>
<tr>
<td>2.</td>
<td>Germany</td>
<td>44,5</td>
<td>44,1</td>
<td>44,3</td>
<td>43,3</td>
<td>43,6</td>
<td>43,7</td>
<td>43,7</td>
</tr>
<tr>
<td>3.</td>
<td>Ireland</td>
<td>34,1</td>
<td>33,2</td>
<td>33,6</td>
<td>35,0</td>
<td>35,5</td>
<td>37,3</td>
<td>36,9</td>
</tr>
<tr>
<td>4.</td>
<td>Greece</td>
<td>40,9</td>
<td>40,3</td>
<td>39,0</td>
<td>38,1</td>
<td>39,0</td>
<td>39,2</td>
<td>40,7</td>
</tr>
<tr>
<td>5.</td>
<td>Spain</td>
<td>38,1</td>
<td>38,7</td>
<td>38,0</td>
<td>38,8</td>
<td>39,7</td>
<td>40,7</td>
<td>41,1</td>
</tr>
<tr>
<td>6.</td>
<td>France</td>
<td>50,0</td>
<td>49,6</td>
<td>49,3</td>
<td>49,6</td>
<td>50,6</td>
<td>50,6</td>
<td>49,9</td>
</tr>
<tr>
<td>7.</td>
<td>Italy</td>
<td>44,5</td>
<td>44,0</td>
<td>44,4</td>
<td>44,0</td>
<td>43,4</td>
<td>45,0</td>
<td>46,0</td>
</tr>
<tr>
<td>8.</td>
<td>Luxemburg</td>
<td>44,2</td>
<td>43,6</td>
<td>42,3</td>
<td>41,5</td>
<td>41,5</td>
<td>39,9</td>
<td>39,9</td>
</tr>
<tr>
<td>9.</td>
<td>Holland</td>
<td>45,1</td>
<td>44,1</td>
<td>43,9</td>
<td>44,3</td>
<td>44,5</td>
<td>46,1</td>
<td>45,4</td>
</tr>
<tr>
<td>10.</td>
<td>Austria</td>
<td>51,1</td>
<td>49,8</td>
<td>49,7</td>
<td>49,2</td>
<td>48,2</td>
<td>47,5</td>
<td>47,6</td>
</tr>
<tr>
<td>11.</td>
<td>Portugal</td>
<td>38,3</td>
<td>39,6</td>
<td>40,9</td>
<td>41,4</td>
<td>40,1</td>
<td>40,6</td>
<td>41,1</td>
</tr>
<tr>
<td>12.</td>
<td>Slovenia</td>
<td>43,4</td>
<td>43,8</td>
<td>43,6</td>
<td>43,5</td>
<td>43,8</td>
<td>43,2</td>
<td>42,4</td>
</tr>
<tr>
<td>13.</td>
<td>Finland</td>
<td>53,1</td>
<td>53,2</td>
<td>52,8</td>
<td>52,5</td>
<td>53,0</td>
<td>53,3</td>
<td>52,7</td>
</tr>
</tbody>
</table>


On the basis of data presented in Table 2, it can be noticed that only in Ireland the public sector “collected” the smallest percentage of revenue in comparison to the rest of the euro zone countries. The countries where the
percentage of the revenue to the state’s budget reaches the value close to 50% had smaller deficits. Together with the revenue value drop, the deficits increased. The expenses affected the size of deficits – Table 3.

Table 3. Total expenses of the public sector of the euro zone countries as a percentage of GDP in 2001-2007

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Belgium</td>
<td>49,1</td>
<td>49,8</td>
<td>51</td>
<td>49,2</td>
<td>51,9</td>
<td>48,5</td>
<td>48,2</td>
</tr>
<tr>
<td>2.</td>
<td>Germany</td>
<td>47,6</td>
<td>47,9</td>
<td>48,5</td>
<td>47,1</td>
<td>46,9</td>
<td>45,3</td>
<td>43,5</td>
</tr>
<tr>
<td>3.</td>
<td>Ireland</td>
<td>33,2</td>
<td>33,5</td>
<td>33,2</td>
<td>33,6</td>
<td>33,8</td>
<td>34,4</td>
<td>36,8</td>
</tr>
<tr>
<td>4.</td>
<td>Greece</td>
<td>45,4</td>
<td>45,1</td>
<td>44,7</td>
<td>45,5</td>
<td>44,6</td>
<td>45,3</td>
<td>47,5</td>
</tr>
<tr>
<td>5.</td>
<td>Spain</td>
<td>38,7</td>
<td>38,9</td>
<td>38,4</td>
<td>38,9</td>
<td>38,4</td>
<td>38,4</td>
<td>39,2</td>
</tr>
<tr>
<td>6.</td>
<td>France</td>
<td>51,7</td>
<td>52,9</td>
<td>53,4</td>
<td>53,3</td>
<td>53,6</td>
<td>53,0</td>
<td>52,6</td>
</tr>
<tr>
<td>7.</td>
<td>Italy</td>
<td>47,7</td>
<td>47,1</td>
<td>48,1</td>
<td>47,5</td>
<td>47,9</td>
<td>48,5</td>
<td>47,6</td>
</tr>
<tr>
<td>8.</td>
<td>Luxembourg</td>
<td>38,1</td>
<td>41,5</td>
<td>41,8</td>
<td>42,6</td>
<td>41,5</td>
<td>38,6</td>
<td>36,3</td>
</tr>
<tr>
<td>9.</td>
<td>Holland</td>
<td>45,4</td>
<td>46,2</td>
<td>47,1</td>
<td>46,1</td>
<td>44,8</td>
<td>45,5</td>
<td>45,3</td>
</tr>
<tr>
<td>10.</td>
<td>Austria</td>
<td>51,3</td>
<td>50,7</td>
<td>51,3</td>
<td>53,8</td>
<td>50,0</td>
<td>49,1</td>
<td>48,6</td>
</tr>
<tr>
<td>11.</td>
<td>Portugal</td>
<td>43,2</td>
<td>43,1</td>
<td>44,7</td>
<td>45,4</td>
<td>46,6</td>
<td>45,2</td>
<td>44,4</td>
</tr>
<tr>
<td>12.</td>
<td>Slovenia</td>
<td>47,3</td>
<td>46,2</td>
<td>46,2</td>
<td>45,7</td>
<td>45,3</td>
<td>44,6</td>
<td>42,4</td>
</tr>
<tr>
<td>13.</td>
<td>Finland</td>
<td>48,0</td>
<td>49,0</td>
<td>50,3</td>
<td>50,2</td>
<td>50,3</td>
<td>49,2</td>
<td>47,4</td>
</tr>
</tbody>
</table>


In the period when the Economic and Monetary Union was being formed and it was before the present crisis, the expenses fluctuations were not big, although in 2007 the fluctuations drop was noticed in almost all countries (exception: Ireland, Greece and Spain) in comparison to former years.

Now the theory of optimal economic areas formulated by Robert Mundell in the beginning of the 60’s of the XX century should be mentioned. This theory determines benefits of the common currency introduction. R. Mundell claimed that it was profitable for the state to resign from the state’s own currency at the time when profits resulting from the elimination of traditional costs (the necessity of the currency exchange in international transactions) were bigger than costs resulting from the loss of independence in monetary and exchange rate policy. He also commented on the situation when the economies of partner countries are heterogenic, what means that they are receptive to asymmetric shocks, and when labor markets do not provide the sufficient mobility of the labor force as well as payments flexibility. In such a situation these countries should not change their present currency and should possess possibilities of introducing changes of the exchange rate in
order to adapt the economy to external shocks without the necessity of the employment decline (Rosati 2013: 107-108).

After a couple of years R. Mundell modified his theory completing it with a description of a situation on the assets financial market and he took into consideration the existence of dynamic expectations. He paid attention to a private sector which kept its resources in the form of a currency or securities. R. Mundel also indicated that assets would lose their value if the state that is the assets issuer suffered the asymmetric shock. Because of this reason and in order to diversify a risk, a private sector of a given country will aim at differentiating its assets completing them with ones emitted by other countries and in different currencies. However, the factor that inhibits the desirable diversification of assets is the risk of the exchange rate. It induces the financial agents to balance assets and liabilities in one currency. This way the striving for lowering the risk of assets value loss caused by the asymmetric shock remains in a conflict with lowering the foreign exchange risk (Rosati 2013: 109). On the basis of this study, R. Mundell drew the following conclusion: the more a country is vulnerable to asymmetric shocks, the more justified is its entrance to the common currency.

Then a private sector in a given country can protect itself from the risk of loosing the assets value caused by the asymmetric shock thanks to exchange rate risk elimination. Maintaining own currency in these conditions makes the desired diversification of assets impossible and it increases bonuses for the exchange rate risk in national interest rates. This observation has become important for the purposefulness analysis to enter the currency union by countries possessing small open economies and whose currencies are at big rate risk. Since that moment it has been realized that a key advantage of entering the currency union can be the drop of interest rates resulting from a rate risk elimination (Rosati 2013: 110).

The theory of the currency union has gone through a deep evolution. The main reasons of these transformations were changes in the world economy including globalization and markets integration. In the last half-century the autonomy of particular countries in running the independent monetary policy was limited significantly because of capital flows whose effects were mirrored in exogenous changes in the national currency supply. Transaction expenses connected with currency exchange as a result of a rapid development of international trade and financial markets increased. Possessing an own currency was more expensive and entering the currency union became advantageous – not mentioning the macroeconomic strengthening in less developed countries (Rosati 2013: 110-112).

Despite a new perspective on problems connected with the optimal currency area, since 2002 the situation in the European Union has started to
get worse. At that time the decrease of GDP both in Germany and Portugal happened but on the whole territory of the European Union it increased only by 1,5%. It was mirrored in the financial situation of member countries where the increase of deficit and a public debt occurred. These unfavorable changes hit the following countries: Germany, Italy, France, Austria – the leading UE countries. The change of the trend took place in 2004 when the European Union was enlarged by 10 countries of the Middle East Europe. The Union started to develop and the growth rate was about 2-3% of GDP, but the development was observed in the newly recruited countries. But the growth which was noted was not reflected in sufficient reforms that would let fulfill the convergence criteria.

Another element is worth mentioning. The research that was conducted in European Union countries indicated that significant reductions of budget deficit and public debts caused the so called non-Keynes’ effects and fast economic growth (Wojciechowska-Toruńska 2009: 44-45). However European experience indicates that the phenomenon of non Keynes’ effects have a lot in common with a fiscal policy consisting in stimulating the economic growth through structural reforms of public expenses and a tax system rather than through the reduction of deficit and a public debt (Wojciechowska-Toruńska 2009: 44). Germany and France, these are the countries that were striving for stabilization of the increase of the public debt in order to cope with the requirements of the Stability and Growth Pact. On the other hand Ireland or Finland concentrated on achieving the excessive economic growth, at the same time, achieving successes in public finance stabilization, in comparison with the first group of European countries.

Moreover, in the case of some member countries of the euro zone, the initial cause of the debt crisis was not the excessive indebtedness of a public sector but the immoderate expansion of bank loans and the indebtedness of a private sector. In Ireland or Spain the debt level of the public sector before the crisis was low and it was adequately 25,0% and 36,0%. However, as a result of the expansive policy run by banks that granted loans in order to finance houses building or real estate purchases, banks got into financial trouble. The scale of losses turned out big enough to question the solvency of banks and their deposits security. Regardless of the fact whether the initial cause of the debt crisis was the excessive public or private sectors indebtedness, there appeared the necessity of rescuing domestic banks what, at the same time, was an attempt and a challenge for the European Union where, despite the existence of the common currency, there are 17 different systems of banks control and supervision. It turned out that it is one of the most important drawbacks of European integration causing the crisis deepening.
Increase of public finance importance in conditions of financial crisis...


European public finance crisis has resulted from the crisis that started in the United States of America in 2007. The crisis in the euro zone started one year later when the next EU countries fell into the debt trap, financial markets subjected to instability and the economic growth rapidly slowed down. The deficit/surplus and the public debt as a percentage of GDP in the euro zone countries in 2008-2012 are presented in the Tables 4 and 5.

Table 4. Deficit/surplus of the public finance sector of the euro zone countries as a percentage of GDP in 2008-2012

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Belgium</td>
<td>-1.0</td>
<td>-5.6</td>
<td>-3.8</td>
<td>-3.7</td>
<td>-3.9</td>
</tr>
<tr>
<td>2.</td>
<td>Germany</td>
<td>-0.1</td>
<td>-3.1</td>
<td>-4.1</td>
<td>-0.8</td>
<td>0.2</td>
</tr>
<tr>
<td>3.</td>
<td>Estonia</td>
<td>-2.9</td>
<td>-2.0</td>
<td>0.2</td>
<td>1.2</td>
<td>-0.3</td>
</tr>
<tr>
<td>4.</td>
<td>Ireland</td>
<td>-7.4</td>
<td>-13.9</td>
<td>-30.8</td>
<td>-13.4</td>
<td>-7.6</td>
</tr>
<tr>
<td>5.</td>
<td>Greece</td>
<td>-9.8</td>
<td>-15.6</td>
<td>-10.7</td>
<td>-9.5</td>
<td>-10.0</td>
</tr>
<tr>
<td>6.</td>
<td>Spain</td>
<td>-4.5</td>
<td>-11.2</td>
<td>-9.7</td>
<td>-9.4</td>
<td>-10.6</td>
</tr>
<tr>
<td>7.</td>
<td>France</td>
<td>-3.3</td>
<td>-7.5</td>
<td>-7.1</td>
<td>-5.3</td>
<td>-4.8</td>
</tr>
<tr>
<td>8.</td>
<td>Italy</td>
<td>-2.7</td>
<td>-5.5</td>
<td>-4.5</td>
<td>-3.8</td>
<td>-3.0</td>
</tr>
<tr>
<td>9.</td>
<td>Cyprus</td>
<td>0.9</td>
<td>-6.1</td>
<td>-5.3</td>
<td>-6.3</td>
<td>-6.3</td>
</tr>
<tr>
<td>10.</td>
<td>Luxemburg</td>
<td>3.2</td>
<td>-0.8</td>
<td>-0.9</td>
<td>-0.2</td>
<td>-0.8</td>
</tr>
<tr>
<td>11.</td>
<td>Malta</td>
<td>-4.6</td>
<td>-3.7</td>
<td>-3.6</td>
<td>-2.8</td>
<td>-3.3</td>
</tr>
<tr>
<td>12.</td>
<td>Holland</td>
<td>0.5</td>
<td>-5.6</td>
<td>-5.1</td>
<td>-4.5</td>
<td>-4.1</td>
</tr>
<tr>
<td>13.</td>
<td>Austria</td>
<td>-0.9</td>
<td>-4.1</td>
<td>-4.5</td>
<td>-2.5</td>
<td>-2.5</td>
</tr>
<tr>
<td>14.</td>
<td>Portugal</td>
<td>-3.6</td>
<td>-10.2</td>
<td>-9.8</td>
<td>-4.4</td>
<td>-6.4</td>
</tr>
<tr>
<td>15.</td>
<td>Slovenia</td>
<td>-1.9</td>
<td>-6.2</td>
<td>-5.9</td>
<td>-6.4</td>
<td>-4.0</td>
</tr>
<tr>
<td>16.</td>
<td>Slovakia</td>
<td>-2.1</td>
<td>-8.0</td>
<td>-7.7</td>
<td>-5.1</td>
<td>-4.3</td>
</tr>
<tr>
<td>17.</td>
<td>Finland</td>
<td>4.4</td>
<td>-2.5</td>
<td>-2.5</td>
<td>-0.8</td>
<td>-1.9</td>
</tr>
</tbody>
</table>

Source: Own study on the basis of Eurostat, II nd quarter of 2013

The deficit criterion was met in Germany, Malta, Estonia, Luxemburg, Austria and Finland. The situation got worse in Ireland where the year 2010 was the worst one because the deficit reached the value of 30%. Also the situation was not interesting in Greece, Spain, and Portugal. The increase of deficits that should have been financed affected the increase of the public debt /Table 5/.
Table 5. Public debt of the euro zone countries as a percentage of GDP in 2008-2012

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Belgium</td>
<td>89,2</td>
<td>95,7</td>
<td>95,5</td>
<td>97,8</td>
<td>99,6</td>
</tr>
<tr>
<td>2.</td>
<td>Germany</td>
<td>66,8</td>
<td>74,5</td>
<td>82,4</td>
<td>80,4</td>
<td>81,9</td>
</tr>
<tr>
<td>3.</td>
<td>Estonia</td>
<td>4,5</td>
<td>7,2</td>
<td>6,7</td>
<td>6,2</td>
<td>10,1</td>
</tr>
<tr>
<td>4.</td>
<td>Ireland</td>
<td>44,5</td>
<td>64,8</td>
<td>92,1</td>
<td>106,4</td>
<td>117,6</td>
</tr>
<tr>
<td>5.</td>
<td>Greece</td>
<td>112,9</td>
<td>129,7</td>
<td>148,3</td>
<td>170,3</td>
<td>156,9</td>
</tr>
<tr>
<td>6.</td>
<td>Spain</td>
<td>40,2</td>
<td>53,9</td>
<td>61,5</td>
<td>69,3</td>
<td>84,2</td>
</tr>
<tr>
<td>7.</td>
<td>France</td>
<td>68,2</td>
<td>79,2</td>
<td>82,4</td>
<td>85,8</td>
<td>90,2</td>
</tr>
<tr>
<td>8.</td>
<td>Italy</td>
<td>106,1</td>
<td>116,4</td>
<td>119,3</td>
<td>120,8</td>
<td>127</td>
</tr>
<tr>
<td>9.</td>
<td>Cyprus</td>
<td>48,9</td>
<td>58,5</td>
<td>61,3</td>
<td>71,1</td>
<td>85,8</td>
</tr>
<tr>
<td>10.</td>
<td>Luxemburg</td>
<td>14,4</td>
<td>15,3</td>
<td>19,2</td>
<td>18,3</td>
<td>20,8</td>
</tr>
<tr>
<td>11.</td>
<td>Malta</td>
<td>60,9</td>
<td>66,4</td>
<td>67,4</td>
<td>70,3</td>
<td>72,1</td>
</tr>
<tr>
<td>12.</td>
<td>Holland</td>
<td>58,5</td>
<td>60,8</td>
<td>63,1</td>
<td>65,5</td>
<td>71,2</td>
</tr>
<tr>
<td>13.</td>
<td>Austria</td>
<td>63,8</td>
<td>69,2</td>
<td>72,0</td>
<td>72,5</td>
<td>73,4</td>
</tr>
<tr>
<td>14.</td>
<td>Portugal</td>
<td>71,7</td>
<td>83,7</td>
<td>94,0</td>
<td>108,3</td>
<td>123,6</td>
</tr>
<tr>
<td>15.</td>
<td>Slovenia</td>
<td>22,0</td>
<td>35,0</td>
<td>38,6</td>
<td>46,9</td>
<td>54,1</td>
</tr>
<tr>
<td>16.</td>
<td>Slovakia</td>
<td>27,9</td>
<td>35,6</td>
<td>41,0</td>
<td>43,3</td>
<td>52,1</td>
</tr>
<tr>
<td>17.</td>
<td>Finland</td>
<td>33,9</td>
<td>43,5</td>
<td>48,6</td>
<td>49,0</td>
<td>53,0</td>
</tr>
</tbody>
</table>

Source: Own study on the basis of Eurostat, II nd quarter of 2013

The amount of the public debt in Estonia, Luxemburg, Slovenia, Slovakia and Finland was not the European Union’s concern. Similarly, as in the case of deficits, the high level of the public debt was noted in Ireland, Greece, Portugal or in Italy and France – the next two financial powers in the EU.

However after 2009 the new problem occurred and it was connected with the inability of the EU countries to undertake activities aiming at overcoming the crisis. At the same time the weakness of the European institutional and political system that was not able to handle new challenges was revealed. What we deal with nowadays is the indebtedness crisis of some euro zone member countries. It is accompanied by the political crisis connected with the inability of joined actions in the European Union (Rosati 2013: 60-64). Wherein in some European countries, the crisis was caused by the excessive indebtedness of the government sector – examples: Greece and Portugal, or by the excessive banks indebtedness of the private sector – the example: Spain, or by the excessive and risky expansion of the bank sector – the example: Ireland. All these examples, regardless of the reason, present that the excessive debts ultimately affected the private
Increase of public finance importance in conditions of financial crisis...

sector. If these countries were out of the common currency area such a huge indebtedness would not happen. However, the fact that countries belong to the Economic and Monetary Union causes that member countries provide help in order to avoid negative consequences of their possible bankruptcy and the collapse of the economy in the euro zone.

The activities that were undertaken by particular euro zone member countries governments during the economic crisis led to changes of budgets balances. The biggest deficits occurred in 2009 in connection with activities that had to limit consequences of the crisis in the real sphere. Next year the majority of European countries further limited the size of the deficit, excluding Ireland where the deficit amounted to 31% of GDP – 5 times more than the permissible value agreed in Maastricht. At the same time, the situation in Slovenia got worse. Both the deficit and the public debt increased there.

The financial situation worsening resulted, first of all, from reducing the rate of the economic growth. The negative midyear economic growth rate was noted in Ireland, Denmark, Greece, Italy, France and Portugal.

In consecutive years the European economy was shrinking. The year 2010 was completed with the 2% increase of the real production in comparison to 2009. After this short-term economy improvement, in most of the EU countries, again, the GDP growth rate slowed down reaching the level of 1,5% (Szymańska 2012: 35-36).

However, something else is worth mentioning. Countries belonging to the Economic and Monetary Union that were hit by the crisis have been suffering from the imbalance of international turnover and they indicate deficits on the current accounts of payment transactions for a long time. The situation is presented in the Table 6.

Table 6. Current account balance as a percentage of GDP in 2003-2011

<table>
<thead>
<tr>
<th>Item No</th>
<th>Country/years</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Belgium</td>
<td>3,4</td>
<td>3,2</td>
<td>2,0</td>
<td>1,9</td>
<td>1,9</td>
<td>-1,3</td>
<td>-1,4</td>
<td>1,9</td>
<td>-1,4</td>
<td></td>
</tr>
<tr>
<td>2. Germany</td>
<td>1,9</td>
<td>4,7</td>
<td>5,1</td>
<td>6,3</td>
<td>7,4</td>
<td>6,2</td>
<td>5,9</td>
<td>6,0</td>
<td>5,7</td>
<td></td>
</tr>
<tr>
<td>3. Estonia</td>
<td>-11,3</td>
<td>-11,3</td>
<td>-10</td>
<td>-15,3</td>
<td>-15,9</td>
<td>-9,2</td>
<td>3,4</td>
<td>2,9</td>
<td>2,1</td>
<td></td>
</tr>
<tr>
<td>4. Ireland</td>
<td>0</td>
<td>-0,6</td>
<td>-3,5</td>
<td>-3,5</td>
<td>-5,4</td>
<td>-5,7</td>
<td>-2,3</td>
<td>1,1</td>
<td>1,1</td>
<td></td>
</tr>
<tr>
<td>5. Greece</td>
<td>-6,5</td>
<td>-5,8</td>
<td>-7,6</td>
<td>-11,4</td>
<td>-14,6</td>
<td>-14,9</td>
<td>-11,2</td>
<td>-10,1</td>
<td>-9,9</td>
<td></td>
</tr>
<tr>
<td>6. Spain</td>
<td>-3,5</td>
<td>-5,2</td>
<td>-7,4</td>
<td>-9,0</td>
<td>-10,0</td>
<td>-9,6</td>
<td>-4,8</td>
<td>-4,5</td>
<td>-3,5</td>
<td></td>
</tr>
<tr>
<td>7. France</td>
<td>0,4</td>
<td>0,5</td>
<td>-0,5</td>
<td>-0,6</td>
<td>-1,0</td>
<td>-1,7</td>
<td>-1,3</td>
<td>-1,6</td>
<td>-2,0</td>
<td></td>
</tr>
<tr>
<td>8. Italy</td>
<td>-0,8</td>
<td>-0,3</td>
<td>-0,9</td>
<td>-1,5</td>
<td>-1,3</td>
<td>-2,9</td>
<td>-2,0</td>
<td>-3,5</td>
<td>-3,1</td>
<td></td>
</tr>
<tr>
<td>9. Cyprus</td>
<td>-2,3</td>
<td>-5,0</td>
<td>-5,9</td>
<td>-6,9</td>
<td>-11,7</td>
<td>-15,6</td>
<td>-10,7</td>
<td>-9,8</td>
<td>-4,7</td>
<td></td>
</tr>
<tr>
<td>10. Luxemburg</td>
<td>8,1</td>
<td>11,9</td>
<td>11,5</td>
<td>10,4</td>
<td>10,1</td>
<td>5,4</td>
<td>7,2</td>
<td>8,2</td>
<td>7,1</td>
<td></td>
</tr>
<tr>
<td>11. Malta</td>
<td>-3,0</td>
<td>-5,8</td>
<td>-8,5</td>
<td>-9,5</td>
<td>-6,2</td>
<td>-4,9</td>
<td>-7,4</td>
<td>-4,9</td>
<td>-0,3</td>
<td></td>
</tr>
<tr>
<td>12. Holland</td>
<td>5,5</td>
<td>7,6</td>
<td>7,4</td>
<td>9,4</td>
<td>6,7</td>
<td>4,3</td>
<td>5,2</td>
<td>7,7</td>
<td>9,7</td>
<td></td>
</tr>
</tbody>
</table>
Germany running the policy of slowing down the nominal payments increase in relation to the increase of labor efficiency for a long time has caused the decrease of labor costs and increase of competitiveness obtaining new outlets at the same time. Countries that could not cope with such competitiveness had to introduce the currency devaluation. As a result of such a situation, the problem started again. However, since the moment of entering the Economic and Monetary Union, the possibility of the national currency devaluation disappeared.

Then the countries forming the Economic and Monetary Union should start running the stabilization policy of mutual competitive ability. That means that every country should adjust the increase of nominal payments to the increase of real labor efficiency and correct it according to the inflation goal of the European Central Bank (Łaski 2011: 11-12). However it has not happened.

The weakness of the Economic and Monetary Union, which was ignoring the problem of relative competitiveness inside the European Union, has not been revealed since the moment of the crisis. What is worse, this problem has been passed over in the moment of demanding the finance consolidation in order to calm financial markets.

The countries response to the present crisis indisputably indicates that despite the progressing European integration, the fiscal policy is still the domain of member countries. The main burden of the crisis consequences struggle rests on the states budgets. The scale of this fiscal expansion is significant, although, differences both in relation to its size and its structure occur among countries. In 2009 Germany of France supported the financial sector suitably: 4,2% and 2,7% of GDP while Great Britain and Holland had to pump money into the financial sector in the amount of 17,8% and 13,7% of GDP (Tomkiewicz 2010: 142-143). Table 7 presents the costs that were born by member countries to fight the crisis.
Increase of public finance importance in conditions of financial crisis...

Table 7. Financial support of the euro zone countries in 2008-2011 according to used instruments

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>20,40</td>
<td>5,54%</td>
<td>44,23</td>
<td>12,01%</td>
<td>7,73</td>
<td>2,10%</td>
<td>0</td>
<td>0%</td>
<td>72,36</td>
<td>19,65%</td>
</tr>
<tr>
<td>Germany</td>
<td>63,24</td>
<td>2,46%</td>
<td>135,03</td>
<td>5,25%</td>
<td>56,17</td>
<td>2,19%</td>
<td>4,75</td>
<td>0,18%</td>
<td>259,19</td>
<td>10,08%</td>
</tr>
<tr>
<td>Estonia</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>Ireland</td>
<td>62,78</td>
<td>40,13%</td>
<td>284,25</td>
<td>181,70%</td>
<td>2,60</td>
<td>1,66%</td>
<td>0,08</td>
<td>0,05%</td>
<td>349,71</td>
<td>223,54%</td>
</tr>
<tr>
<td>Greece</td>
<td>6,30</td>
<td>2,93%</td>
<td>56,30</td>
<td>26,17%</td>
<td>0</td>
<td>0%</td>
<td>6,90</td>
<td>3,21%</td>
<td>69,49</td>
<td>32,31%</td>
</tr>
<tr>
<td>Spain</td>
<td>19,31</td>
<td>1,80%</td>
<td>62,20</td>
<td>5,79%</td>
<td>2,86</td>
<td>0,27%</td>
<td>19,31</td>
<td>1,80%</td>
<td>103,68</td>
<td>9,66%</td>
</tr>
<tr>
<td>France</td>
<td>22,46</td>
<td>1,12%</td>
<td>92,73</td>
<td>4,64%</td>
<td>1,20</td>
<td>0,06%</td>
<td>0</td>
<td>0%</td>
<td>116,39</td>
<td>5,83%</td>
</tr>
<tr>
<td>Italy</td>
<td>4,05</td>
<td>0,26%</td>
<td>10,90</td>
<td>0,69%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>14,95</td>
<td>0,95%</td>
</tr>
<tr>
<td>Cyprus</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
<td>2,83</td>
<td>15,91%</td>
</tr>
<tr>
<td>Latvia</td>
<td>0,51</td>
<td>2,53%</td>
<td>0,54</td>
<td>2,69%</td>
<td>0,41</td>
<td>2,03%</td>
<td>0,97</td>
<td>4,86%</td>
<td>2,43</td>
<td>12,12%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2,60</td>
<td>6,07%</td>
<td>1,65</td>
<td>3,84%</td>
<td>0</td>
<td>0%</td>
<td>0,19</td>
<td>0,44%</td>
<td>4,43</td>
<td>10,35%</td>
</tr>
<tr>
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Source: Own study on the basis of Eurostat, Source: DG Competition 07.05.2013.

The level of member countries involvement in the crisis struggle is different both in the scope of relations to GDP and to provided tools. The financial sector capital support and warranties have become the instruments that are mostly implemented. The uncertain financial situation is still a threat for the national budgets stability in many countries, first of all in Spain and Cyprus. These mutual relations of governments and banks create a vicious circle that is difficult to cut. The situation is worsened by the increasing unemployment rate that reaches the highest levels in Spain, Greece or Portugal. It causes the increase of expenses of states whose public finance are in an extremely poor condition. It brings about the necessity to increase budget revenues what is connected with the perspective of increasing the tax burden (direct and indirect taxes) but this consequently decreases the citizens’ income. It arouses the moods of anxiety and the lack of trust to undertaken government’s actions among European societies. In reply to the situation, the member countries had to decide on institutional reforms.
5. Methods of public finance improvement of the European Union member countries

Since 2009 the European Union has been involved in the arrangements concerning the second reform of the Stability and Growth Pact as well as changes in the scope of strengthening the economic policy coordination of member countries. The suggested solution postulates aim at enlarging preventive and repairing activities within the scope of supervision and realization of the convergence criteria including aspects of the government institutions sector indebtedness (Marchewka-Bartkowiak 2011: 48).

Undertaken activities, in response to the crisis, were following two directions. Firstly, the European Union countries tried to control the persisting crisis and to restore the stability on financial markets. Secondly, it was desired to run such reforms in the EU economic management in order to prevent similar crises in future and to create an effective system that would make impossible to get into debts by member countries (Rosati 2013: 72-73).

In 2011 the so called “Sześciopak” was agreed. It is the set of 6 legal acts concerning, among others, the rules of creating state budgets, the rate of expenses increase as well as the required rate of a public debt reduction. First of all, the aim of this package is to strengthen the economic management in the European Union, mainly in the euro zone. The procedure of the exceeded imbalance” that provides sanctions for the lack of discipline has been established. The main element of the package is: strengthening the debt criterion that played less vital part than the deficit criterion. The package provides also for increasing the transparency of the decision-making process of economic policies coordination in the European Union. Establishing and strengthening a dialogue among EU institutions, as well as intensifying governments’ and parliaments’ commitments to obey commonly worked out rules are the crucial objectives included in the package.

Next, the fiscal treaty specifies that the balance of government institutions must be balanced or it has to demonstrate a surplus. This requirement will be possible to fulfill if the annual balance of government institutions is equal to the MTO – medium term objective defined in the amended package, admitting that the lower limit of the structural deficit equals 0.5% of GDP. Every nation’s objective is to reach the MTO quickly but the time frame of this relation will be presented by the European Commission taking into account the risk of a given country economic stability.

The treaty provides for situations when a nation can temporarily give up the defined MTO and the adjustment path. These exceptional circumstances occur when:
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- a debt of government institutions sector in relation to GDP, counted in market prices, remains below 60% and a low risk of losing the long-term stability of public finance occurs,
- a lower limit of MTO can be equal to a structural deficit that amounts at the most 1% of GDP in market prices.

The automatic correcting mechanism in which the European Commission will present the description, range and plan of repair activities will be activated when significant deviations from MTO and from the adjustment path are noted. In the situation when the public debt exceeds the reference value – it is 60% of GDP, the state will be obliged to decrease the debt value, on average, one twentieth annually. At the same time the pact forces countries of the high debt level to limit the expenditure growth. The agreed rate of the GDP increase in the medium term cannot be exceeded.

The treaty defines also the role of the European Commission while monitoring and applying programs of the deficit limitation. This institution is important because it monitors and approves these programs126.

Among new European Commission propositions that have to contribute to the discipline and supervision increase in public finance of the European Union countries there is a postulate to implement the procedure of excessive macroeconomic imbalance as well as to establish the uniform requirements concerning rules and procedures that create budgetary framework in member countries (Marchewka-Bartkowiak 2011: 52).

The treaty, first of all, concerns countries that create the euro zone, but the rest of the member countries, especially those that plan to introduce the common currency in future, should take into consideration the change of the attitude related to a problem of the exceed deficit and a public debt in connection with realized integration processes.

The acceptance of the fiscal treaty, which assumes the discretionary fiscal sovereignty limitation, seems to be right if a defense for the common currency will become successful. Especially Germany strives for this. For this country accepting binding fiscal rules and effective European Union control of the rules obeying are the key elements of the success. Poland has also managed to obtain advantageous bequests. During negotiations it was possible to agree issues that increase the flexibility in the approach to the pension reform system. The commission, while assessing the macroeconomic situation of our country, has to take into consideration processes connected with the change of the economic system and the necessity of

“catching up” the European leading member countries what entails incurring financial expenditures and affects financial balance\(^2\).

Undertaking actions leading to tightening cooperation in the framework of the fiscal pact aims at accelerating the consolidation of public finance that will open the way to the euro zone.

The undertaken structural reforms should be mentioned here. In 2011 the European Union adopted the “Euro plus Pact” containing resolutions aiming at strengthening the economic dimension of the currency union, improving the coordination of the economic policy and strengthening the competitiveness of European economies in longer perspective. It has to be done thanks to the labor marker reforms, pension systems and increasing expenditures for education and academic research. Every year member countries will be obliged to undertake reforms in order to bring their economies closer to each other. The status of commitments implementation will be evaluated periodically in the framework of, the so called: “European system”. It should be remembered that this pact is the political commitment; it does not have the legal binding and its regulations are implemented by means of secondary legislative acts, including the “Sześciopak” (Rosati 2013: 77).

Undertaken actions should be assessed in a positive way because they fill out the gap in the previous European system of finance and economic management. The weakness of these resolutions can be the commitments voluntariness (Pact „Euro plus”), others present the compromise character what has an impact upon the effectiveness of their implementation and realization. The European Union suffers from the lack of the sense of community and member countries still describe their priorities in the name of the narrowly defined public interest.

6. Summary

Nowadays in Europe (but also in USA) that is in crisis, the problem of the state’s role and public finance involvement come into being again. Today a demand is the problem but actually its insufficient level (not a supply). A big number of European countries plunge in a deep stagnation that is close to the economic breakdown. In order to go out of the impasse, the expansion both monetary and fiscal is necessary. Blaming the state’s well-being for a crisis is not fair because this is not the reason of the excessive indebtedness of a give country. Today we pay for debts. They sprang into existence as a result of the bank and financial crisis and expenditures cuts, including

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social spending, cause further consumption decrease as well as the economy slowing down what can result in further recession3.

In the era of the financial crisis, the increase of state’s activity in the field of economic situation stability, including the increase of public finance, is expected. It has been noticed several times that markets response to governments’ interventions is positive but unfortunately short-lived. This mechanism is listed in the economy functioning. The financial system has an important meaning for the whole economy and taking risk of further financial system destabilization can be recognized as irresponsible. For the next time the crisis revealed the weakness of institutional framework, especially regulations and supervision. To avoid the repetition of the next crisis or economic collapses in future, it seems to be necessary to change the terms of its functioning. We hope that the prepared by the European Union fiscal pact will contribute to the improvement of the financial condition of member countries. However it will be possible on conditions – widely understood economic aspect will get a chance to be spoken or when the destabilization is not profitable. It is predicted to be a long-lasting process.

References


Internet sources:

Piotr Ostaszewski, Prof.
piotr.ostaszewski@sgh.waw.pl
Warsaw School of Economics

Abstract
The global financial crisis first hit Iceland, which until 2008 had remained a symbol of the economic boom and the successful experiment of the transition from state interventionism to the stage of gradual privatization and then total liberalization of the market, in which the banking sector played the leading role. In a short time it became a negative symbol of the destruction of the system creating sustainable development, rational economy and a high standard of living of citizens. The model of liberalized economy based on the principles generally considered as unshakeable foundations of liberalism, a free game of market entities led by an invisible hand of the market, suddenly crashed. In the case of Iceland, however, the point was not just the excessive liberalization, but the basic question about the possibility of joining the European Union by this small country as the only lifeline for the economy plunged into destruction. After several years of digressions, Iceland was skeptical about the concept. The Eurozone crisis questioned the European monetary union. Moreover, skeptics began to doubt the fate of the united Europe. On the other hand, Iceland seems to be conceiving their own way out of the crisis, not only by reforming the economy (but the effects will be long-lasting), but also the political system by holding a public referendum on constitutional issues and even by creating the social constituent assembly. Icelandic solutions can take place in a small society of 320 thousand people with deep – rooted values and democratic procedures. However, more thought should be given to the Icelandic model of
fighting the crisis, as well as to its impact on changing the model of the democracy system and the functioning of state institutions. In other words, the fundamental question is to what extent the reforms undertaken since the early 1990s have proved to be positive for the political system and the state institutions and to what extent the financial crisis has stimulated citizens to demand political changes affecting both the political world and the model of the state institution that it shapes.

**Key words:** democracy, political implications, liberalizations, Iceland.


   The image of the Iceland economy before 2008 was created by the following: high economic growth, low unemployment rate and the extremely dynamic development of economy based on low-interest loans. The Icelandic society was one of the fastest growing ones. It would be wrong, however, to think that a gradual shift of individual sectors of economy to private hands, thus departing from the traditional Scandinavian model, led straight to the great collapse that took place in September 2008.

   In the traditional presentation, the backbone of economy was the fishing industry accounting for 40% of the income from export and employing about 7% of the working population. The dominance of state ownership manifested itself, inter alia, in the monopoly in the tobacco, alcohol, media, steel and heating sectors. The crisis in fishery resulted in introducing the fishing limits by the state in the late 1980s and early 1990s. Moreover, through the turn of the decades, the Iceland economy was already in decline. The budget deficit reached 3% of Gross Domestic Product (GDP), consumption fell by 4% and GDP per capita in 1988-1991 decreased by 0.72% (National Economic Institute 1999: 9). As far as HDI (Human Development Index) is concerned, Iceland occupied undisputed first place, and this was due to a certain social model in which the fundamental role was played by factors such as the rate of education, health care, and GDP per capita (Gołębiowski, Szczepanowski 2008: 6). But did the classic Scandinavian model in the Icelandic form withstand the challenges of the new times?

   In view of the fundamental principles, namely:

2 Available at: http://www.fisheries.is/management/fisheries-management/.
Iceland – political implications of the financial crisis of 2008...

1. Pursuing a policy of sustainable development and concern for the natural environment;
2. Recognizing the role of the state in minimizing the negative effects of free-market economy;
3. Access to free education;
4. Good health care;
5. Extensive pensions and allowances,

Iceland faced the spectre of revolutionizing the domestic economy, which was already in decline (Gołębiowski, Szczepanowski 2008: 15).

That traditional model began to transform in the early 1990s. The emphasis was shifted towards manufacturing and services, especially as far as the computer software sector, biotechnology and tourism were concerned. The geothermal sector and the use of hydroelectric power created ideal conditions for foreign investment in the aluminum smelting industry and in the development of so-called green energy. Economic liberalism received another boost in 1994 when Iceland joined the European Economic Area and the Uruguay Round, changing GATT into OECD, increased the possibilities of Icelandic export. In the first case, opportunities for the free movement of capital, services, goods and labour were created in relations with the European Union markets, in the second one conditions for export to world markets were improved. In the pre-crisis period the average rate of inflation stood at 2.5% and the exchange rate of Euro to Icelandic krona at its peak was 72 : 1, which contrasts with the end of September 2008, when the value of ISK plummeted to the lowest level with the rate 185 : 1. As it turned out, depreciation of Icelandic krona had beneficial consequences as it provided a strong impetus for exports, affecting the competitiveness of Icelandic goods. However, in this case we can speak of the long-lasting consequences because in the period of crisis escalation it was rather destructive for the economy. But export itself still showed the upward trend at the beginning of 2008, and processed goods accounted for over 34% of total exports.

Liberalization of the Icelandic market is a process that began only in the 1990s, although its symptoms could already be observed in the 1980s. For over 30 years, that is from the 1950s to the 1980s, the economy remained virtually under state control, which manifested itself in a number of

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6 Bank Centralny Islandii..., p. 23.
regulations. The state determined the exchange rate, prices for agricultural produce, not to mention the control over imports. The level of national income kept pace with the Scandinavian countries (Mattiason 2008: 37). The agreement to build the first aluminum smelter in 1969 is a kind of turning point in the economic policy of the government, which decided to diversify the economy of the state and depart from the mono-cultural approach in the form of fishery priority. The energy intensity of aluminum production put the issue of developing energy based on natural resources on the agenda and in the case of Iceland, using hydropower and thermal springs.

The unprecedented growth of the Iceland economy by almost 25% in just four years, i.e. in the period of 2003-2007 caused a dangerous phenomena such as over-indebtedness of the private sector as well as excessive dependence on external funding sources. Excessive investments such as aluminum smelters and a hydroelectric plant, worth more than 30% of GDP, had a negative importance in terms of the current account. Nevertheless, in the period preceding the Icelandic collapse, the credit market grew so extremely rapidly that it was ranked 62 by Frasier Economic Index on the list of 102 countries in 1980s and in 2002 it was ranked 14 out of 123 countries (Eggertson, Herbertsson 2005: 74).

The years 1995-2004 are the period of real deregulation and privatization, which is characterized by stable economic growth of 3-4%. The climax was the year 2005 when the economic growth reached 6%, and the inflation rate exceeded 8.6%, with interest rates at 6.9%. The proponents of such a course of the economic policy were not only the accused Prime Minister Geir Haarde but initially his predecessor Davio Oddsson. As a supporter of the “invisible hand of the market”, he pursued the tax reduction policy. For 11 years corporate income tax (CIT) was reduced from 50% to 18%, and for 16 years personal income tax (PIT) was reduced from 47% to 36% in 2007 (Pruchnik 2010: 6) for big business and the financial sector tax thresholds for small and medium enterprises were increased (Ólafsson 2007: 23). In 2007 a flat tax was also introduced (not linear, as it was outside the sphere of taxation of the amount of 5 and 2 thousand dollars from adults and children respectively) (Mitchell 2007).

The privatization of the banking sector, as well as of fisheries, which had been under state control until 2004, is considered to be a fundamental cause of the financial crisis and almost the bankruptcy of Iceland. In 2003, the Prime Minister D. Oddsson, the former governor of the central
Iceland – political implications of the financial crisis of 2008...

Bank decided to privatize three state-owned banks: Islandsbanki, Glitnir and Kaupthing and also Telecom. The expanded activity in the sector and the excessive credit policy soon resulted in the situation that the assets of the three banks exceeded the national GDP nine times, which in fact meant it was nine times higher than the value of the Iceland economy. The access to cheap loans resulted in the steadily rising debt of Icelandic companies, which in 2008 was estimated at over 308% of GDP. The credit policy proved to be extremely dangerous in its second phase, i.e. in the period of 2005-2007, when the Icelandic banks began their international expansion, which basically was a correlation between high interest rates that allowed them to finance their credit policy in the country. It turned out to have far-reaching consequences in the case of deposits in the UK and the Netherlands, which is illustrated by Icesave, which collected British deposits amounting to more than 4 billion pounds and Dutch ones in the amount of 1.7 billion EUR. In times of the crisis it caused a diplomatic dispute resulting in the legal repercussions, when both governments decided to defend the deposit of their citizens before Icesave was declared insolvent.

The sources of the crisis were presented synthetically by K. Pruchnik in his analysis. He detailed the following mistakes:

1. Too low an interest rate for refinanced loans of the central bank in Iceland in 2001-2008;
2. Interventions in the housing market (government guarantees for cheap credits offered by the Finance Housing Found (HFF) and commercial banks);
3. Mistakes made by state institutions and identifying too late the threats posed by the state institutions in relation to the credit policy of HFF and commercial banks;
4. Cranny capitalism known as a “crony republic”, that is involvement of the people associated with the business and government circles in the privatization (Pruchnik 2012: 1).

A mark of the great economic boom, which Iceland had become, was reduced to an artificially prosperous economy, which was quite cynically depicted in one of the press articles: the country with four times more sheep (more than 1.2 million) than people has more than 600 thousand foreign bank accounts (Matracka 2013). The artificial boom ended in less than four

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9 http://finanse.wnp.pl/b-premier-islandii- prywatyzacja-bankow-byla-powaznym – bledem, 76767_1_0_0.html.
weeks after the collapse of the U.S. Lehman Brothers, showing fragile foundations of the Icelandic boom based on a policy of economic liberalization and cheap loans.

2. The financial collapse in 2008

The very fact of the privatization of the banking sector cannot be considered as a factor stimulating the crisis processes in Iceland. It would be more appropriate to say that it was freedom with which privatized banks operated in the domestic and then foreign market. The idee fixe of the government led by the Prime Minister D. Oddsson of making Iceland the country where economic barriers are overcome effectively and where everybody is given equal opportunities resulted in a peculiar credit situation, in which the state institution, Housing Financing Found, which initially was to provide lending to people who could not afford to buy their own accommodation, competed with commercial banks. Soon, however, in the free market, it became an institution influencing commercial banks, which lowered the requirements for obtaining the mortgage loans, leading ultimately to the credit policy based on loan to value ratio of 100%. It resulted in a growing demand for real estate, and thus increase in its prices (incommensurate to the real value, because their value increased by 200% since 2000). This syndrome also occurred in the United States of America. Another important factor was the government’s decision to reduce the required bank reserves from 4 to 2%.

Figure 1. Development of real estate prices in Iceland in 2007-2012

Source: Icelandic Property Registry, 2012
Iceland – political implications of the financial crisis of 2008...

In 2005-2007, the commercial banks (Landsbanki, Kaupthing and Glitnir) started expansion activities outside by offering high interest rates (over 15%), including the possibility of starting accounts online. Landsbanki founded a subsidiary called Icesave, which collected deposits mainly from the UK and the Netherlands. Surplus profit financed cheap domestic loans. The remaining surplus was used to fund the unsuccessful investment, especially for foreign entities and what is worse, also for the organizations whose representatives had shares in banks. In this way, the idea of the “republic of cronies” was implemented. For example, Glitnir granted a loan to Bangura company with the total value of 80% of the equity, which obviously resulted from personal links between the company and the bank. The same was the issue of loans granted by Kaupthing to Exista hf company for a total value exceeding $400 million EUR. Einskip company was granted a loan of 1 billion EUR by Landsbanki.

However, before Lehman Brothers collapsed, Europe became the scene of the first signs of the crisis, revealing the lack of liquidity in mutual settlements. Loans granted by Icelandic banks were premature and as a result of the crisis in the USA, European banks were not able to pay them off, also because they had very high interest rates. As a consequence, the Icelandic banks lost their liquidity and the entire banking sector collapsed. The collapse of Lehman Brothers only reinforced the policy, but it also had a significant direct impact on what happened in Iceland in autumn 2008.

In the same month, the government announced that the Central Bank of Iceland would acquire a commercial bank Glitnir. The next piece of news was insolvency of Icelandic banks which meant the total collapse of the financial market. The Icelandic society faced bankruptcy. Almost immediately Icelandic krona depreciated against the euro by 50%, GDP shrank by 3%, unemployment rose from 1 to 9% (Figure 2) and OMX15 Iceland stock index saw an unprecedented decline of 90%. The public debt-to-GDP ratio was 115%. Over 65% of Icelandic companies became insolvent.

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12 The official announcement of the government said that the acquisition of the bank by the State was to be short-term, in order to improve bank’s assets and its liabilities, then it would be transferred back to private hands, but it was not mentioned that the bank debt was 750 million USD, which in fact meant bankruptcy: Iceland nationalises Glitnir bank. BBC News. 29 September 2008.
3. Direct personal consequences

The collapse affected mainly the Independence Party, ruling continuously since 1946, which was in coalition government either with the Social Democratic Alliance or the Progressive Party. The dismissal of Prime Minister, G. Haardee in January 2009 led to early elections and a new government of Prime Minister Johanna Sigurdardottir was appointed. At the same time it was the announcement that not only appropriate measures would be taken against the rulers but also that far-reaching reforms aimed to stabilize the country’s economy would be undertaken.
It was the first time the Prime Minister of Iceland had been threatened with the State Tribunal. On the one hand, Geir Haarde admitted that the Party of Independence had accepted “controversial donation” in the amount of 8 million from the FL Group investment group USD and a slightly smaller amount from Landsbanki\(^\text{13}\). But the most important thing was the Prime Minister’s personal responsibility for the policy of the banking sector privatization and for the lack of proper supervision of the sector, which led to charges of “negligence”. It was an unprecedented trial on a world scale. Although acquitted, the Prime Minister G. Haarde is a classic example of personal responsibility for the decisions taken, which certainly is an example for the future. G. Haarde himself admitted that the privatization process beyond the control of any state factors had turned out to be a fiasco\(^\text{14}\). In addition to the Prime Minister, people who were in the dock and were sentenced to several years of prison included former CEOs of BYR and CEO commercial banks. They were classic examples of relations between the bank, company and bank shareholders, which involved granting loans.

The Financial Supervision Authority (FSA) in Iceland was criticised as well and was accused of incompetence. Being under pressure, FSA board resigned (which did not happen in the USA). The re-nationalization of the Kaupthing and Islandsbanki banks was a clear signal of departing from the policy of liberalization beyond the state control. Landsbanki was placed under supervision of the Icelandic FSA. In contrast to the Irish or Greek variant, the Icelandic government decided not to fund the bank deficit with taxpayer money, which in the longer term seems to be a reasonable step in the Icelandic economic reality.

4. The International Monetary Fund and the European Union – programmes of support and accession to the EU

Negotiations with the International Monetary Fund (IMF) started on 24 October 2008, when a preliminary agreement was concluded to give Iceland a loan of 2 billion USD payable in several tranches\(^\text{15}\). The first one available in October amounted to 827 million USD, then a further seven tranches were


\(^{14}\) http://finanse.wnp.pl/b-premier-islandii-privyrzacja-bankow-byla-powaznym-bledem,76767_1_0_0.html.

to be paid (Andersen 2008). What motivated the IMF offering assistance to Iceland? Firstly, the goal was to stop the depreciation of the Icelandic krona, but as previously mentioned, its devaluation stimulated the export policy. Secondly, the focus was on the need to restructure the Icelandic banking sector, which required direct capital injection. Thirdly, the goal was to ensure the medium time range financial sustainability. Other institutions that supported the bankrupt Icelandic economy were the Scandinavian countries, the European Central Bank and the U.S. Federal Reserve – a total of 4 billion USD.

The crisis put the issue of the accession of Iceland to the European Union on the agenda – then treated on the island as a possible remedy for the bankruptcy of the state. As for the EU, it was the initiative of the President of the European Commission Jose Manuel Barroso. Iceland applied to join the European Union formally on 16 July 2009, and negotiations began a year later. However, despite many economic links with the European market, membership of Iceland in the EU aroused much controversy, related for example to the fishing policy, making their own fisheries available for the EU countries and complying with the EU restrictions in this matter.

European exports to Iceland in 2009 (the year the negotiations started) was 1.34 billion EUR, while imports stood at 2.7 billion EUR.

The problem of accession to the European Union has, in fact, a political dimension rather than economic one. Traditionally, the Independence Party (a conservative one) and the Progressive Party (a more liberal one) did not hide their skepticism about the alternative. But the Social Democrats were a staunch advocate of negotiations on this issue. In 2006, the year 2015 was presented as the time when accession negotiations have been finalized. They were just announcements as the new coalition government with the participation of the Social Democrats was by no means eager to start accession negotiations. The problem of accession appeared again when the financial crisis hit. At that time, the Party of Independence of Prime Minister Haardee began to present the concept of starting negotiations with the European Union, seeing it as a remedy for the financial crisis and when parliamentary elections were approaching in April 2009, the Party called for development of the agenda for negotiations. It became one of the items in the election manifesto.

IMF Executive Board approves US$2.1 billion stand-by arrangement for Iceland.
18 Timeline of events – Iceland’s application for membership of the EU, Icelandic Ministry for Foreign Affairs.
19 http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/iceland/.
for the Social Democratic Alliance. The issue of accession to the European Union was seen in terms of the election manifesto as the element ensuring the stabilization of the internal market and most of all state finances. What is more important – a few days after the election victory, the Prime Minister Johanna Sigurdardottir announced the immediate start of negotiations with the EU and a programme of adopting euro within the next four years (i.e. until 2013). On July 16, 2009, Iceland officially started negotiations on accession to the EU, but as a result of the Icelandic economic reform processes, initiated in 2010 and the implementation of the repair process of finance and national economy, most Icelandic society in 2012 were skeptical about the demands of the Social Democrats. This was due to several reasons:

1. Starting the economic and financial reforms;
2. Problems that the European Union faced, no longer seen in terms of a remedy for the Icelandic crisis;
3. Taking the citizens’ initiative that provides new democratic foundations of society with high level of political awareness, capable of putting forward the initiative to change the constitution of the state.

5. Reforms undertaken by the government of the Prime Minister J. Sigurdardottir

The reform package presented by the new government of Iceland included a number of key issues that needed immediate intervention of the state. The first of them was the consolidation of public spending. This was associated with the stabilization of the labour market (stopping rapidly rising unemployment), stimulation of the investment policy especially towards foreign capital and restrictions on the transfer of capital and the restructuring of the banking sector, a reform of the tax system, not to mention both natural and model activities like cuts in the area of the social policy, including health care and education.

As far as the labour market is concerned, concluding collective wage agreements to secure the lowest income groups became a paramount issue. The investment policy is seen as quite ambiguous due to capital transfer restrictions until 2015, which as a result kept over 6 billion EUR in Iceland, which foreign businessmen invested in real estate, leading to an increase in


\(^{24}\) Confederation of Iceland employers, reforms providing foundations for Iceland’s economic recovery, August 2009.
their value\textsuperscript{25}. The situation in the real estate market was so worrying that since 2000 property value had increased by 240\%, which could lead to a new price “bubble” in the sector\textsuperscript{26}.

As for restructuring the banking sector, participation of the IMF providing financial support to Iceland turned out to be necessary, and the institutions had to be subjected to the FSA supervision and then obligations were to be taken over by the state. This policy consisted of replacing the old banking institutions with new ones taking over their assets and also of selling foreign bank branches and covering (at least in part) the obligations arising from Icesave. Moreover, one of the most important political solutions was to establish the special banking supervision with increased administrative powers as regards to the banking sector\textsuperscript{27}.

A tax reform primarily consisted of the idea of increasing tax rates without adversely affecting the planned sustainable growth. Personal income tax rates (PIT) were lowered by 1.2\% while local government rates increased from 13.12\% in 2010 to 14.41\% in 2011\textsuperscript{28}. Moreover, the following taxes were raised: corporate income tax (CIT), from 18 to 20\%, which resulted in budget revenue increase by 0.03\% of GDP, inheritance tax from 5 to 10\% and VAT from 24.5 to 25.5\%\textsuperscript{29}.

6. The Icesave issue as a test of a citizens’ initiative – the foundations of new participatory democracy

The case of debt of Icesave online bank (Landsbanki branch) had significant political consequences, at the same time stimulating the Icelandic society. Icesave bankruptcy could mean that the high-interest deposits mainly of customers in the UK and the Netherlands were lost, the consequence of which was a dispute between three countries. Initially, the government in Rejkjavik said that bankruptcy of a banking institution was a natural phenomenon, and it involved risk of depositors. The response from London was unequivocal – it threatened to apply anti-terrorism legislation to Iceland,

\textsuperscript{25} Only in 2011 r. their value increased by 10\% compared to the previous year, cf. Kamil Pruchnik, p. 18.
\textsuperscript{26} The assessment of the situation in the Icelandic market in 2009 – the International Monetary Fund, Survey Magazine Interview, Iceland quiet progress on key reforms, Washington D.C. October 21, 2009.
\textsuperscript{27} Ministry of Foreign Affairs of Iceland, Reforms in the Iceland financial sector, Rejkjavik, April 2010, p. 1.
\textsuperscript{29} Ibidem.
which in fact meant that the Icelandic state had committed one of the most serious crimes. Eventually, British and Dutch governments agreed to cover the Icesave debt to their own citizens, demanding that the Icelandic government takes action to pay off the debt.

Assumption of liabilities by the Icelandic government forced the authorities to hold the national referendum on the issue, in other words, the question was whether the Icelandic taxpayers should pay out of their own pockets for activities of a commercial bank. Therefore, the issue of a national referendum on the matter was put on the agenda. This form of direct democracy had not been used in Iceland since its independence in 1944. The precedent began to pave the way for a citizens’ initiative and an increased degree of direct democracy. The first referendum was held on 6 March 2010. Definite rejection of the government proposal of guarantees for private British and Dutch deposits meant that the opinion of citizens had to be respected. The President of the Republic of Iceland Olaffur Grimmson was a kind of inspiration for the civil protest, as he had not enacted the law passed by the parliament in January 2010, aimed to impose liabilities of a commercial bank on the public. Rejection of the proposal to repay liabilities under the agreement with the government in 2010 led again to discussing the issue of British and Dutch deposits in the parliament.

This time an agreement was concluded, under which Iceland would repay debt to the British and Dutch governments within 30 years starting from 2016, accepting the debt interest rate at 3.3% for the UK and 3% for the Netherlands. President Grimmson again refused to countersign the agreement, leading to another referendum on the issue, which rejected the proposal in April 2011. This in turn led to a sharp response of the British government, especially the Treasury Minister Danny Allexandra, promising to bring the case before the International Court of EFTA (European Free Trade Agreement). As it was expected in both countries, this solution would definitely put the issue of Iceland’s accession to the European Union on the agenda. However, as a result of improved economic condition of the country in 2012, it seems to be unimportant in the light of the growing skepticism about this issue. Nevertheless, this can affect the international position of Iceland as a trading partner, not only in the European market. Eventually,

30 http://wiadomosci.gazeta.pl/wiadomosci/1,114873,7435528,Islandia_W_referendum_zdecyduja_czy_oddac_pozyczzone.html.
32 Declaration by the President of Iceland, http://english.forseti.is/media/PDF/10_01_05_declaration_w_sign.pdf
the case was before the EFTA court, which declared the Icelandic government responsible for repaying the debt to the British and Dutch authorities, which covered the Icesave liabilities in 2009, which in fact means accepting the claims made by London and Hague\(^3\). The response of authorities in Reykjavik was negative. This meant that the Icelandic authorities did not want to cover the liabilities of the Icelandic commercial banks. Although the problem has a political dimension, it should be noted that the citizens’ initiative proved to be stronger than the parliamentary laws and supported by presidential veto, it made the institution of referendum credible, at the same time showing the political force of politically aware citizens.

7. The referendum on the constitution – the second citizens’ initiative

The financial crisis stimulated the citizens of Iceland, who appealed to the institution of referendum. After the results of the referendum on the Icesave case, humiliating the Icelandic authorities, the referendum on constitution was held. Political maturity of the Icelandic society, which in 2003-2007 was inspired by the fantasies of getting rich on credit, manifested in inferring conclusions from the painful lessons of the artificial prosperity period and in the need to introduce new political mechanisms. It inevitably led to a constitutional initiative, because the majority of people recognized the political changes as a necessary factor in the process of economic reforms. In a way it confirms the primacy of political decisions over economic ones. In addition, it is a testimony to a grassroots initiative aimed to shape the system of increased control over state institutions and economy. A goal is to prevent the repetition of mistakes resulting from the activity of the Prime Minister Haarde and the FSA, who virtually left banking institutions, demanding to cover their liabilities at the expense of citizens, beyond control.

235 thousand Icelanders entitled to vote were expected on 21 October 2012 to express their opinion on changes in the supreme law of state proposed by the 25-member Constitutional Council. The questions to the public were about:

1. Changes in the Constitutional Act;
2. Nationalization of natural resources;
3. Establishment of a national church;
4. A possibility to elect to parliament people not belonging to any political party;

\(^3\) http://www.icenews.is/index.php/2011/06/10/esa-iceland-is-responsible-for-icesave-refund/.
5. Equality of votes cast in different parts of the country;
6. Determining the statutory number of persons entitled to call a referendum\textsuperscript{35}.

Despite its non-binding nature, the referendum revealed that the society was determined to change the system of democracy for more direct democracy. The item of the statutory number of people required to hold a referendum should be of particular importance, which means that in the future this institution will be even more important than so far. The referendum results should not be surprising – 80\% of Icelanders were in favour of proposals for amendments, which implies that it was necessary to take into account the vote of the overwhelming majority in the state political reforms\textsuperscript{36}.

Support for the reform of the state results from a need for preventing previous practices, from awareness that the natural resources of the country should be supervised, which has long-term consequences as well as from the gradual recovery from the crisis, which result from the rationalized government policy.

8. The effects of economic reforms and skepticism about accession to the European Union

The reform programme announced by the Prime Minister J. Sigurardottir created the foundations for a controlled activity of the banking sector. First of all, the government pursues a policy of gradually separating the investment activity from that of depositing, which is supported by a growing number of Icelandic parliament members. They demand the introduction of an American-like Glass-Steagall Act of 1933 legislating such a diversification\textsuperscript{37}. In October 2012, investment activity of the Icelandic banks stood at 5\%, which represents a decrease of 28\% compared with the period 2005-2008 (Turliński 2012). The reforms of the banking sector shrank bank assets nearly 5 times, which had a stabilizing impact on state finances and on overall economy. The strict discipline of keeping the exchange rate determined by the IMF led significantly to stabilizing the exchange rate, restructuring the financial system and to improving public finances.

Current economic growth stands at 5.6\%\textsuperscript{38}. In contrast to many European countries in crisis, Icelandic GDP is 2.6\% (Baj, Maciejewicz 2013).

\textsuperscript{35} http://www.kosning.is/thjodaratkvaedagreidslur2012/english/.
\textsuperscript{37} www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html.
\textsuperscript{38} http://www.phrasebase.com/countries/iceland/.
good condition of the Icelandic financial market is also reflected in a higher position on the lists of credit rating agencies, among others Fitch, according to which Iceland moved to the investment category from the speculative one. The unemployment rate stands at 4.9%, which is high, given the fact that it is a small economy, but compared with the peak of the crisis, it was brought down by almost 50% (Figure 4).

Figure 4. Fluctuations in the unemployment rate in Iceland in 2011-2012.

However, one of the most serious phenomena is unemployment among Icelandic youth. Over 16.4% of young Icelanders are out of work, for whom emigration to the European Union countries of one of the solutions (Jónsson 2010). The collapse of the Icelandic financial market resulted in a number of pathological phenomena, previously unknown on the island, among others domestic violence and increased alcohol consumption. It is extremely dangerous in such a small market. On the other hand, political awareness has proved to be an inspiring example for many European societies, where governments are struggling in different ways with the effects of the crisis. It is also important that the accession to the European Union no longer wins so many supporters like in 2008. The view that their own particular benefits will be lost for the Union is increasingly dominating.

9. Summary

Is Iceland a model of solving the economic problems in the modern world? Although the Icelandic crisis in 2008 resulted from classic activ-

39  http://wolnemedia.net/gospodarka/islandia-ma-lepsze-notowania/.
Iceland – political implications of the financial crisis of 2008...

ities of the banking sector, based on low-cost loans, the lack of financial supervision and a wrong investment policy abroad, Iceland turned out to be a country that is trying to solve its own problems positively by itself. In contrast to many cases of crisis ranging from the USA to Greece, the Icelandic authorities, having found themselves under exceptional social pressure, were forced to take unprecedented steps. Bringing the former Prime Minister G. Haardee to the State Tribunal, although he was not convicted, showed determination in personalizing responsibility for decisions taken. G. Haardee himself had to publicly admit government mistakes in the banking sector. Arresting some of the presidents of commercial banks and sentencing them for irresponsible activity in the financial market convinced the public that the country was able to take appropriate measures against people representing the sector, called “too big to fail” in the USA. In other words, a small Icelandic market did not enable activities that took place in the U.S. economy.

But the activities in the political sphere are most important – grassroots social demands stimulating the government reforms. Allowing commercial banks to go bankrupt was an unprecedented move. While European countries and the USA decided to save the banking sector using the taxpayer money, Iceland yielded to public pressure and did not allow an Icelandic taxpayer to bear the consequences of wrong decisions taken by commercial bank presidents. A diplomatic conflict between Reykjavik, London and The Hague triggered by deposits of the bankrupt Icesave would in fact be resolved due to the decision of the Icelandic parliament, ready to fulfill the demands of the British and Dutch governments. Backed by the President’s decision, the society imposed a definite veto, which forced the Icelandic government to renegotiate the agreement, to hold a referendum twice and finally to be taken to court by the United Kingdom and the Netherlands. This phenomenon led to a process of developing direct democracy, which resulted not so much in changing the constitution top-down by a special constitutional committee as in appealing to the public, who decided about the shape of constitutional reforms in a referendum. The referendum is an institution that has existed in the Icelandic political system since 1944 but it had never been applied before 2009, which was due to the development conditions for the society since independence.

One key question remains, namely about the nature of the privatization reforms. Many researchers blame the privatization process itself as the reason for the collapse of 2008, while the economic stagnation of the late 1980 and the early 1990s was ignored. Privatization in the 1990s proved to have positive effects; it was an incredible economic boom caused by uncontrolled privatization of banks and virtually leaving their activities beyond control
of the government that led to the crisis. Not differing from the crisis model of 2008, Iceland however, is a perfect example of the particular method of fighting with crisis effects, of determination of the government to implement reforms. The effectiveness of support from the IMF depended on consistency in implementing the reforms, from 2009 onwards. However, the social problems that arose, for example unemployment, especially among the younger generation, or an increase in real estate prices show the scale of the problem in such a small market. Therefore, it seems reasonable that the positive results achieved today by the Icelandic economy are due to the specific nature of the society, the political and economic system, for which the excess is extremely dangerous. As it turns out, citizens’ initiative is feasible only with a high degree of political awareness in society, functioning in a small country.

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IMPACT OF THE CRISIS IN THE EURO ZONE ON THE BUSINESS CYCLE IN POLAND FROM A MACROECONOMIC POINT OF VIEW

Adam Lipowski, Prof.
Econ@supermedia.pl
Polish Academy of Sciences, Institute of Economics

Abstract

The paper is devoted to:

– the state of a business cycle in the last five years;
– the picture of the Polish economy as a “green isle”.

Both of these points will be analyzed from a point of view:

– economy as a whole, which Gross Domestic Product (GDP) is a measure of production;
– economic sectors – material production/service sector (MPS) and non material service sector (NMPS) – which gross value – added is a measure of production.

The aim of the is paper is to prove that the crisis in the euro zone had a different impact on the business cycle in the sectors MPS and NMPS. A macroeconomic analysis of the business cycle may by a source of the false diagnostic and the wrong political decisions. When in an economy a sector business cycle asymmetry takes place, a macroeconomic analysis cannot reveal this phenomenon. In the consequence, the specific sector factors of the business cycle are not observed.

The purpose of the publication is to determine whether, in the Polish economy in 2008-2012 there was an asymmetry or not. It is assumed that the sector business cycle asymmetry (in the following quarters of the year) occurs if:
a) the gross value added of a sector shows a positive growth rate (more than 1%), while the second sector – negative rate (more than 1%),
b) the gross value added of a sector shows a positive growth rate, while the second sector – the rate of zero (to within ±1%).,
c) the gross value added of a sector has a zero growth rate, while the second sector – a rate of zero;
d) gross value added has a positive/negative growth rate higher/lower by at least 3 percentage points from that for the second sector.

A Sector business cycle asymmetry may have a dual nature. In point a), b) and c) it relates to the directional differences in terms of trade (zero versus positive versus negative) growth of particular sectors (directional asymmetry), and in point d) – the difference in terms of positive/negative growth (dynamic asymmetry). The study takes a rare situation under consideration in the analysis of the issue of asymmetry cyclical sector, based on a new methodology which assumes the division of the economy into sectors NMPS MPS.

Key words: crisis, Gross Domestic Product, material production/service sector, nonmaterial service sector, sector business cycle asymmetry.

1. Macroeconomics of Polish business cycles in 2008-2012 (annual data)

In today’s globalized world cyclical impulses reach the national economy through three channels:

a) export-import channel;
b) channel financial and capital;
c) channel banking and credit.

During the boom in the world economy to an open economy there flow positive impulses which are bringing beneficial effect on the dynamics of its growth conditions. So it must have been the case in the Polish economy in the years before the global crisis, when the growing demand in the European Union (especially Germany) for Polish goods and the foreign investors’ demand for shares of economic operators and The National Treasury bonds were growing in terms of the expanding credit action of foreign banking groups.

However, the high economic situation in Poland in years 2006 and 2007 manifested by dynamic growth in the volume of GDP by 6.2% and 6.8%¹, only to a certain extent, resulted of these positive in-

¹ Presenting the figures for the Polish economy based on the latest statistics by the Depart-
ternational impulses because domestic demand played the leading role. This is typical in circumstances where there is relatively low share of foreign trade in GDP and small businesses dependent on the loan. As for the year 2008, it was high boom (mainly in the first three quarters), resulted in an increase in GDP of 5.1% which was also primarily due to strong growth in domestic demand (by 5.8%), including consumption (by 6.1%). The attention catching was also an increase in investment demand (by 9.6%). However, foreign demand to GDP growth had a negative impact, because net exports was negative (imports increased by 8.5% and exports by 6.8%). It is very interesting that zloty has depreciated against the euro (over 15%) and the dollar (about 21%). This suggests that the effect of the depreciation personalized by stronger reduction of growth in imports than exports will occur in 2009. And when the global economic situation worsens, as it happened following the collapse of the subprime mortgage market in the U.S. between 2007 and 2008 and the bankruptcy of Lehman Brothers (15 September 2008), the economy began to reach negative impulses (Arestis 2011: 40 et seq). These impulses made themselves felt in 2009 as among other factors – recession in the euro zone 4.4%, Germany – 5.1%, resulting in these countries in the falling demand for Polish export goods. This was accompanied by a tendency to undersell Polish assets by foreign investors as a result of rising risk aversion in global financial markets and the reduction in credit action by international banks. In 2009, there was a downturn in Poland, revealing a decrease in GDP growth to 1.6%. However, this was due to an absolute decline in domestic demand (by 1.1%). Due to decrease in the gross capital formation (a decrease of 11.5%) mainly due to a strong reduction of inventories, and a decrease in gross fixed capital formation (1.2%). However, the growth rate showed consumption (private and public), which increased by 2%. This rate, however, was lower than in 2006-2008 (5.2%, 4.6%, and 6.1%). In the same year there was also observed a prominent decrease in exports (about 8%), although there was an even bigger drop in imports (by 14.3%). With a decrease in the growth rate of GDP was milder respectively, as net exports increased (by 5.2%), which contribution to GDP growth was 2.9 percentage points. This export was the main factor in GDP growth that year. It should be noted that the above dynamics of foreign trade has had a mixed impact of exchange rate (euro and dollar) on one hand a strong depreciation of the zloty against both currencies in the second half of 2008 (3.2 cents/euro in the first half of 2008 and 4.0 in end of 2008), caused by the aforementioned increase in risk aversion of foreign
investors, could activate and inhibit export growth in imports in 2009, on the other hand – its appreciation in 2009 (4,14 zł at the end of the year to 4.9 zł in the second half of February) could cause an opposite tendency, if we abstract from the effect of the delay. However, taking into account the effect – export-import contracts are typically specified in advance – it can be assumed that the advantage of a given dynamics of foreign trade in 2009 has had a greater impact on strong depreciation of the zloty in the second half of 2008, rather than its appreciation in 2009.

Between 2010 and 2011, the economic situation improved, but it did not reach the level of the years 2006 to 2007, as GDP grew by 3.9%, respectively and 4.5%. The improvement of economic situation has had a positive impact of domestic demand growth (4.6% respectively, and 3.6%) and accumulation (9.3%, and 11.2%). When it comes to investments, in 2010, they had a negative impact on GDP growth (down 0.4%). Discrepancy between increased accumulation and investment decline is explained by the rebuilding of inventories, whose contribution to GDP growth was 1.9 percentage points. However, in 2011, the investments recorded a high growth (8.5%). It should be noted that in 2011, consumption growth slowed to 1.6%, including public consumption which recorded an absolute decline (by 1.7%). As for the foreign demand in 2010, while exports recorded a strong increase (by 12.1%), imports showed a higher growth rate (by 13.9%). Thus, the contribution of net exports to GDP growth in 2010 was negative. Conversely, it was in 2011, when exports grew more slowly than in 2010 (for a 7.7%), but faster than imports (5.5%). As a result, net exports had a positive impact on the GDP growth.

It should be added that in 2010 the exchange rate of the zloty against the euro and the dollar was relatively stable, and therefore the exchange rate factor had a neutral impact on foreign trade. However, in 2011, when the euro zone crisis deepened, zloty began to depreciate gradually (a total of about 10% to euro and dollar).

However, in 2012, the situation deteriorated again as the GDP growth slowed to 1.9%. This was due to the inhibition of the domestic demand growth (down 0.2%), including consumption (an increase of 0.6%) and recourse in the accumulation of (a decrease of 3.3%), mainly caused by a decrease of inventory balance by 30.8%, as investment fell by 0.8%.

When it comes to international trade, it is indeed due to the recession in the euro area which decreased export growth rate to 2.8%, while imports recorded an absolute decline of 1.8%. Thus, an increase in net exports, which means that foreign demand was a factor in the GDP growth.
2. The situation in Poland in the sectors of MPS and NMPS in 2008-2012 (quarterly data)

The MPS sector includes the following sections: four sections of the industry (B, C, D, E), construction (F), trade and repair of motor vehicles (G) and transport and storage (H). Sections B, C, D, E² and F belong to the sphere of material production in the strict sense, and sections G and H – to the realm of the so-called material services, logistics related to these five sections. Therefore, both sections included in the sector MPS (in the broad sense). The NMPS sector includes other services sections: accommodation and catering (I), information and communication (J), financial and insurance (K), real estate services (L), professional, scientific, technical (M), administer and support service activities (N) and sections O, P, Q, Z, S, T³.

So defined MPS sector produced in Poland, in the period under consideration, around 50% of GDP, while sector NMPS – about 35% of GDP⁴. Based on GUS data on quarterly growth rates in the volume of gross value added of individual sections (or groups) in 2008-2012, there were calculated quarterly volume indices of gross value added sectors of the MPS and NMPS⁵. Then, for a comparative analysis these indicators were compared with analogous indicators of GDP (Table 1).

Table 1. Volume growth in gross value added sectors MPS and NMPS by quarters in 2008-2012. Corresponding period of previous year = 100, constant prices of the previous year.

<table>
<thead>
<tr>
<th>Years</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>quarter</td>
<td>I</td>
<td>II</td>
<td>III</td>
<td>IV</td>
<td>I</td>
</tr>
<tr>
<td>PKB</td>
<td>106.2</td>
<td>106.1</td>
<td>105.2</td>
<td>103.2</td>
<td>100.4</td>
</tr>
<tr>
<td>MPS</td>
<td>108.3</td>
<td>104.7</td>
<td>104.1</td>
<td>104.4</td>
<td>105.1</td>
</tr>
<tr>
<td>NMPS</td>
<td>103.2</td>
<td>104.7</td>
<td>106.5</td>
<td>107.6</td>
<td>107.2</td>
</tr>
</tbody>
</table>

Source: Own calculations based on data from the Central Statistical Office of National Accounts GUS (April 2013).

² That means mining and quarrying (B), manufacturing (C), the production and supply of electricity, gas, steam and hot water and air climate (D), water supply, sewerage, waste management and remediation activities (E).
³ That means public administration and defense (A), education (P), health care and social assistance (Q), cultural activities and entertainment and recreation (R), other services (S), households (T).
⁴ The difference between GDP and the sum of gross value added and NMPS MPS results from the omission of section A (Agriculture, forestry, hunting and fishing), due to the strong influence it non-economic factors (weather) and net taxes and subsidies.
⁵ Presenting figures on a quarterly basis for the production of gross added value in current prices by section are based on the latest statistics by the Department of National Accounts GUS.
This comparison results in an interesting insights into the sector changes in business conditions during this period. Talking about the changes in economic conditions, we mean the levels in the coming quarters and the trend of changes in these quarters.

Analyzing the economic level measured by GDP between I quarter of 2008 and IV quarter of 2012 we can distinguish four periods:

1. I. 2008 – III. 2008: high boom;
2. IV. 2008 – III. 2009: boom moderate (IV), stagnation (I) and a Low (II and III);

It the light of sector growth rates in can easily be observed that in the previous four periods of economic conditions at the macro level there are the result of:

During period I: in the MPS situation very high in the first half of the year and moderate in the third quarter, and in the NMPS: moderate economic situation in the first half of the year and high in the third quarter.

During period II: in the MPS situation very low in the fourth quarter and the second quarter, the stagnation in the first quarter and moderate in the third quarter, and in the NMPS: situation very high in the fourth quarter and very low in the first quarter, turning into stagnation in the second quarter and a recession in the third quarter.

It should be noted that the stagnation or very bad situation in the first half of 2009 in the MPS resulted in Sections B, C, D, E, which occurred in the recession period (a decrease of 3% in the first quarter and 2.9% in the second quarter), which was caused by manufacturing sector (down 2.5% in the first quarter and stagnation in the second quarter) and transport (down by 6.1%, and 3.4%). It is worth mentioning that in the construction industry then there was a very high boom (an increase of 11.6%, and 10.2%). However, the recession in the NMPS in the third quarter contributed to section financial and insurance activities, the decline was almost 40%.

During period IV: in the MPS situation in the second quarter low and stagnant in the third and fourth quarter and in the NMPS: temperate situation in the second and fourth quarter, and low in the third quarter.

These observations are of particular importance in the asymmetric cyclical sector, especially in times of the crisis in the European Union. At that time, the GDP growth is the result of either multidirection in terms of character growth in gross value added sectors highlighted, and these sections (points a, b, c), or large differences in the growth rates of these values (point d).

It appears, therefore, posed in the introduction question: whether the phenomenon of cyclical sector asymmetries between sectors and NMPS MPS occurred in the Polish economy in the time period? The data in Table 1 indicates that this phenomenon occurred in relation to the directional asymmetry (b) and asymmetric dynamics (d). Asymmetries a and b, when the positive growth rate of the MPS sector accompanied by the zero or negative growth NMPS, happened many times: in the second half of 2009, in the first half of 2010 and in the second half 2012. It implies that in terms of the calendar, including both of these asymmetries they were observed for 18 months. Throughout the whole year without interruption, these asymmetries occurred in the third quarter of 2009 – the second quarter of 2010. The asymmetry d, when the MPS sector growth was significantly higher than that NMPS, starred in I, II and IV in 2008, and in IV, 2010 and the I quarter of 2012. The inverse proportion between the dynamics of these two sectors were in the IV, 2008. On the basis of the above we can observe that the asymmetry d took place mainly in 2008 (three quarters).

In these cases the statistical, not economic nature of macro-measurement of GDP is clearly observed. The statistics substance is revealed only in terms of sector disaggregated approach. In addition, treatment of GDP as a unified and autonomous sector in economic analysis can be a source of statistic illusion; acceleration/deceleration of GDP or it automatically applies to all areas of the economy, or only material production, especially industrial, which is evident by its very nature, as opposed to invisible services assets.

Let us now turn to the second aspect of the analysis of the situation, i.e. the tendency of its fluctuations in the examined quarters. Here we assume that the observations are subjects to change during the growth rates of more than 1 percentage point6.

Observing these trends, the level of GDP can be easily distinguished in five periods:

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6 Growth rates in the range of 0 and 1 is considered to be negligible, as are within the limits of statistical error.
2. III. 2008 – I. 2009 – Slow
3. II. 2009 – IV. 2010 – Acceleration
5. I. 2012 – IV. 2012 – The slowdown

Similar to the general picture of economic trends can be observed in the case of the MPS:
2. III. 2008 – I. 2009 – Slow
3. II. 2009 – II. 2010 – Acceleration
4. III. – IV. 2010 – No trend
6. II. 2012 – IV. 2012 – The slowdown

However, in the case of the distribution of fluctuations NMPS is as follows:
1. 2008 II – IV. 2008 – Acceleration
2. I. 2009 – III. 2009 – Slow
3. 2010 – II. 2011 – Acceleration
5. II. 2012 – IV. 2012 – No trend

On the bases of the above we observe that in this sector the acceleration took place first, and then it slowed down, while in the opposite MPS: the slowing down occurred before the acceleration. Later the NMPS sector recorded the acceleration and the deceleration, while the MPS sector, about the same time, was experiencing the stability. The latter slowdown in 2012 was accompanied by a lack of trend in the NMPS.

The hypothesis that emerges from this observation is as follows: during the crisis phenomena, the fluctuations affected MPS, it can not be observed in the case of the NMPS, which seems to be ruled by its own laws. As the world financial crisis unfolded (2008), the sector recorded the acceleration. This explains also the non-traditional way, why the Polish economy was relatively immune to the global crisis. Simply, about 35% of GDP is not affected by the phenomenon of exchange, or foreign demand (GUS external trade statistics covers only material products).

3. Poland as a “green island”

In 2009 in Poland, the first slowdown in the GDP growth occurred. The analysis of this case will be an exemplification of the existing methodological findings. The idea is that the attention of the observers was focused on the fact, boasted by the Polish Government, that the Polish economy – the
only one in the EU in 2009, had a positive growth in GDP (OECD 2012: Economic Survey of Poland”, March). The standard, meaning the macro-economic explanation of this fact is based on the Keynesian model of the economy (Grace 2010).

Let us recall, first, that in that year, GDP increased by 1.6%. In the analysis of determinants of a demand, however, it is the face value of the GDP which plays the key role, which grew by 5.4% then. And this growth of GDP in this model is the basis for a quantitative analysis of decomposition of the major components of a final demand. The result of this decomposition was the assumption that the nominal GDP growth occurred due to the multiplier increase in a foreign demand (by 5.7 percentage points) and the public sector (by 4.1 percentage points). However, private investment demand reduction (by 4.3 percentage points) by multiplication contributed to reducing the scale of the GDP growth (OECD 2012: Economic Survey of Poland”, March).

Without going into far more detail in the assessment of the methodological assumptions of this decomposition, we must bring to reality the analytical basis: the total volume growth in GDP of 1.6% by an increase in gross value was added by sector MPS 2.4% (including four industrial section of 1.2%, while in the manufacturing industry by 3.7%) and the absolute decline in the value NMPS sector (1.2%). So here we deal with the economic situation asymmetry “a”. It thus appears that not all of the Polish economy was the “green island”, but the material production sector, with the processing industry on top. However, the NMPS sector shared the fate of many of the economies of the EU, in which there was a recession. This was the result, the slowdown in the sector in the first – third quarters as the recession in the third and fourth quarters.

In such a state of affairs the conclusion comes that this decomposition of the nominal GDP made in the scale of the economy as a whole is a purely a statistical procedure (otherwise sophisticated accounting), a devoid of economic substance. The content of this decomposition can take different shapes when carried out separately for the MPS industry, including the processing industry and NMPS. So it was about disaggregating the decomposition of the nominal gross value added generated in the MPS/manufacturing (an increase of respectively up 10.2% and 9.0%) and in the NMPS (an increase of only 3.0%), according to the separate components demand for the production of these sectors.

It is, however, controversial, if in the case of the NMPS decomposition it would be an adequate basis for Keynesian theory of the effective demand. This problem is not developed, it is left open. In any case, there is no doubt that this theory is applicable in the MPS, due to two of its fundamental principles and main categories of demand that operate.
These assumptions are:
1. under-utilization of production factors;
2. no difficulty in balancing the trade (OECD 2012: Economic Survey of Poland, March).

The assumptions above are fully adequate to the nature of the MPS industry for which there is the opportunity to correct the econometric estimation of potential output and the foreign trade statistics includes the production of the material. As for the main categories of demand to this theory, it is about:
1. multiplier investment demand, including wrestling (multiplier);
2. multiplier demand of the state (fiscal multiplier);

There is no need to justify closer that from the point of view of the sector categories, in its quantitative meaning, on the basis of standard statistical data, they are material. Thus, they are relevant to the MPS industry, especially for the production of a processing industry. The nature of this production is particularly suitable for Keynesian concept of the multiplier mechanism (investment, foreign trade and fiscal). However, it is questionable, as already mentioned, whether this concept is compatible with the specific NMPS sector.

If this reasoning is correct, it calls for the conclusion that the analysis of the sources of “green islands” should not be made on the level of GDP, but the MPS/processing industry sector. For that we use the volume and value growth rates of value added of the sector/section.

4. Summary

A sector analysis presented in this paper demonstrated that the meter of the GDP manufacturing – is a non-uniform sector and therefore autonomous, as it is the resulting sum being the gross value added of individual sections. Thus, in case of research of a demand situation, in the case of its sector business asymmetry situations cannot be limited to the aggregated factors at the macro level (domestic demand – consumption, accumulation – foreign demand) of the situation, which usually takes place in a variety of studies, but these studies need to be expanded, taking into account the specific demand factors relevant to the highlighted sectors, and further more to individual sections. So in our case, the attention should be paid by the analysts to the explanation of the reasons of recession in the face of a very low situation in the MPS sector in the first half of 2009 and the recession in the
manufacturing industry in the 2009 and the recession in IV 2009 and stagnation in the first half of 2010 in the NMPS, as surely demand conditions, at the time, were completely different from those in a construction sector.

Thus, only the economic sector research including differential impacts on the crisis in the EU, can be the basis for the formulation of possible applications at economic policy.

Any economic policy should be based on facts of the diagnosis made on the basis of relevant indicators of production. Referring now to the results of our analysis of the sector, we saw in the three cases, the incompatibility with the reality of macro-economic diagnosis. At the level of GDP in the Polish economy in 2008, it slowed down. However, this is a misleading diagnosis, since it is limited to half of the GDP, the MPS industry. In the remaining part of GDP – the NMPS sector – there was a good and growing prosperity.

If now, on the basis of this diagnosis, one will prepare a macroeconomic forecast further slowdown, the result for the purpose of economic policy is clear: to energize a global demand by increasing the budget deficit. But such a solution in the NMPS sector will be at least unnecessary, if not counterproductive. And for the MPS sector calculated from macro theory, the required size of the effective demand increases in a budget expenditure (including estimated level of the fiscal multiplier) is excessive, taking into account the scale of the sector in the GDP.

In 2009, the GDP quarterly indicators showed improvement in the economic situation. But this improvement took place in the MPS, and in the NMPS – deterioration until the recession. The diagnosis and macroeconomic forecast that economic policy should be neutral, and the diagnosis of the sector – need to be an activated NMPS sector. In 2012, the GDP slowed again, but again the sector NMPS broke away from this trend. The application at economic policy – negative and positive – is analogous to that for 2008.

From the statements above, the final conclusion emerges that the asymmetry in terms of sector cyclical economic policy at the macro level is inadequate. The condition of adequacy is the sector breakdown, so that the policy tools are compatible with the specific demand-side factors of production in a particular economic sector. This is particularly important when the external environment (recession in the euro zone) has a varying impact on the situation on a sector basis. But for this, it is necessary to draw up a business cycle forecasts in this system, not only at the macroeconomic level, as it is commonly done. This last statement acquires significance in the light
of the current pessimistic macroeconomic forecasts for the EU and Poland in 2013\(^7\).

References

6. NBP (2013), Raport o inflacji, March.

\(^7\) For example, NBP has recently forecasted that this year the GDP growth in Poland to be further reduced, to 1.3\% (NBP 2013: 72 and 73). On the other hand, according to the European Commission, the GDP growth is projected at 1.1\%. (European Commission 2013:81), while according to the IMF – 1.3\% (IMF 2013:48).
ETHICS IN THE NEW MILLENNIUM.
AN INDIAN VIEWPOINT

Jayashree Sadri, Prof.
jayashree_sadri@yahoo.com.in
JECRC University, Jaipur, India

Abstract

This paper is based on the conviction that the corporate leader in the future will have to be the ethical leader. This argument is divided into four parts. The first defines the subject matter of the paper and deals with issues like values, beliefs and ethics. This part lays down the theoretical underpinning for the ensuing argument. The second takes up the issue of Managerial Styles examining a landmark study, conducted in India, in the process. The underlying assumption is that the answers we get to social issues depend on the questions we ask. The questions we ask depend on the values we have. Moreover, these values give rise to our beliefs and our ethical conduct. Hence, the Managerial Style is a good proxy for Managerial Work Beliefs. The third part deals with the question of the Values of the Chief Executive. The underlying assumption is that in a positivist framework, power flows downward and the tone as well as the tenor of managerial behavior is set by the behavior of the Chief Executive. This becomes all the more important when the organization is forced to thrive on the cutting edge of competition. The fourth part deals with what lies ahead and to that extent posits a considered opinion on the issue of Managerial Work Ethics.

Key words: ethics, management, Managerial Work Beliefs, India.

1. Introduction

This long and rather pedagogical paper is based on two convictions. Firstly, that it is through HR intervention, that organizational change will make the corporate body more effective, more efficient and hence more competitive. Since the positivist nature of organizational change in India demands that it is
implemented from the top downward, it is only logical that we argument with a treatment of leadership as well as of the work ethic. The nature of the change is a movement of top management from the feudal-mercantilist-trader mode into the competitive-innovative-entrepreneurial one. Secondly, this transition will require that the leader bases his actions on trust transparency and teamwork while adding value to the organization as well to all the stakeholders involved in it. This conceptualization of the change processes will be the basis on which the work ethic in the new millennium must develop.

No argument, no matter how profound, is tenable without a theoretical basis, an empirical validation and a cogent structure. Indeed theoretical underpinning and empirical validation are the two pillars on which every scientific inquiry must rest. So important is the former that Aldous Huxley, the famous British essayist once stated *without theory facts shall continue to fall on the plains of human ignorance*. In keeping with the highest traditions of academia, this paper predicates its prognosis on certain theoretical propositions, which have been empirically validated by research. This is necessary especially because every conceivable species of man has had something to say both on the topic of work as well as that on ethics. What he has to say forms the basis of his behavior. Like all social processes when corporate behavior is repeated it becomes a style and is consequently legitimized (Habermas 1976). Managerial Style also fits into a theoretical framework and this needs to be tested out.

Without empirical validation any construct would remain in the realm of hypothesis and cannot form the basis of a theory. This is even so in the case of social science where most theories are empirically validated tendencies rather than watertight principles as in the case of the physical sciences. The mutable nature of reality, with which social science is concerned, dictates this difference (Durkheim 1982).

Hence, this paper begins with laying down the definitional premise and then goes on to examining the argument empirically. This leaves out structure, the third requirement in any argument. The abstract of the paper given at the beginning delineates the structure of the argument briefly and cogently. The ambit of relevance of this argument is global no doubt but examples are limited to India.

2. The theoretical underpinning

Kings and commoners, freemen and slaves, saints and sinners, iconolaters and iconoclasts have all spoken of ethics at some time or the other. More often they took either one of these two positions: (1) My ethics for the rest of you or (2) my subjective perception taken to be the objective social reality.
It would, therefore be in order for us to examine the progression of thought, not necessarily in chronological order but certainly in order of the development of intellect.

As the tradition of social science, let us at the outset define our position unequivocally.

Value is a *thought-based concept* whereas ethics is an *activity-based one*. Whereas values are *intrinsic* to man ethics is the *manifested* behavior. Whereas profit making is a necessary condition of being in business, when profit making becomes the sole aim of business, we find that the transition from the *feudal-mercantile trader* mode to the *innovative-creative-entrepreneurial* mode has not taken place. Ethics is conveniently placed on the back burner and reserved for after dinner speeches. Trumpet tooting and loud boasts at cocktails (probably when the speaker is sufficiently inebriated), are the occasions when ethics is debated. That is indeed sad.

Let it be made abundantly clear that the ethicality of corporate behavior is the primary concern of *Business Ethics*. Management is concerned with the science of decision-making and the art of decision executing. In their daily business life, managers face ethical dilemmas. A dilemma exists when the manager is faced with conflicting or alternative choices of action. Reality is hardly ever clearly perceived in black and white. What exists is a vast gray area with several shades within it. The response of an executive to a managerial dilemma having an ethical connotation becomes the central concern of *Managerial Ethics*.

It is singularly unfortunate that both terms Business Ethics and Managerial Ethics are usually used synonymously. So it is true of the two terms *values* and *ethics*. The academia is guilty of this confusion and even so called experts in ethics have been known to make this error. They have consistently refrained from defining their position, and this paper suspects, nay it alleges, that this is because they are unsure of their own positions.

Those who take the contingency route and refuse to define their position are usually those who feel safe in being the *will o’ the wisp* or continue masking their ignorance in connived abstraction. Schoolteachers who take lessons in moral science are no different. Consequentially the syllabus of the subject is nebulous and without rigor, the student adopts the *chalta hai chalne do* (let it be) attitude. Case studies and projects make for story telling sessions and interesting pass times. Homily is reduced to doing good and being good without bothering to define what being good actually means. Deep study eludes the student unless the teacher and the taught are both involved in the exercise.

The manager on the other hand has his own brand of ethics which he has picked up along the way and which sound conveniently close to what
the manager actually thinks he does. This student enters the real world of business with half-baked ideas of ethics and meets the manager with his half-baked ideas of values. What ensues would make Lewis Carroll’s *mad tea party* look like a very orderly piece of business. This is because like the schoolteacher, the CEO too promotes a culture where *ends* matter and the *means* taking a back seat.

There is, in India, over the last decade and a half, a great deal of talk about ethics in various occupations but seldom do we come across speakers who define *what is ethics*. The basic position adopted in this paper is akin to that taken in numerous co-authored works of Sadri and Jayashree. What this paper attempts is to address the issue of work ethics as we witness the dawn of the new millennium. Literature is replete with examples where scholars have used the word *morality* and *ethics* interchangeably. The lecture theatres are full of academicians who come to speak of ethics from either a moralistic perspective or based on their personal normative beliefs. In addition, most often they disagree on the fundamentals since each of them is ruled by his heart rather than by his mind.

The *soul-based philosopher* relies on a particular scripture or interpretations and variations thereof. The *mind-based philosopher* relies on the logic of choice in the face of a dilemma. The former is normative whereas the latter is positivist in approach. Morality lies within the domain of the former while ethics forms the concern of the latter. The distinction is very fine indeed.

Soul based philosophers will take the cue from the scripture they follow and these differ. Does that mean that they are unclear about their terminology? This author does not think so. The lack of clarity comes only when ethics is replaced by morality and restricted to either good or bad, right and wrong or conformity and non-conformity to some standard of behavior.

At the etymological level morality and ethics *can be* used interchangeably. The word ethics has been derived from the Greek word ethos and the word morality has been derived from the Latin word mores. Both words imply *from a culture*. Hence, it would be quite in order to refer to Ethics as moral philosophy or to refer to Morality as an aspect of ethical philosophy. Moreover, morality is usually all pervasive whereas ethics is person specific, context specific, and culture specific. The third aspect of this author’s position is of relevance in this paper. This is primarily because *work* is a social activity and its form and content is determined by the culture of the environment within which it is performed. Hence, *the general managerial ethic conditions the general work ethic*.

The culture, in turn, has its roots in time and space rather than in ideology alone. Its study is also guided by the rules of sociological method
Ethics in the new millennium

(Giddens 1976). The culture specificity of ethics is not lost on corporate giants who left their inimitable footsteps on the sands of time. Consider the statement of the legendary JRD Tata:

_There is need to rekindle old principles and ethical values which alas, have too often been ignored and neglected during recent years in the belief that quicker profits and greater accumulation of wealth will be the result._

The need to go back to the roots is therefore very important so that in our quest for the illusionary rainbow we do not forget our heritage and loose our cultural _raison d’être_. However, heritage is like a rear view mirror in a car. It tells you what has passed but not what is happening. If you are too busy, looking at the car mirror you will run down a pedestrian! The principle problem with persons speaking of ethics in India is threefold.

(a) Some authors are so seeped in the past that they can only talk about either the Vedanta or the Christian Catechism or the Islamic doctrine or the Zoroastrian antiquity. They seek to draw parallels with the present day practices and are rather rigid in their beliefs leaving no room for dissent. They sermonize on the basis of historical constructs of a bygone culture. Those among this lot, who have intellectually degenerated further and/or have a historical agenda, become fundamentalists.

(b) Others politicize the whole issue of ethics and end up pontificating and their message invariably is camouflaged as _my values for the rest of you_. Such is the bitter anachronism of fate that even bent politicians dare to speak of ethics. Indeed, there is talk of ethics even in the Bombay Stock Exchange. This is not an oxymoron, as S Jayashree (2005) argued, but a new albeit belated awakening. When fundamentalist beliefs take over and morality is preached from the pulpit as well as the presbytery (irrespective of the religion), the issue becomes a dangerous one. The priest, the pundit, the rabbi, the mullah and the dastoor, have a personal stake in preserving _status quo_ since their livelihood depends on it. Hence, their version of morality is politically motivated, logically skewed and its acceptance must be tempered with restraint.

(c) Yet, others reduce ethics to a list of dos and don’ts. They derive a code of conduct and having done so, act like petty bookkeepers that are more concerned with the letter of the rule rather than the spirit or the substance of it. Hence, to them ethical conduct is yet another company rule. Moreover, like all rules, as long as people think you follow them, it seems to be enough. Corporate governance is reduced to rule compliance. Perhaps
this is what lies beneath the surface of the unending differences between the academia and the administration in Universities and Management Schools.

The distinction between morality and ethics, at one level, does not exist and another its division is important though fine. The import of this statement must be gleaned. Academics like Dhun Dastoor see ethics as moral philosophy (Fellowship Thesis 1995). Other scholars like this author go further and see ethics as being person specific, culture specific and context specific. Hence, whereas Dastoor restricts herself to examining the difference between good and bad, right and wrong, while this author goes further and maintains that the subjectivity is absolute only if it exists within bounded rationality. Here this author’s position is similar to that both Sadri and Chakraborty who maintain that objective reality is just our subjective perception of it.

Chakraborty, while being a logical analyst, successfully holds the flag of soul-based philosophy aloft and almost single-handedly so. He depends on the goodness of man and the Vedantic roots of Hindu culture for his prognosis. Others like Peter Bonnerjee, (comments on his work in Sadri et al, 1999 as well Sadri and Jayashree 2006) are much thought provoking but appear somewhat caught up by their own dogma. Yet others like Ananta Giri have actually collated opinions and called it ethics for reasons that appear neither logical nor are they easy to comprehend. The other Indian authors on ethics who can be taken seriously belong to what we call the soul based thought and they are Theo Mathias and R C Sekhar. They deal with the trilogy of the heart-soul-mind, and predicate their prognosis on spiritualism. R C Sekhar (1997) for instance, posits an extremely erudite exposition of soul-based philosophy. This work falls in the same intellectual category as the work of Mathias or Bonnerjee who take a strong position. Subhash Sharma who brilliantly traverses the middle road can also be conveniently (though not accurately) bracketed with this train of thought since he cannot extricate himself from the moralistic framework. But his uniqueness makes him a class apart from Mathias and the rest, and at par with Chakraborty and Sadri while retaining his scientific temper.

In contradistinction, this author has always taken up the position from mind-based thought. She is concerned with the duality of the heart and the mind. Economics teach us that in making a choice, an individual has to satisfy the willingness condition, which is the subjective condition, and satisfy the ability condition or the objective condition. When man makes a choice, he is consistent in that choice and makes it in such a way that his utility function is maximized, he is said to be acting rationally.

Therefore, taking the argument to its logical end, a confirmed drunkard, a habitual rapist and a drug addict would be rational under that Benthamite
definition. Therefore, we must limit that rationality within socially accepted norms of behavior and here we enter the realms of bounded rationality. The position taken is that mankind acts along perceived notions of right and wrong, good and bad, so by definition these perceptions can neither be absolute or immutable. Hence, ethics has to do with a principled-based choice between competing alternatives. In this author’s opinion, it is here that the contribution of Welfare Economics and Choice Theory has left their indelible mark on the study of ethics. Similarly, when faced with an ethical dilemma, the manager reacts in one general manner. The manner of this reaction, in turn, conditions the work ethic in the organization. Three positions in which a manager reacts can be summarized as being Teleological, Deontological and Praxis.

The first is Teleological or Consequential wherein the end was justified by the means adopted. The end, of course, was emancipation of the soul and the locus standi was obtained from formal religion and accepted metaphysics.

In Western Thought this takes the shape of Jeremy Bentham’s utilitarianism where a man makes an informed choice so as to maximize his pleasure and minimize his pain. Ethics is subsumed within this parameter and the question asked is what is in it for me? Or better still how will the decision benefit me personally? This we shall call the individualized level of response. Bentham honestly believed that it was the white man’s burden to be ethical and educate the savages. He called it the Christian Duty of an Englishman.

Then comes William Stanley Jevons who spoke of sumnum bonum or the greatest good of the greatest number. Social altruism ruled the roost and the contention was whatever is good for the majority is ethical. This we shall call the collective level of response. The emphasis here has been on the heart, the emotion and the feelings of man and society. Hence, the subjectivity constraint is placed on a high pedestal. Once again, it is the Christian dogma that held sway.

The second is Deontological or Non Consequential position. In India, there was a socio-metaphysical revolution when such giant intellects as Dayanand Saraswati, Raja Ram Mohan Roy, Anne Besant and the Theosophists questioned organized religion from a logical and socio-scientific platform. Madame Blavatsky too was deontological in a spiritualist sense. Even the clergy in the persons of Swami Ram Das, Ram Krishna Paramhansa, Sant Tukaram, Meher Baba and Sai Baba of Shirdi placed the needs of Man above those of God stating that service to Man was service to God. They disagreed with the accepted notions of ethicality and laid down their own genuine position without fear or favor.

Noted lawyers like Bal Gangadhar Tilak and Dinshah Wacha, politicians like Bhikhajee Cama and Vinayak Savarkar, and modern day crusad-
ers like G R Khairnar, Baba Amte, Sunderlal Bahaguna and Medha Patkar fall in that category. They looked at morals and ethics in a Non Consequential way. The non-consequentialist holds that some things were right or wrong irrespective of the consequences or the actors. These were the social reformers who blazed a trail for lesser mortals to follow. They challenged the right of the powers that be in society to justify the unjustifiable and questioned their using of blatant money power, muscle power, metaphysical constructs and spiritual hyperbole as the case may be.

In Western Thought, Immanuel Kant stated the same thing when he laid down the *categorical imperative*. This was an unconditional moral obligation derived from pure reason. Kant divided the universe into the real world (where he placed man) and the metaphysical world (where he placed God). He stated that man sought to justify himself in the name of God and constantly legitimized the illegitimate. To him some actions were right or wrong irrespective of the consequences. This we shall call *didactic* and *absolute* variant of truth.

Georg Frederick Wilhelm Hegel then gave the astounding view that *all truth was relative*. He argued that the only absolute truth was God and the only absolute certainty was Death. He gave the world a new dialectic, a specific form of logic, which viewed life, two folds: one comprised of a *unity of opposites* and the other seeing *reality in contradictions*. Hegel said that when a moral issue was at stake the minority of one was enough to guide one’s decision. If one were convinced that his path was that of righteousness then the philosophy of history would be on his side. This we shall call the *logical* and *relative* variant of truth. Using the analogy of *thesis antithesis and synthesis* Hegel posited a *circular* logic in contradistinction of Rene’ Descrates’ *linear logic*.

Both Kant and Hegel, like Marx and Engels, later, were concerned with the dignity of man. (c.f. Cohen). Marxists like Victor Allen, Richard Hyman, Sorab Sadri, Robin Cohen and Amiya Bagchi correctly reiterate that *man is the beginning and the end of all analysis; he is both the subject and the object of social inquiry*. At heart Marx and Engels, one has to admit, were profound thinkers and social reformers who saw in ethics a necessary condition, which needs to be fulfilled before social emancipation, can take place (*Economic and Philosophical Manuscripts of 1844*). The quality of human life was of paramount concern and they moved towards *metaphysics* and *spirituality* rather than *dogma* and *religion*. Their concern all along has been to make this world a better place to live in. In addition, ethical behavior formed an important part of their larger scheme of things (Althusser 1969).

To all of them it was the *means* that were important and the *ends* were historically inconsequential. The emphasis here is on the mind, the intellect
of the actor. Goal and role clarity become paramount under this approach and the objectivity constraint is placed on a high pedestal. Moreover, this is very important for persons in our profession, i.e. for persons who are the supposed guardians of the business of education and the self-styled promoters of education in business.

Examining the terrain objectively, there are two dominant strands of thought in the field of ethics in India. S K Chakraborty of Calcutta heads the first school and Sorab Sadri in Pune leads the other one. Chakraborty relies on spirituality and the Vedanta whereas this author relies on positivist social science methodology. To Chakraborty one must develop one’s inner self so as to understand the external reality. To Sadri it is the external reality, which conditions the inner self and that, in turn, reacts to that stimulus. Chakraborty’s appeal is to the heart and the soul of the manager while Sadri’s appeal is to the mind and the intellect of the manager. The soul has to be recognized by the mind before it can enter the logical calculus!

In an XLRI-NITIE all India survey in 1993-95 found 48% of the senior managers were operating in the non-consequential mode while 52% were consequential in their response to an ethical dilemma. This led Sadri to question the initial findings of Dastoor and another dimension was inserted through a question: *If I can discuss a decision openly and freely then that decision is ethical. Do you agree?* The three authors in *The Theory and Practice of Managerial Ethics* (1999) discovered to their horror that a majority of the managers [85% from an all India sample of 3000 senior level executives] fell into the last category. They operated in the *Social Acceptance Mode*.

This author then called it the *Praxis School*. [Praxis is a term borrowed from Marx to denote the process of conversion of theory to practice.] It signifies that the subjective need to gain acceptability showed that Indian managers were not prepared to walk their talk put their money where their mouth is or stand up for their beliefs. The preponderance of managers ascribing to this mode of behavior and the concomitant rise in mediocrity vindicates in a way, this author’s (1999) position that the finding of Sadri *et al* is incorrect and states:

_We fervently hope that the finding is wrong although the weight of evidence supports it. If so, a specter is haunting us, the specter of mediocrity._

Let us not be hasty and paint every businessman with the same brush. To clarify the author’s position on managerial work ethic further, two hallmarks in conduct need to be pointed out by way of example on non-consequential business leadership.
1. About five decades ago, there was a complaint that something was oozing out of the safe. Pirojshah Godrej suspected that the moisture generating and fire-resisting compound supplied by a firm of international repute was defective. This was not a fault of Godrej and Boyce but even so, the management recalled all the safes, the defect rectified and the safes returned to the delighted owners.

2. About three decades ago, there was a complaint that village folk in Sub-Saharan Africa were using adulterated water to mix with powder milk. The company had not specified on the carton that only filtered water should be used. There was a spate in infant mortality consequently. Lever Brothers recalled all the tins of baby food, re-packaged them with the warning and sent it back for sale.

Now let us look at two instances of the consequential variety where decisions were taken, supposedly for ethical reasons but which led to raising serious questions regarding their propriety.

1. About one and a half decades ago there was a model of the Ford Motor car called Pinto. This had a fuel tank at the rear and on impact the car would go up in flames. In the interest of public safety, the company should have called back all the sold cars from the market, withdrawn the product. Instead they reduced the damage to dollar values and compensated the hapless victims.

2. One fine morning, fish were suddenly found floating in the Powai Lake (Mumbai) in 1992. Nobody thought of taking to task those textile companies that were dumping their waste in the wee hours of the night into the lake and depleting the oxygen content thereby. Instead, the Government chose to soft peddle the issue in the interest of hushing up the event. The Fourth Estate too did not raise a rumpus and was conspicuous by its silence.

Ethical conduct has become the absolute compulsion in every walk of life if India has to make a mark for itself in the global economic order.

Unfortunately when the criminalization of politics and the politicization of crime have become everyday items in the news, the need for ethical leadership is more seriously needed than ever before. The newspapers too have climbed down more than a peg or two. The Hindu and the Statesman continue to hold the fort; but how long? The Times of India today, for instance, is far cry from what it was when Girilal Jain was in charge. Ethics in the Indian stock market with the likes of Harshad Mehta and Ketan Parekh is a pious wish. There is crisis of leadership and a concomitant depletion of moral standards in every occupation. Students try to broker for marks so as to keep up the rat race and in keeping with the spirit of the capitalist dog eat dog mentality. As teachers, we owe it to society to resist bending down to meet the students but
instead stretch our arms out to pull the students up to our level. This means giving man his due dignity and being ethical about it. Moreover, this primary work ethic must permeate all levels of civilized society.

3. The managerial style

The social as well as work ethic is determined by how management behaves. And any behavior when repeated becomes a style. How Managements behave and why they do so has been at the heart of all inquiries. This has been so ever since Adam Smith wrote his *magnum opus* in 1757 and Frederick Taylor posited his version of Scientific Management at the turn of the present century. At the London School of Economics and Political Science, Sorab Sadri (1977) posited a model for measuring the health of an Industrial Relations System. In 1988 Sadri and Williamson tested this model (with the help of postgraduate students) over five countries and examined large corporations having a workforce of at least 1000 men onrolls on an average day during a particular year. In 1990 Sadri and Lukose tested this model for a single country, and found that the model was equally valid for large corporations as it was for macroeconomics traits of a country. In 1991 Carlos Rodrigues Linara examined the Education Sector of Hong Kong and found that the original Sadri model held true. Critics in the academia contended in 1991 that the model might not be valid for small-scale industry of India. They were probably correct.

Small-scale industry was certainly not within the ambit of reference in the original prognosis. Consequently, this author from NITIE between 1992 and 1994 studied the issues and they were empirically validated in Southern India through a monitored and extended research. It undertook an examination of Sadri’s methodology of auditing industrial relations in the context of small-scale industry of three states in Southern India. Kerala, Karnataka and Andhra Pradesh. Sadri’s original prognosis was concerned with only large-scale industry, which had a discernible corporate culture. Jayashree assumed that the *Industrial Relations Styles* of the original model could be converted into *Managerial Styles* without much trouble and without vitiating the *raison d’être* of the original prognosis.

An important clarification is in order. Not for a moment is it implied that all family owned businesses are autocratic and all publicly owned businesses are democratic. Nor does the author imply that power in the private sector is unitary and power in the public sector is pluralistic in character. In fact, it has been observed that many of the family owned businesses were more progressive than the so-called publicly owned businesses in the State Sector. Many students who ape their ill-informed mentors often and errone-
ously make such a generalized assumption. In fact, it has been found that family owned businesses like Godrej and Tata are highly democratic whereas even some publicly owned Management Institutes like NITIE have highly autocratic types of leadership. Power location similarly is found to be unitarist in many high tech software firms while it is found to be pluralistic in BHEL as well as in several units of SAIL.

Management as the representatives of the owners of capital *ipso facto* have a vested class interest in perpetuating the inequality alluded to earlier in this chapter. Hence, it has an ideological motive as well as an economic motive to act in the manner that it does. This ideological motive forces managerial action to retain *status quo* even when *stability* degenerates into *inertia*.

The original work of Sadri had emphasized that no management is wholly unitarist or pluralistic, nor is it possible to have a wholly autocratic or democratic management. Hence, these terms merely signify a tendency towards the direction described by the definition, arrived at by observing past management behavior and present (stated and unstated) objectives. This combination of managerial assumption and controls, they posit, give rise to the above matrix, which depicts four possible styles of Industrial Relations Management.

The original model borrowed the continuum along the vertical axis from Douglas McGregor’s Theory X and Theory Y. The continuum along the horizontal axis was adopted from Alan Fox’s seminal work. A combination of the polarities produced a style. It is the contention of the author that these Industrial Relations Styles could also be used to describe Human Resource Management Styles.

The style mentioned in each quartile also reflects the level of managerial maturity within an organization. In other words as a management ma-
tures it moves from the first quartile on to the second and thence to the third *en route* to the fourth. Contrary evidence also exists to support the view that many organizations unable to withstand the pressures of change regressed from quartile three to quartile two and ensconced themselves in the familiarity of quartile one. Such was the dynamism in the small-scale industries sector.

4. The empirical evidence

A scientific prognosis is unless it can be empirically validated and this was taken up by the Jayashree study whose findings (with permission) are reproduced here. Any business concern that employed more than 5 and less than 100 employees was taken as a small-scale industry. Names of concerns were taken from the local offices of the Registrar of Companies in Bangalore, Hyderabad and Trivandrum. No names will be disclosed as the interviews were conducted on the tacit understanding that anonymity will be ensured. A sample of ninety small-scale industries chosen at random from the three Southern States formed the basis of the empirical examination. The purpose was to show that the Sadri Model (1977) developed originally for a core capitalist economy was equally valid in a peripheral capitalist economy of a retarded variety as well. In addition, on the strength of the empirical evidence the author advises HRM experts to consider adopting this methodology in their organizations as well. It is simple but not simplistic. It is indicative but can be used for forecasting reactions as well.

In the small-scale sector a manager is known to perform many varied functions and Industrial Relations is just one of them. This author admits that it would be dangerous to generalize, therefrom, without committing the *fallacy of composition* (when what it true for a part is taken to be true for the whole). Hence, she retains the specificity of our findings. In the small-scale sector it must be noted that Human Resources Management is restricted to two activities: General Administration including Pay Roll, and Industrial Relations including Statutory Compliance. Her study examined the latter directly and the former indirectly.

The aforementioned studies assumed that the function of industrial relations is to anticipate and regulate conflicts and aid the parties in achieving their set objectives. Industrial Relations Audit becomes an ongoing exercise in a free market economy. This does not *ipso facto* assume that all conflict is endemic and must be contained. (c.f. Hyman). It only assumes that all conflict, which hinders the achievement of corporate objectives, must be anticipated and regulated by industrial relations. Some theorists justifiably go to the extent of stating that conflict arises out of change, is a proof of
dynamism and hence must be welcomed. This is indeed an extreme view but has great merit: it prevents stability from becoming inertia as has been witnessed in the Public Sector of Indian industry, either in the primary, secondary or the tertiary sectors. The result of this is that there is little or no real value addition arising out of managerial action. What in fact happens is that management perceives that their action will lead to the realization of their objectives and thereby add value *ipso facto*. Since the objectives are those of a mercantilist-trader-businessman, the perception of value addition is flawed and real progress is vitiates. The inevitable result is that we have organizational paralysis with all the symptoms of *development-less-growth*, which is a typical feature of peripheral capitalism of a retarded variety.

A brief examination of each style would be in order since that would indicate what kind of work ethic would devolve from it.

1. **PATERNALISTIC STYLE**

   This might be described as benevolent despotism and is normally associated with an absence of union recognition, (although not necessarily in absence of union members). Management (or owners of capital) takes the initiative and the terms and conditions of employment reflect the general concern for the well being of the employees with the added advantage that the company normally creates a favorable position for blood-relatives or cast-brethren of those who hold power. Discrimination abounds and people are promoted or given benefits on the basis of who they are, they know rather than what they can do or how they know whom they know. This author’s investigation revealed that village affinity, caste bias and political positioning of management accentuated the Paternalistic style. In the plantations of Kerala for instance this was very much in evidence.

2. **RE-ACTIVE STYLE**

   In this kind of scenario, unions or the workers generally take the initiative and management mounts a series of rear guard actions designed to preserve what is magically “the right to manage” (Hyman 1984). The approach to negotiations is on a “win/loose” basis and this philosophy might be described as “fire fighting”. The concept of an industrial relations audit would be somewhat alien to this culture despite the situation in fact demanding it. Management and unions operate on a win-loose basis and terms such as “us” and “them” are common parlance for both the owners of capital and the owners of labor power. This author’s investigation reveals that the reactive style was adopted not so much in respect of the actions of workers themselves. However, the environment in which the company functioned e.g. the PWG in the locality, the interest of the MP or the MLA, determined the
style. So too the state government policy regarding particular industry e.g. small machine shops in Karnataka and Bidi plantations in Andhra Pradesh.

3. **PRO-ACTIVE STYLE**
   
   This might also be called the predictive style where management accepts conflict but regards this as having virtues providing it is channeled in constructive directions. This type of organization is generally sophisticated in its approach believing in a forward-looking philosophy, which is generally associated with a clearly defined corporate policy. Negotiations are on a basis where the aim is for all parties to optimize their varying interests. This sort of philosophy might be called “fire prevention” i.e. where the Management and Unions arrive at an equilibrium saddle-point. In the case of small scale industry, management which take the workers into confidence before affecting a policy would fall into this category. This author’s investigation revealed that the Proactive style was more prevalent in cases where the workers were skilled craftsmen as in small machine shops of Karnataka or where the manager was an educationally qualified person as in Kerala.

4. **PARTICIPATIVE STYLE**
   
   In this approach there is a commonality of purpose based on open and joint management. This should not be confused with participative mechanisms such as Works Councils or Elected Employee Directors, which may simply reflect political expediency rather than a true participative philosophy. In reality very few organizations will be found in this sector due to the difficulty of achieving a common purpose within the organization. In the small-scale sector this would be closer to co-operative societies irrespective of whether they belonged to producers or consumers. This author’s investigation revealed that co-operative societies especially in Kerala fit the description best. In The Case Of Andhra Pradesh, especially where it shares its borders with Tamil Nadu the level of consciousness was found rather low.

   To a positivist political economist like Sorab Sadri, Industrial Relations is nothing but the behavioral aspect of the Micro Economic Production Function. Will it then not be fair to suggest that these styles depict managerial behavior towards capital and labor? Moreover, is that not what HRM is all about anyway? Personnel management as a concept has been criticized and the Sadri – Dastoor (1992) paper which can be seen as having read the funeral rites for the orthodox view of Personnel Management. Jayashree concedes that the sample was biased. It is also conceded that only the owners and few of the employees were interviewed. But the analysis can be well defended on the grounds that within the given limitations and the specificity, the contentions are valid.
In the small-scale industries studied it was found that family owned concerns of feudalistic structures where exploitation of human labor was the norm, the management operated along Paternalistic lines as in the case of the Palm-oil and Bidi Plantations. In exchange for freedom, labor was guaranteed employment and a minimal welfare for the families. With a disequilibrated labor market and an uncertain employment position the exploited labor force welcomed this. Sadri had found that even in 1997-98 a stainless steel cold rolling mill in Navi Mumbai operated under a crass exploitative top management.

In contradistinction thereof, this author had found that the managerial style was reactionary in concerns where the top management was involved in day to day production. This was in machine tool component manufacturing where the level of workers was that of a skilled craftsman with a minimal educational background. Here labor exploitation was overt. Workers knew their rights and also how to exercise them. However, lack of alternative employment prevented them from making too much “noise” when the management became over exploitative. In the case of business where there was some amount of bureaucracy and paper work such as small computer companies, the management followed a proactive style of management. The level of deceit and exploitation was no longer overt but covert. In the case of co-operative societies either of the producers or the consumers the style of management was participative. Power was shared to an extent and decisions were jointly taken. This was because there was a sense of belonging among the participants in the decision making process.

It would indeed be interesting to see where companies in the Middle East or in Japan fit into the typology presented earlier and tested yet again herein. Whereas these were mere tendencies there is no doubt that an absolute categorization is foolhardy. This paper opines that the original 1997 model within certain parameters is found to be valid in the Indian small-scale industry sector as well. Hence, it is a useful instrument to be used by the HRM expert in organizational diagnosis. Nothing more is claimed by this author.

Cognitive learning is important for managerial scientists, not so much for managers, who need to understand more theories in action, to quote Pareek, Rao and Pestonjee (1996). In this paper empirical evidence was used to validate a model of Managerial Styles. How Management behaves conditions the basis of the work ethic and here the role of the chief executive comes to the fore. The final part of the paper will examine the futuristic role of the chief executive from a kind of objectivity alluded to by Chris Frost (1998).
5. Ethics in the future

Corporate Leadership arises out of and determines the nature of the work ethic. Hence, no examination of the work ethic is complete without an examination of the corporate leadership. Along with new global alignments and trade rules, a new set of modalities for business has emerged. To take Sadri’s lead we can name a few:

– Business has per force become transnational. The boundaryless universe has emerged, and an era of concurrent collapse has been ushered in.
– The pace of change is nonlinear, non-Newtonian and nonincremental. New power brokers have emerged and teamwork has gained ascendance.
– The issue of moral hazard has raised its ugly head when state guarantees were no longer adequate safeguards of investment.
– The myth of the technological competitive edge has been exploded. Effects of all managerial decisions are seen

a) In terms of long term growth and stability, and,
b) The effect it has at the point of production or at the point of sale.

– The product profile has changed whereby there is a marked preponderance of the knowledge component over the erstwhile raw material component.
– Dependent economies along the periphery of the capitalist world economy found that their growth was immiserised and their infrastructures were fragile and dependent.

The effect of these modalities on organizational behavior is twofold. Organizations are going through a kind of Corporate Olympiad, a massive change of corporate focus in line with the market scenario, where only the fittest can survive. There is a felt need for creative definition of functions and structures, wherein the approach to organization must be geared towards a culture and style transformation as well as be zero based. The doing executive of the 1950s and 1960s became the learning executive of the 1970s and 1980s. The 1990s beckoned the age of the thinking executive. It was no longer enough for the corporate leader to be activity based but to combine it with being thought based. The leader’s paradigms had to be flexible, proactive, pioneering, holistic and global. Reengineering, which was a fad of the 1990s no longer, gave the desired results. Organizations were no longer satisfied with product leadership; they needed to have competence by competition for opportunity share. (Both Michael Porter’s Diamond and
the B.C.G. Matrix were more descriptive than predictive and consequently had become old hat). It was not enough allocate and utilize to resources optimally but to accumulate them for strategic leverage. The knowledge worker had come to stay and his loyalty was only to technology. Once he found that his technological base was not being expanded, he would quit. Hence, policies had to be designed to stretch along with changes in the environment rather than fit into a particular construct. In addition, all this was expected of the corporate leader who will take the organization into a better tomorrow with a new work ethic.

To begin with, let us see what the organization expects of the leader in the future. Some of the key characteristics that emerged when the question was posed to managers by another XLRI – NITIE research conducted in Western India (1994-1995) were:

i. The leader is to help perpetuate history and yet bring about change.

ii. Adapt the character of the corporate management to the needs placed upon the organization by the environment.

iii. Keep faith and uphold key commitments so that at no point is his credibility questioned.

iv. Maintain a healthy tension between tradition and change.

v. Make a lasting impact on the organization, and in turn the market.

When one were to examine this list a mite more closely, one would find there is a kind of causal link from point (i) to point (v).

In order to predicate the views of this paper, certain key terms need to be properly defined. Hence, this paper must take issue with the nature of corporate leadership itself.

Clearly, the first task of the leader must first of all work towards gaining acceptance. Once that has been achieved, the rest can follow. However, this may not be easy. Vested interests will be keen to scuttle progress for the sake of individual security. The structure of the organization is most often the first thing a leader examines. By structure is meant the distribution along various lines, of people among social positions that influence role relations between the incumbents. One of the biggest hurdles to overcome is that while organizational structures are constructed along concentric lines (for greater effectiveness), the incumbents (managers and workers) still think and act as if the organizational structure is built along hierarchical/ pyramidal lines. To achieve long lasting results the leader must change this attitude.

To bring about a change in attitude, the organization’s mission and purpose must be clearly defined. If one does not know where one is going, one cannot be lost. Unfortunately this fits the description of most traditional organizations in India beautifully, which can help an organization to link its activities to the needs of society and legitimize its existence. By purpose is
meant statement of intent; of what an organization strives for and sets the objectives, goals, policies and plans accordingly.

An **objective** is a close-ended attribute, which is precise and can be expressed, in specific terms of quantity, quality, cost, and time. If not, progress would become hard to measure. The objective in turn springs from a **goal, which** is an open-ended attribute denoting a future state or outcome than organization strives for. To actualize an objective the leader needs to clearly define the policy, the procedure, the rules and the plans.

The organization’s **policy** is a guideline to action. **Procedures** are a series of tasks or steps expressed in a chronological order. Rules are prescribed courses of action which explicitly state what is to be done under a given set of circumstances. The rules could, of course, be either substantive or procedural. And these rules, procedures and policies are to be geared towards achieving the objective of the organization.

It is the task of the leader to define the goal and role of each aspect/function within the organization so that both clarity and nonambiguity exist. This would facilitate the appreciation and understanding that will help fulfill the mission born out of the vision of the organization. To summarize, the organization leader is one who articulates the vision and mission of the organization, brings about goal and role clarity and facilitates the achievement of the objectives through teamwork. The leader builds the team, nurtures it and proactively leads it in order to achieve the organization’s objectives. However, leadership has to be focused, benchmarked and accountable above all else. The leader needs to carry his team along with him and for that, he needs to build trust relations, make decision processes transparent and foster teamwork. He can do so only if he walks his talk. Three factors that will be crucial in the years to come are core values, an entrepreneurial spirit and corporate governance.

This point was not lost on Sir Adrian Cadbury who in an interview in late 1996 stated:

*In India I think one has to focus on opening up the system. I would not try, for example, to control transactions a company is entering into. I would rather try and establish a scenario where more information on that transaction is available to shareholders and the press. The need is for all deals that companies make with others and within themselves to be transparent.*

In the same interview, he went on to say that:

*What is important is that there should be clarity of responsibility between the board and the management. Often there is confusion about
precise responsibilities. There has to be a clear line between the tasks of the board and management as to who plans and manages and who executes the plans.

Obviously, Cadbury’s concept of governance is different from the Inspection House of Bentham. For Cadbury, quality is built into the system and not inspected at the end of the process or product line. Hence, to him good governance is crucial to good management. Most corporate leaders today recognize this.

What will be the nature of this leadership? In 1997 a study conducted by the Sloan School of Management confirmed a commonly held belief. It was fact that only those companies will remain as effective players in the global market during the next century which have placed a great importance on Ethics and which practice Value Based Management. Such a powerful statement needs to be examined in detail to understand what it implies and what ramifications it may have for Indian industry and business. But first, let us see what do these terms in the corporate context mean mean?

– Values are a set of beliefs held by a person or a group of persons or an organization and which the person or group or organization stands for, is known by, and form the basis of its subsequent actions. It is a thought-based concept.

– Ethics are a pattern of moral behavior, of a person, a group of persons or an organization, which are in consonance with some assumed, explicit, stated or unstated beliefs. It is an activity-based concept.

Values and Ethics are dialectically connected to one another and the distinction drawn above is purely epistemological. The question then pops up: So, why should managers study ethics?

Ethics has long been the subject of study but Managerial Ethics has gained importance only after the Stock Market crash of 1987 when one stock market after another crashed: Tokyo, Zurich, London, Sydney, New York, Singapore, and Hong Kong. A study conducted by the China Economic Research Center, Macau, in 1986-88 (with which Sorab Sadri was involved), came to the conclusion that the three main reasons for this stock market crash, which threatened the fabric of several free market economies were:

1. Ham handed economic policies on the technical side.
2. Poor communication between the banks (lenders) and the industries (borrowers) both of whom were speculating without adequate gold reserves.
3. Low level of Business Ethics in the financial sector which created disharmony and lack of trust between the various markets: Sydney, London, New York, Hong Kong etc.,
Hence, to an economist like the present author, a serious study of ethics is crucial for business and industry. What does this imply? To this author it implies five main things or attributes: (a) dependability (b) trust relationships (c) quality assurance (d) consistency and (e) marketability.

The question was posed: at what levels do these five traits imply? The answer is that it must be studies at the level of the PERSON, the PROCESS and the PRODUCT. Naturally, one need to know how does the business or industry benefit from this? The answer lies in the fact that it enables the company to gain a competitive edge in the market place by converting the customer into a client.

When a person comes to buy a product he is a customer. When he comes again for the product, since he is convinced that he gets good value for his money, he is a client. Managerial Work Ethics makes this possible based on the five traits given above. The study on ethics conducted from XLRI and NITIE and cited earlier in the paper meant that the top-level manager was not always a leader who stood for values and blazed a trail for others to follow. Rather, he was someone who wanted to play safe, hurt nobody in power, ruffle no feathers and thereby continue to enjoy his position of authority. As a people we were perpetuating mediocrity. This being the case, industry must shake off its lethargy otherwise stability will lapse into inertia and we would have achieved development-less-growth. The study also found that as managers move up the hierarchical ladder they become less ethical. The all-important question is begged: why do senior level managers who are financially secure, act unethically? What happens to the work ethic at that point?

Five possible reasons are thrown up by further research conducted in U.K. between 1994 and 1997.

1. The individual and internalized values of the manager are either unclear or weak: e.g. he does not have the guts to stand up for his beliefs.
2. The individual is concerned with the bottom line only: e.g. he wants to get profits at any cost.
3. The individual believes that anything is right so long as others believe it to be right: e.g. a public relations guided mentality where the person is eager to be popular.
4. The individual is inherently exploitative for meeting personal goals and ambitions: e.g. riding piggyback on colleagues’ efforts and taking the credit.
5. The individual is insecure and is afraid of change so he promotes stereotypes and undermines empathy as well as compassion: e.g. the boss who promotes “yes men” and thereby empowers mediocrity.
Similar researches in the USA showed organizations tend to reward behavior that violates ethical norms. Most societies value ethics and imbibe morality in its citizens. The study concluded that managers faced an ethical dilemma because of the conflict between societal norms and organizational counter norms e.g.

<table>
<thead>
<tr>
<th>SOCIETAL NORMS</th>
<th>ORGANISATIONAL COUNTER-NORMS</th>
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<tr>
<td>Be open and honest</td>
<td>Vs Be secretive and deceitful</td>
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<tr>
<td>Follow the rules at all costs</td>
<td>Vs Get the job done any how</td>
</tr>
<tr>
<td>Be cost effective</td>
<td>Vs Use it or lose it (as in a high priced computer)</td>
</tr>
<tr>
<td>Take the responsibility</td>
<td>Vs Pass the buck (save your butt)</td>
</tr>
<tr>
<td>Be a team player</td>
<td>Vs Take credit and move up</td>
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Given the capitalist nature of most developing economies today could the above views not be universalized? If so, what sort of HRM intervention is needed to address this anomaly? Therein lies the key to improving the work ethic: to convert competition into cooperation for sustained development.

In Denmark, Switzerland, Holland, Germany, France and Sweden, as well, Managerial Ethics is given a very high priority. Ethical Codes and Audits are consequently introduced in every major company/business. Cadbury speaking on Governance alludes to this all the time. However, what does this mean?

A Code of Ethics is a set of documents describing what an organization stands for and the general rules of conduct expected from all employees irrespective of rank.

An Ethics Audit is a practice of regular assessment of employee behavior so as to identify incidents of dubious (questionable) behavior. Here two systems can operate. Anyone can complain about anyone to an Ethics Manager. Where everyone is his brothers’ keeper and is duty bound to complain, correct, and guide anyone who may be seen as falling out of line with corporate norms of conduct.

The final question can then be thus posed:

Is it just good business sense for management to be Ethical?

or

It is good for management to be ethical and be seen to be acting ethically anyway?
The precise answer given by top management will determine the kind of ideology and the concomitant work ethic. History demonstrates and Sadri’s research supports the fact that:

- Managers operating in the Consequential Mode are usually opportunists and carpetbaggers. Very often they do well in life.
- Managers operating in the Acceptance Mode are usually insecure, seek peer approval and promote mediocrity. Very often they live behind a facade.
- Managers operating in the Non Consequential Mode are the trailblazers, history makers and true leaders. Most often they are the ones who make the difference.

An atmosphere that promotes creativity and innovation clearly allows trailblazers to flourish. Moreover, it is here that the HRM facilitator must take his cue in formulating the intervention needed so that a work culture emanates and enables the organization to thrive on the cutting edge of global competition. There is little doubt that next to God if man should fear anything then it is History. For, when history passes judgement it is most unforgiving. Every person like every country makes his own history but does so under definite conditions over which he has little control. What kind of history would you like to be a part of? Are we perpetuating a culture of mediocrity in the name of conformity? Each of us has to make his own decision, walk his talk and stand up to be counted. What will your decision be? What kind of a work ethic will your HRM intervention produce? That is the important question we must, as professionals, address to ourselves if we are to help India move into the new millennium from a position of strength. If meritocracy is indeed to replace mediocrity then we really have no other choice but to make ethical management a passion.

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A BENCHMARK APPROACH FOR SUCCESSFUL CHANGES IN CORPORATE STRATEGY

Navid Mollaee
Mollaee.navid@gmail.com
University of Applied Science and Technology, Tehran, Iran

Maryam Kandi
Kandi.Maryam@yahoo.com
Petroleum University of Technology, Tehran, Iran

Mahsa Damroodi
M.Damroodi@usc.ac.ir
University of Science and Culture, Tehran, Iran

Abstract

The so rapid changes in the world make it too hard to predict the business environment in future. It causes some business owners not to do anything to avoid wrong choices whereas sustained success comes after searching opportunities. So, the important question of “What can we do to make our business survive and grow faster than competitors?” should be answered. It is also necessary to appropriately handle the change strategies in both poor and good times to have a well-run organization. Seeking out and copying the best products and methods has always been a usual way of life since the earliest human to modern organizations. For long-standing success and survival, the ability to translate the successful experience of one organization for the benefit of others needs a learning development for implementing the adaptation to each situation. The tool we suggest here to envelop both intra-organizational and inter-organizational learning (either from partners or from competitors) to implement a best practice effectively is benchmarking. In this paper we use a modified model of benchmarking (as an organizational learning tool) to propose how to make a learning organization for change strategies implementation.
1. Introduction

The so rapid changes in the world make it too hard to predict the business environment in future. It causes some business owners not to do anything to avoid wrong choices whereas sustained success comes after searching opportunities. So, the important question of “What can we do to make our business survive and grow faster than competitors?” should be answered. In this regard, we need a comprehensive tool to let us see and even foresee the novel upcoming situation. Otherwise, some terrible crisis will be inevitable as it is!

The current crisis that we are in, as an industry and as a nation, is not the only reason why organizations should focus on change management. It is also necessary to appropriately handle the change strategies in both poor and good times to have a well-run organization. According to David Axson, seeking out and copying the best products and methods have always been a usual way of life since the earliest human to modern organizations (Axson 2006). For long-standing success and survival, the ability to translate the successful experience of one organization for the benefit of others needs a learning development for implementing the adaptation to each situation. The tool we suggest here to envelop both intra-organizational and inter-organizational learning (either from partners or from competitors) to implement a best practice effectively is benchmarking.

To ensure positive changes happening to organizations, managers should consider resistance to change and lack of a clear understanding of the change being made. Educating individuals about new ways of operations in novel situations leads to a durable commitment but if the resistances continue to exist, achieving change is an impossible process, especially when time is not on your side.

2. Literature review

2.1. Benchmarking

Traditionally, companies with all of their components of business models working together can often achieve long-lasting success (Johnston & Bate 2003: 3). It is often stated that those who benchmark do not have to reinvent the wheel (Parker 1996).

Benchmarking is not just making changes and improvements for the sake of making a change, benchmarking is about adding value. No organization should make changes to their products, processes, or their organization if the changes do not bring benefits (Mollaee, Rahimi, & Tavassoli 2009).
Benchmarking is not just about comparing data or copying your competitors. Benchmarking is more about continuously learning from others, learning more about your organization strength and weaknesses in the process and then acting on the lessons learned (Camp 2006). This is what leads to real improvement. Benchmarking is a mean to an end, not an end in itself.

2.2. Background on benchmarking

Benchmarking can be called the management tool that Xerox revived. Xerox defines benchmarking as the “continuous process measuring our products, services, and practices against our toughest competitors or those companies recognized as leaders (Camp 2006). The Xerox of today is not the Xerox of the sixties and seventies. During that time period the organization experienced market erosion from competitors, primarily Japanese. These competitors were marketing higher quality products in the United States at the same price or lower as Xerox. Xerox found that the Japanese were able to assemble quality products at a low price. This was hard for Xerox to grasp because they were the first to develop the photocopy and their name had come to be synonymous with photocopies. How could the Japanese be beating them at their own game? Xerox found that they had to regroup. In doing this they used reverse engineering and made competitive benchmarking a fundamental part of their operations by the early eighties. Xerox began to study other organizations within and out of their industry.

By 1983, Xerox had benchmarked more than 230 process performance areas in their operation. They looked at all aspects of their business. Identifying the best processes used by others, Xerox adapted them for their own use. This is how they regained their core competency and strategic advantage in the photocopying industry (Bogan 1994).

Since the first publication on benchmarking in 1989 by Robert C. Camp of “Benchmarking: The search for Industry Best Practices that Lead to Superior Performance”, the improvement technique benchmarking has been established as an important tool in the process focused manufacturing or production environment. The use of benchmarking has expanded to other types of industry.

2.3. What benchmarking is?

Basically benchmarking means learned from others. It is using the knowledge and the experience of others to improve the organization. It is analyzing the performance and noting the strengths and weaknesses of the organization and assessing what must be done to improve. A vast number of
publications exist on benchmarking with no agreed upon definition of the term benchmarking.

Bendell, Boulter and Kelly (1993) write: “Today, quite clearly, the term is ambiguous, woolly, a mystery. It appears to require great subtlety of understanding and clearly means different things to different people.” (Bendell, Boutler, & Kelly 1993).

The absence of a simple definition that is accepted as the real one, leads Carey (1995) to take the key points from a number of definitions and express them stepwise in the following clear terms:

– The methodology of examining in detail something your organization does (the performance measures and practices).
– Then comparing it with a similar process being performed more efficiently and effectively in your own or another organization.
– With the objective of finding ways of making significant improvements to your own process.

Andersen and Pettersen (1996) write: “The process of continuous measuring and comparing one’s business processes against comparable processes in leading organizations to obtain information which will help the organization identify and implement improvements”.

2.4. How benchmarking is applied?

Benchmarking is a five-step cycle aimed at ensuring continuous improvement, fig. 1. Each step is described briefly (Mollae, & Rahimi 2009).

Figure 1: Five-step cycle of benchmarking.
STEP 1: Deciding what to benchmark

You can apply benchmarking to any aspect of business. It makes sense to prioritize. Benchmarking allows real improvement to be made as you examine what goes on and how it could be done better. Processes may be at workplace level (operations) or management level (strategies). Strategic level benchmarking work can be led by or involve various people, for example managers, company representatives or trade association representatives. You will need both senior management and employee commitment and involvement at all key stages. At this level, organizations start out with few assumptions about the business itself, what it is “good” at, and what the future will be like.

STEP 2: Analyzing where you are

You need to identify your starting position. You need to think about how you will Measure where you are and where you want to be. This will help you measure your improvement from benchmarking. If you use an audit system you could use your results (sometimes these are ‘scores’) as a measure. Later you could compare your results with others who use the same system. As part of this process, you may choose to survey employees to find out what they think. In particular, we use Balanced Score Card (BSC) to compare the results with objectives. After a mission has been defined and a SWOT (strengths, weaknesses, opportunities and threats) analysis is completed, an organization can then define its measures, goals, strategies, etc.

STEP 3: Selecting a partner

If you are part of a large organization you could find partners both within your organization (internal benchmarking) and outside (external benchmarking). Smaller organizations will probably need to look outside, as they are too small to have a wide range of potential partners to choose from inside their firms. The chart shows the advantages and disadvantages of both approaches.

You may choose to work with one partner or a number of them. You could join a benchmarking club where you will have a range of potential partners to choose from. Your trade association or benchmarking organizations sometimes offer this service. You can use different ways to find partners. For management processes you will have a wider choice of partners, as these processes are common across industries. When you agree a partnership there needs to be mutual benefit – ‘give and take’. You should be prepared to give your partner something in return. You should also be aware of the Benchmarking Code of Conduct and check you work within it. This is particularly important if you are planning to benchmark with a competitor, as it will help to ensure you keep within competition law (Boxwel 2007).
A benchmark approach for successful changes in corporate strategy

Table 1: Advantages and disadvantages of internal & external benchmarking

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Internal</th>
<th>External</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>● Easier to get information and therefore cheaper</td>
<td>With competitors;</td>
</tr>
<tr>
<td></td>
<td>● Improves consistency within firm</td>
<td>● Easy to identify partners</td>
</tr>
<tr>
<td></td>
<td>● Help to improve communication and information sharing</td>
<td>● Help your competitive edge</td>
</tr>
<tr>
<td></td>
<td>● Easier to get management commitment</td>
<td>● Use as a marketing feature if you are the ‘Benchmark’</td>
</tr>
<tr>
<td></td>
<td>● Good practice of technique before looking for an outside organization</td>
<td></td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Disadvantages</th>
<th>With competitors;</th>
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<tbody>
<tr>
<td></td>
<td>● Doesn’t identify overall best practice</td>
</tr>
<tr>
<td></td>
<td>● Can be ‘blinkered’</td>
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Decide whether you will need to visit your partner’s work place. Sharing information by phone may be enough. It is usually best to meet, so you can see for yourself, and talk to relevant people. If you decide to visit, involve your managers and safety representatives in the visit because they are the ones who will be helping to put in place any improvements you identify.

**STEP 4: Working with your partner**

With the right planning and preparation (Steps 1 to 3), this stage should be straightforward.

- Be realistic – don’t try to do too much in one go.
- When exchanging information you need to make sure it’s comparable – ‘apple with apples’. For example, you may try to compare statistics, but if you record this data in different ways it won’t be a valid comparison.
- ‘Respect your partner’. Remember confidentiality, give and take equally, keep to agreed topics, do your homework in advance, show awareness of the Benchmarking Code of Conduct, keep to timescales and send a message of thanks.
During contact with partners make sure you really understand what they do, how they do it and why it’s better. This is the information you will need to learn. Rather than focus on modest improvements, benchmarking focuses on making major structural changes to everyday with the goal of substantially improving productivity, efficiency, quality or customer satisfaction.

**STEP 5: Learning and acting on lessons learned**

This is a key step – if you don’t get this right, all the work you’ve done so far will be lost! Remember the purpose of benchmarking is not to copy but to learn from others, learn more about yourself and, as a result, take action to improve. Devise an action plan, based on your findings. It’s important to make sure your plan fits in with the ‘culture’ of your organization otherwise, the plan doomed to failure. Your partner may have a very different culture, and the language and methods they use may need to be adapted for your organization. Make your action plan SMARTT (Specific, Measurable, Agreed, Realistic Track able and Time bound).

Identify what you need to do, who should do it and when. Make sure you get senior management and employee commitment to the action plan. Implement your action plan and regularly review progress with it. Are you where you want to be? If there are problems it may be useful to contact your partner(s) again to see if they can help you overcome them. Remember continuous improvement – keep an eye out to see if standards have moved on. If they have, reset your benchmark and you can start from Step 1 again. As in any other area of business, you shouldn’t stand still.

### 3. Change of strategy

#### 3.1. Goals focus on what, while strategies focus on how

The term “strategy” has been used for years in military planning and tactics in wars. Nowadays business strategy is so popular that it seems to be the secret of being successful. Although managers who have planned strategy can’t always be seen at the zenith of their business but there is evidence to show that organizations which undertake strategic planning do tend to perform better than those who don’t. Fred. R. David (2007) defines strategy as “the means by which long-term objectives will be achieved”. He also states that “strategies are potential actions that require top management decisions and large amount of firm’s resources”. According to Chris Jeffs (2008) “business strategy is the management of organisation’s resources and competences in order to match the aim of the organisation and the threats and opportunities in the environment”. He also considers strategy as interdisciplinary subjects to
encourage practitioners make use of other knowledge such as finance, marketing, supply chain logistic and human resource management.

There is a debate about whether business strategy is a science or an art. One who reviews the development of strategic management can find that the initial focus on scientific method of management has led to a rational perspective in analyzing the environment. During the 1980s and dramatic change in the world economy nature some flexible approaches whose emphasis was more on internal potentials to make the old approaches consistent with unforeseen events was developed.

What makes strategy so valuable for managers is the belief that strategy has to do several things simultaneously. Considering strategy as a purposeful attempt to achieve an objective, these items has identified by Anne Sigismund Huff and others (2009);

- Communicate a compelling purpose or vision to others
- Connect organizational strengths with environmental opportunities
- Exploit current success while exploring new opportunities
- Generate more resources than it uses
- Coordinate and guide activities
- Respond to new conditions over time

3.2. Different approaches towards changes

As mentioned in different changes theories, we have 3 general approaches to change:

- Change strategies as adaption or selection: looking at change from the outside
- Change strategies as transportation and evolution: looking at change from above
- Change strategies as natural evolution or social dynamics: looking at change from inside

3.2.1. Change of strategies as an adaption or a selection

From the post World War II to the late 1970s changes was deliberately mentioned as growth and development in an optimistic view. As Demerse (2007) says; “During that period, change is more or less explicitly conceived as a process of gradual adaptation. Except for a small group of scholars who view change as emergent, the dominant view is that adaptation is largely controlled by management reacting to either internal or external pressure”. In the other words there is a belief that everything is possible. “Growth is therefore seen as the normal evolutionary path for organization, because larger size is associated with economies of scale, higher profits, and higher survival rates, as well as more prestige, power and job security for execu-
tives. But among researchers who explain organizational development and
growth in term of internal forces there are three trends” (Demers 2007: 5).

First there is a group of theories that called rational adaptation approaches. These theories focus on organizational change in very different from one perspective to another but they all agree that organizations can change to pursue goals that are adaptive. The second approach is Organic adaptation. Cyert and March (1963), characterizing the firm as adaptively rational system rather than omnisciently rational system, propose a decision process theory that seeks to explain how organizations adapt. The last approach is life-cycle theory that developed by Cameron & Whetten (1993), chandler (1962) and Stopford & Wells (1972). The life-cycle model gains popularity in organization and management theory in the early 1970s. In this theory change is a progressive, natural evolution through a series of fundamental transitions from birth to adolescence. This period of optimism ends with a recession brought about according to most accounts, by the 1973 oil embargo. Two approaches stand out as being particularly important (Demers, 2007: 5-19): population ecology (Aldrich 1979; Hannan & Freeman 1977, 1984) and neo institutional theory (DiMaggio & Powell 1983; Meyer & Rowan 1977).

3.2.2. Change of strategies as transportation and evolution

In 1980s a real change is seen as a period of discontinuity, of disruption; it is talked about in terms of transformation and revolution. There is a recognition that change does not always follow a path of cumulative, gradual adaptation; episodes of transformation and radical change now take center stage. During this period more attention is given to defining what a transformation and radical change is, as opposed to an incremental or gradual change, to examining the process by which such a change is realized. This shift in tone occurs while environmental uncertainty and turbulence initiated by the 1970s oil crisis. There are four approaches to change in this view (Demers 2007: 43-58); configurational, cognitive, cultural and political approach.

The configurational approach displaced contingency theory as the dominant perspective in the literature on change in the 1980s. This perspective explores the concept of radical change, in term of both its content and dynamics. Cognitive and cultural approaches view organization as archetype or integrated wholes. This conception reinforces the monolithic top-down view of change as a radical transformation. Thus, the cognitive school draws attention to the importance of transforming the worldview of organizational members, starting with top management, to achieve profound change. According to cultural approach, fundamental change involves a deliberate attempt by management to change the basic, taken-for granted assumptions and values that guide collective action. And finally the authors
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of the political view, who adapt a managerial point of view, consider that organizations are pluralistic entities and change process leading to radical change as piecemeal and incremental.

3.2.3. Change of strategies as a natural evolution or a social dynamics

At the end the 1980s, alongside the dominant conception of change as an episode, a view of change as process without clear beginning or end became increasingly prevalent. In fact the opposition between continuity and change itself starts to be questioned. With globalization, due among other factors to the advent of new information technologies, there comes an acceleration of economic cycles driven by fierce competition. The transformation of the world economy results in layoffs and increasing insecurity in western world. New organizational forms, labeled the virtual, modular, or postmodern organization, are heralded as providing the flexibility required to succeed in this new era. In this context the process view of organizational change take center stage. While a preoccupation with the link between strategy and environment remains strong, strategic change starts being viewed less as a matter of radical transformation than as a long term process of organizational renewal, often defined in terms of learning and associated with innovation. The idea promoted is that change is not only something that is done to the organization by visionary manager; rather, it is something that the organization does itself, in which all members are involved.

From the 1990s, the topic of change including anything concerned with organizational process is subsumed under variety of labels, such as learning, evolving, innovating, narrating and etc. Under these labels approaches are presented that look at organizational change as behavioral learning, evolving, and emerging. In the behavioral or adaptive learning approach developed by March and his colleagues, the generative mechanism is behavior modification as a result of experience. In contrast to the cognitive approach, which describes organizational learning as a change in the dominant coalition’s mental frameworks, organizations are conceived as adaptive systems that learn from trial and error and that encode and retain learning in routines.

Organizational learning is without doubt the success story of the 1990s. In this view, organizations are adaptively rational systems directed toward the attainment of goals, whose behavior is generated by rules and procedures that allow them to react to performance feedback. Performance feedback rules – problem-driven search and choice rules – are the basic building blocks of organizations as experimental learning systems. In other words experience leads organizations to develop relatively fixed rules that allow for considerable changes in behaviors (Demers 2007: 115-123).
4. How learning embodies the change?

4.1. Organizational learning

The field of organizational learning explores ways to design organizations so that they fulfill their function effectively, encourage people to reach their full potential, and, at the same time, help the world to be a better place. Before proposing organizational learning main approaches, it’s necessary to mean what is the concept of learning in the organizational literature.

Learning, we propose, is the process of technical change achieved by diffusion (in the perspective of technology absorption) and incremental innovation. In other words, learning is the absorption of already existing techniques, i.e., the absorption of innovations produced elsewhere, and the generation of improvements in the vicinity of acquired techniques (Viotti 2001). Learning is best described through the ‘learning organization’ concept, which Senge (1992: 14) describes as ‘an organization that is continually expanding its capacity to create its future’. Generally, one can distinguish between two different processes of organizational change that are associated with organizational learning (OL): adaptive learning and proactive learning.

Adaptive learning it is assumed to involve a lower degree of organizational change. It is seen as a process of incremental changes, more automatic and less cognitively induced. The limitations of adaptive learning in comparing to proactive learning are also expressed by the different labels which have been used to describe these two types of OL: “Single-Loop versus Double-Loop Learning” (Argyris and Schön, 1978), “Adaptive versus Generative Learning” (Senge 1990).

Cognitive learning turned to the individual’s mental processes. In other words, it is concerned with cognition: the act or process of knowing. It was regarding to residing in the heads of individuals; social, cultural, and technological factors have been relegated to the role of backdrops or external sources of stimulation (Salomon 1993: xii).

4.2. Balanced Scorecard (BSC)

In response to the question “how balanced scorecard companies thrive in the new business environment”, Robert S. Kaplan and David P. Norton (2001) in their book, “Strategy-Focused Organization” explain how adopters of Balance Scorecard throughout the world include large and small, manufacturing and service, mature and rapid-growth, public and private, and for-profit and non-profit organizations achieved remarkable results. Many evidences from companies like Mobil Oil Corporation’s North America Marketing and Refining Division (Mobil NAM&R), CIGNA Corpora-
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...tion’s Property & Casualty Insurance, Chemical (chase) Retail Bank, Nova Scotia Power Inc, and Brown & Root Energy Services’ Rockwater Division and others can be regarded as a reasonable proof for their claim that this program is really a change project.

They believed that one main reason for organizations that had difficulty implementing well-formulated strategies was that strategies – the unique and sustainable ways by which organizations create value – are changing but the tools for measuring strategies have not kept pace. To overcome this problem, they suggested a new approach to managing a strategy-focused organization. The balanced scorecard provided a framework to look at the strategy used for value creation from four different perspectives (Kaplan & Norton 2001):

1. Financial – the strategy for growth, profitability, and risk viewed from the perspective of shareholder.
2. Customer – the strategy for creating value and differentiation from the perspective of the customer.
3. Internal business processes – the strategic priorities for various business processes, which create customer and shareholder satisfaction.
4. Learning and growth – the priorities to create the climate that supports organizational change, innovation and growth.

We believe that the most important perspective to make a better understanding of the strategy and hence provide long term competitive advantage and profitability is the last one. That’s why the learning and growth perspective serve as the foundation for strategies in different types of organizations. If the strategy focused organization use the balanced scorecard, strategy improvement will be possible rather that tactics, by a new feedback system and learning method.

4.3. Modified model for a successful strategy accomplishment

We suggest that learning is the best starting point to achieve a long term, sustainable change strategy. Maybe the low consensus about defining and proposing a model makes it harder to address. A genius design of a model which connect learning strategies to other elements offer an opportunity for executives to align their limited organizational resources including human resources, financial resources, information technology and so on. What is proposed here, take a look at Balanced Scorecard as a necessary but not sufficient tool in its first perspective; Learning and Growth!
A nearer look to the organization reveals that managers have to deal with human behaviors. Although there is usually one person in charge, the managers interact with others in problem solving. So we have to start our course of action from individuals. The process of decision making in an uncertain dynamic environment, where the information are ambiguous and incomplete about future, requires cognition as defined by Stephen K. Reed (2007) as both the acquisition and the use of knowledge. Organizational learning as discussed before includes cognitive learning. Contrasting to the personal life decisions that we all face, organizational goals will guide the group decision making. Some factors like threatening mistakes, competing goals, and changing environment makes it necessary to improve the strategy over the time and hence a dynamic strategy will exist. With both individual cognition and systemic organizational learning, it is likely to have a better perception on what the organization is intended to do; what is labeled as dynamic strategy understanding.

Modified Model for Strategy Implementation

Creating synergy is also important to find valuable combination in which the whole is greater than the sum of its parts. By strategy alignment, cooperation and coordination of different Strategic Business Units (SBU’s), more integrated solutions will be found to enhance strategy accomplish-
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ment. Finally there is a considerable need for feedbacks. Strategy awareness (internal adaptation) and making adjustment to business ever-changing environment can never occur except to have an immediate feedback system. What you can find as a double-loop learning system in related literatures is covered here. By the wide-ranging feedback system a direct communication make the analysis of happenings easier to perform and understand, participation of different organizational level will be enhanced, the budget and resource allocation will be adjusted corresponding to the dynamic environment, and finally goal achievement will be measured simultaneously.

5. Summary

Strategy is a matter of concern for managers. In the rapid changing environment it’s impossible for organizations to adapt the environmental uncertainty. On the other hand if the organizations choose a strategy, they will need to provide a clear understanding of strategies to align its resources directed to the goal achievement. What we proposed in this paper is a modified model for strategy implementation. Our findings show that Balanced Scorecard chooses a proper foundation, but it should be considered that individual cognition stands before organizational learning.

A better understanding of strategy needs both personal cognition and organizational level perception of happenings. It is also a must to have a dynamic strategy in changing environment. If the strategy does not meet the early objectives defined in strategy map, it should be adjusted corresponding to the external and internal alteration. By a wide-ranging comprehension of strategy, aligning resources leads to a great accomplishment. What is planned as feedback has a key role in overall awareness. It makes learning a continuous process which spreads all over the organization. Using this modified model managers can ensure they set genius strategies which works both in poor and good times to have a long standing well-run organizations.

References

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