Money and Finance in Transition

Research in contemporary and historical finance

Economics is today undergoing important shifts in focus and theoretical orientation. In part, this has been a response to the need to address changing economic circumstances, including the collapse of communism and transition to market, globalisation and financial volatility. In addressing those problems economists have also been forced to re-open many long held principles and approaches. This book is a collection of essays addressing themes that are part of that process of critical re-evaluation: exchange rate regimes, internationalisation of investment, and the economics of transition. The book brings these issues together in a way that draws out some of the common themes and issues as well the current frontier of research in each area. It will be of interest to economists as well as those interested in the way economics as a discipline has been addressing important questions about the world we are living in as well as how history can help us to understand it.

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Money and Finance in Transition

Research in contemporary and historical finance

Editors

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Södertörns högskola
In memory of Katie Pratt
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Preface

This collection of essays had its origins in a workshop held at the University of Western Sydney in February 2001. The workshop brought together researchers engaged in research around three basic themes: exchange rate regimes, internationalisation of investment, and the economics of transition. This conference provided a forum to explore research on both historical and contemporary issues in each of the areas. A number of invited papers from international and Australian scholars were organised and other scholars contributed as discussants or participants. Scholars were particularly drawn from a research network based around the Baltic Financial Markets Group at the University College of South Stockholm, and academics at the University of Western Sydney, but included researchers from as far a field as New Zealand, the Slovak Republic and China.

A number of participants commented on the quality of the papers and their complementarity both within the topic areas and across the spectrum. It was partly for this reason that the decision was taken to publish a selection of these papers in this book.

The selected papers are arranged around the three basic themes of the workshop with an introductory essay drawing out some of the common themes and issues of the papers. Taken together, these papers show something of the direction of financial and economic research occurring in these areas. I am sure you will find these papers an interesting and useful addition to the literature.

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Stockholm, June 2003

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Introduction

Research in several areas of finance and economics has been undergoing an exciting (and in some ways perhaps alarming) period of development. The period has seen changes across a wide spectrum of economics, from many of its concepts and methodology to areas of study and the time horizons of research. In the process, economics as a discipline is being forced to reconsider the way many economic and financial processes are conceptualised. Many of these questions remain open ones.

The pressure for change in economics has not come from any single source, but from several directions. One of the most important and powerful pressures forcing economics to reconsider long held concepts and methods has come from contemporaneous developments occurring in the world economy (including the fall of the Berlin Wall, the rapid industrialisation of many developing countries – and the stagnation of others, large-scale privatisation, the internationalisation of finance and of firms, and the instability of exchange rates).\(^1\) A characteristic of most of these developments is that not only were many not predicted by existing theory (such as for instance, the growth and pattern of cross national financial flows), many remain difficult for economic theory to explain (for example ongoing volatility in asset, currency and financial markets, and the pattern of economic change in transition countries). Taken together, these developments have forced researchers to pose questions of economic and finance theory in fresh ways, but in a theoretical environment that is much less secure.\(^2\) Not surprisingly then, the period has been one of renewed theoretical speculation, debate and testing. And economists are finding that developing a satisfactory explanation of many of these developments is re-opening many important questions in economics and finance. It might be said then that economics is undergoing its own period of transition.

These developments have stimulated new as well as reviving earlier approaches to economic analysis (including the explicit introduction of insti-


tutions and transaction costs). They have also led to the development of new fields of economic inquiry (such as the economics of privatisation and behavioural economics).

One way that economists have responded to these challenges has been through a re-examination of historical experiences. Some of this research has benefited from the use of new or previously unavailable historical data. The use of new techniques in data analysis (such as time series econometrics) has also permitted much more robust testing of hypotheses, and allowed many old debates to be reconsidered. Importantly, the research has permitted economic historians to once again play an important role in debates about economic theory (including for instance in assessing theoretical claims for the apparent newness of recent globalisation, as well as in commenting on claims for the durability and efficacy of particular exchange rate regimes).

* * *

This book brings together some of the important strands in recent economic research. It presents research in three of the key areas of recent research: exchange rate economics, the internationalisation of finance and investment, and the economics of transition. Research presented in the chapters also deploys some of the new concepts and categories that have emerged in economic discourse: institutional economics, the theories of internationalisation, and the concept of incomplete contracts and the issue of corporate governance. And several of the papers utilise either new time series econometrics and/or historical approaches to economic problems.

The book is divided into three broad sections organised around the themes of exchange rates, internationalisation of investment, and transition. But there are links between papers in the sections that cut across these themes. Social, political and economic institutions are, for instance not only now seen as critical for transition economics, institutions and rules are important in exchange rate regimes, as they are for analysing forms and pat-

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3 Standard references for modern institutional and transaction cost economics include Alston et al. (1996), Hodgson (1988), Nelson and Winter (1982), North (1990), and Williamson (1975).


5 Indeed, the growing importance of historical research has extended to debates about the recent past, and led one historian to make an explicit case for a ‘history of the present’ (Garton Ash 1999). On historical research on globalisation, cf. Baldwin and Martin (1999), O’Rourke and Williamson (2000), Bordo et al. (2002). On exchange rates, cf. Calvo and Reinhart (2000), Reinhardt and Rogoff (2002), and Eichengreen and Bordo (2002).
terns of international capital flows. And while there is a separate section on international investment, the issue of internationalisation is a theme running through the book. The international environment is critical to understanding exchange rate regimes, and more directly the success and failure of exchange rate regimes depends in important ways on the scale of capital flows they can attract and retain. Of course, the study of transition economics has focussed on the way that these economies can be opened up to the international economy. And of course change (both recent and the longer historical process) is a theme that links the sections. While transition economics has its own section, in both exchange rate regimes and the growth and changing patterns of investment we are studying important transformations and transitions.

The remainder of this chapter considers these themes in turn, but the reader is reminded that the organising themes are topic based, and that the links between are also important. It is in exploring developments in the different areas of economics and what links the separate areas together that publications such as this remind us what constitutes economics as a distinct and developing discourse.

1. Exchange rates and currency crises

The international role of national moneys (exchange rates) in terms of securing international price stability and facilitating international capital flows has been one of the most enduring themes in economics. The international mobility of finance capital is nothing new – a profound process of globalisation and international financial integration occurred in the nineteenth century during the era of laissez-faire capitalism and the heyday of free trade. During this period, and in contrast to more recent experiences, internationalisation occurred through forms of fixed exchange rates, especially the gold standard. There have in fact been several distinct periods of international monetary relations over the last two centuries, with fixed exchange rate regimes being followed by floating-rate regimes. For most of the post-World War II period, however, exchange rate stability led many to conclude that the problem of international money had been settled if not solved. Since the breakdown of the Bretton-Woods system of exchange rates, and the move to flexible exchange rates, there has been a period of much more instability in international monetary relations. This is paradoxical because it was predicted that the move to a floating-rate regime would actually reduce

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6 Eichengreen and Iverson (1999), for instance, argue that the role of labour market and democratic institutions has been critical in exchange rate regimes, while FDI theory, from its inception with Hymer (1960) made institutions central to its conceptual agenda.
monetary instability. Yet it can also be observed that exchange rate volatility has occurred during a period of rapid internationalisation of investment, finance and trade. Not surprisingly, the issue of how different national monies relate, and how to secure the stability and durability of monetary values have moved back to centre stage in economics. And having been reopened by real historical processes, exchange rate economics remains very much an open issue.

The move to a floating-rate regime in the 1970s was promoted ex ante as a way of reducing exchange rate volatility. We now know that the floating exchange rate regime has not only failed to arrest volatility, it has rather occurred during a period of increasing exchange rate instability. This has led many researchers and policy makers to reconsider earlier experiences with fixed-rate regimes, to understand what made them stable, often for long periods, and what made them eventually be superseded by other less binding currency regimes. Indeed, the European Monetary Union is an explicit attempt to mediate exchange rate instability between members of the union. The recent adoption of a currency union by most EU countries has thus given that interest a new twist.

Three of the papers in this section explore earlier fixed exchange rate regimes in an attempt to explore the factors that made them endure and, eventually, break down. They find that different fixed exchange rate regimes have prevailed, and that their functioning was much more complex than ideal-type models have assumed. Importantly the success and failure of various exchange rate regimes seems to be closely connected to changes occurring in wider economic and social environments, which the exchange rate regimes were forced to mediate.

The final paper in the section takes a different interest to the study of financial development. It explores the closely related question of the tension between the global and national functions of money as investment capital. Internationally mobile British capital has been held responsible for significantly retarding the development of British industrial capitalism during this era. More recently, the activities of international hedge funds have been held responsible by some commentators for exacerbating, if not causing, the 1997 Asian economic meltdown. An influential strand of the debate about the ‘British disease’ posits a fundamental disjunction between the international orientation of British finance capital and the development of domestic industrial capitalism in Britain in the late nineteenth century and beyond.

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7 For the work that started the so called ‘rules of the game’ discourse regarding the gold standard, see Bloomfield (1978). For some of the first articles arguing for a monetary approach to the balance of payments during the gold standard see McCloskey and Zecher (1984, 1985) For an important recent work, see Bayoumi and Eichengreen (1995).
While exchange rate dynamics can have a considerable influence on domestic economic stability and performance, international capital mobility in itself can exert a considerable pressure. The paper considers the degree to which this has been the case in the British context.

* * *

Anders Ögren’s study of Sweden’s participation in the silver and gold standard during the period 1834-1913 looks at the tension between the growing domestic demand for credit and means of payment during a period of rapid industrialisation set against the requirement of maintaining the country’s connection to international markets via the specie standard. Ögren shows that even though the theoretical working of a fixed exchange rate as the classical specie standard implied the existence of a finite stock of reserves this was not the case in reality. The adjustment mechanism partly worked according to the monetary approach to the balance of payments, and partly in accordance with the quantity theory. Without providing an answer to this puzzle, Ögren’s paper suggests that the emergence of credit-based economies allows for an alternative explanation of the adjustment mechanism. Such an explanation should involve the financial sector in creating assets to be used as reserves, and the importance of expectations in the valuation of these reserves.

Krim Talia discusses an overlapping, yet distinct international institutional arrangement, the Scandinavian Currency Union 1874-1924. Under this arrangement, Sweden, Denmark and shortly thereafter, Norway, agreed to a form of monetary co-operation, which led to a common currency area. Notes, gold coins and token coins of the three member states were accepted at par and circulated freely in all countries. The currency area pivoted on common adherence to the gold standard, and although the countries often had their currencies valued at different rates externally, the covenant of 1873 made them tradable at par within the union. Until 1914, the currency union worked well, but the suspension of gold convertibility at the outbreak of World War I began a decade long process of gradual dissolution of the currency union. Talia shows that no single factor led to the breakdown of the currency union, but that at least three factors were particularly important: suspension of gold convertibility, growing divergence of exchange rates between union members and finally the smuggling of token coins within the union. Talia’s research suggests that currency unions have been important ways of securing both domestic economic growth and international integration, but that these unions can, like other fixed exchange rate regimes, fall victim to their own success.

Tom Valentine’s paper also explores the operation and the gradual breakdown of a currency union, through which Australia maintained con-
vertibility into sterling during the period 1901-1939. Lasting almost half a century, the Sterling Exchange Standard (SES) was an unusual arrangement. At a formal level, this exchange rate mechanism pivoted around the London funds of Australian banks, whereby changes in their London balances both reflected national trade imbalances, and by impacting on the banks’ total bank reserves would help to influence bank-lending policies back in Australia. As Valentine points out, however, these London funds did not constitute part of the bank’s Australian balance sheets, so that these London funds could only exert credit behaviour in Australia in an indirect effect. Valentine develops a simple econometric model to show that the mechanism indeed operated, but in an indirect way. The SES mechanism could have been made more binding, but at the expense of flexibility. He predicts that a more binding mechanism would, for instance have probably resulted in a deeper depression in the thirties. Valentine’s paper also concludes that sharp increases in wages in Australia during the 1920s, which were partly facilitated by this non-binding exchange rate mechanism, created a greater vulnerability to the depression because Australia entered the depression with a wages overhang. Valentine’s paper suggests that exchange rate stability involves a complex and wide ranging institutional arrangement, and in many ways the durability of exchange rate regimes is contingent as much upon what sort of domestic and international pressures it is expected to absorb, as it is upon the formal elegance and logic of actual exchange rate regulations.

Nalson’s paper, finally, explores the relationship between industry and finance in the British case and concludes that the international mobility of British capital was not a hindrance to British industrial development. A central and according to Nalson, unhelpful strand in the British disease debate, locates a central reason for perceived British industrial lethargy in an alleged rift between industry and finance arising out of the distinctive and ‘exceptional’ structure of British capitalism. The paper presents a variety of reasons why this line of argument tells us as little about the history of British capitalism as it does about the specific historical relationship between industry and finance in Britain. On the one hand, the famous cultural critiques of British capitalism advanced by Perry Anderson and Martin Wiener seriously overstate the degree of long-term industrial retardation in Britain. On the other, because chronic industrial retardation is assumed, the explanation of it necessarily overstates the ubiquity and potency of anti-industrial cultural forces disrupting industrial capitalist development. Nalson argues that capitalism in Britain has indeed developed in distinctive ways but not predominantly for the cultural reasons offered by the great cultural critiques. Britain’s industrial forerunner status, the pioneering of export-driven industrial capitalism by a small island nation, and Britain’s geopolitical responsi-
bilities in the twentieth century are presented as the decisive and distinctive features of the development of capitalism in Britain. According the Nalson, the evidence examined overwhelmingly suggests symbiosis rather than a rift between, financial and industrial capital.

2. Internationalisation of finance and investment

The last twenty-five years has seen the internationalisation of finance and investment in a way and on a scale that was quite unexpected. It used to be thought that finance and investment were inherently national in character. In order to overcome the additional costs of operating abroad, firms were for instance thought to require a special advantage over firms in host countries. During the 1950s and 1960s, it was thought that any such advantages were likely to be quite rare, and so the study of the international firm remained an important but marginal area of study. In the period since then, international investment by firms has become much more common. The idea that a special advantage is required to sustain international operation is now not very persuasive. Research now attempts to understand the way international investment is being integrated into the normal operation of firms. But a comprehensive theory of international business still remains elusive.

Similarly, the study of international capital flows, especially as it was consolidated under the Bretton-Woods regime of capital controls contained a strong assumption that capital flows would be of a limited nature and would function at the margin mainly to channel funds from capital abundant countries to capital scarce countries. International capital flows were expected to remain secondary to trade in developing the global economy.

The break down of the Bretton-Woods regime and the rapid expansion of international financial flows from the 1970s onwards, and the concentration of those flows between leading industrial countries, and the exchange rate and financial volatility that has accompanied these developments has been confronting to international finance theory. For some, it has even represented a new era in world economic history.

The issues of international investment and finance are drawn together in the internationalisation of banking. The first paper in this section makes the point that the distinction between finance and portfolio flows and direct

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9 For a critique of the theory, see Fieldhouse (1986) and Buckley (1990).
10 For some of the development in FDI theory see Pitelis and Sugden (1990), Rugman (1979), Dunning (1980 and 1988).
investment is a creation of balance of payments accounting. The distinction has relied on certain assumptions about the institutional behaviour of banks and industrial firms, as well as on the particular forms that internationalisation of investment and finance would take. As these forms have changed, balance of payments categories have had to be modified. This provides some logic to the fact that distinct theories of capital, based around these distinctions have been unstable over time.

Several other papers in the section show that financial institutions have been at the forefront of recent internationalisation. The papers show that there are many features that are similar for the internationalisation of banks, both from Australia and Scandinavia. All have, for instance, established offices in key international financial centres, such as London, New York, Hong Kong, Tokyo and Singapore. The driving forces behind their expansion seems to be as a means of communication with other international banks, to be able to gain access to first-hand information concerning the international capital market and to provide access to key financial markets. This surprising result of the research in the papers indicates that a large amount of international expansion among financial organisations can be explained by factors that have not usually been employed in the theoretical literature on internationalisation.

Another conclusion that can be drawn from the papers concerns the question of whether financial organisations with foreign establishments should be regarded as truly international entities or as basically domestic players with an international network. Authors draw different conclusions, where some argue that banks are still national in character. Other authors suggested that even the appearance of nationality might be related more to the need to create an image of acting as a domestic entity (even for banks moving to new markets). There was more general agreement that the boundaries between international and domestic financial organisations are becoming harder to define, but also that the hypothesis of financial institutions acting as truly global entities without any ties to national economies is questionable.

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Michael Rafferty uses the recent international merger boom and trends in the financing of foreign direct investment to pose questions about the concept of FDI as an economic category, and about the way international capital flows are measured and understood through balance of payments accounting. He notes that much of the boom in FDI occurred in banking and financial services, traditionally thought to be institutions of portfolio not direct investment. Much of the funding of merger-related FDI occurred through internationalised credit and equity swaps, and these have been diffi-
cult to incorporate in a consistent way into FDI measures. This has added to the already strained concept of FDI. Recent changes in the balance of payments definition of FDI is in part a recognition of these difficulties, but Rafferty suggests that in the process the essence of the concept of FDI is now becoming different to the one that has been at the heart of economists conception.

Nick Coates examines the behaviour of ‘Australian’ pension funds in the context of Australia’s national savings policy, as presaged by the Fitzgerald Report (1993) and effected by the Superannuation Guarantee (1993). One of the key goals of this policy has been to reduce Australia’s external imbalance by increasing Australia’s pool of national saving and thereby reduce reliance on overseas savings to fund investment. The core of Coates’ argument is that the viability of this agenda is drawn into question by the globalisation of Australia’s Superannuation sector. For example, a national savings policy may ‘capture’ a stream of savings, which is then lost as a source of domestic investment because of the global mobility of savings funds.

Pension funds designated ‘Australian’ may not necessarily be of Australian nationality – they may be vertically or horizontally linked to TNCs with large offshore investment portfolios. Coates observes that “market-pooled Superannuation funds are generally part of large financial multinationals” and that “the nationality of the savings they are investing globally is also questionable”. The characteristics of the funds are illustrated in a case study on AMP, formerly called Australian Mutual Provident Society. AMP one of Australia’s largest insurance companies is now a predominant mediator and funds manager of superannuation savings and a TNC in its own right.

Coates examines how AMP has utilized its dominance as a funds manager of this so-called national savings, to facilitate the organisations own international diversification. Now, particularly due to its UK funds management operations, the majority of its profits and assets are held outside Australia. As AMP internationalises so has it increased its international diversification of its pension fund investments. “The AMP example shows, the business from this (national) savings policy facilitated both the global expansion of the institution and its (international) investment of these pension savings”. Coates argues that these developments show how naive the original 1992 policy justification for introducing mandatory pension savings really was in so far as it was conceived as a national investment strategy.

David Tripe and Claire Matthews investigate the international expansion of the four major Australian banks. The paper starts out with a review of several theoretical approaches that have been used to explain the internationalisation of banks. This extensive framework is then related to the history of international expansion of the major Australian banks, and how the
individual stories relates to the theoretical models. Finally, attention is given
to the profitability of the banks international operations, and consideration
given as to what extent these may explain the banks internationalisation.

One of the important conclusions in the paper is that none of the different
approaches can solely explain the internationalisation of the four banks. The
theory with the highest explanatory ability, according to the authors, is the
four strands of Industrial Organisation theory. Several of the establishments
are conducted with the aim to secure home-market based business, when
customers are expanding abroad.

An interesting question that is indicated by the paper is that banks, which
have expanded internationally, were more profitable than the regional banks
whose business remains solely domestic. It is not strictly proven in the pa-
er, because on an average international operations are not more profitable
than domestic business, but it raises questions for further research. Is the
greater domestic profitability a reflection of a different mix of business and
do the banks’ international networks provide a basis for increased profit-
ability in their domestic operations?

Sue Wilkins’ paper is a micro-study that discusses international diversifi-
cation and investigates the international strategies for four major Australian
banks. Wilkins uses Steven Davis’ four-stage model to investigate the inter-
national strategies of these banks. The model focuses on where future profit
growth of banks is expected to be earned, suggesting that the international
life cycle of banks can be represented by four stages; a foreign department,
‘going international’, multinational or finally a global banking organisation.
In the first two stages banks would mainly be serving domestic customers,
while in the latter two, multinationals and others based in overseas markets
would be the main interest for banks. In the fourth stage the distinction be-
tween domestic and international would deteriorate as the focus for the
banks shifts towards customer or product profitability, rather than to the
previous distinction between domestic and international profitability. In that
sense, the fourth stage of the model would be a situation where the banks
become truly global, with no direct ties to a single national market. Ac-
cording to Wilkins the model is a useful way of understanding the interna-
tionalisation of banks from Australia, although the process has been neither
sequential nor unidirectional.

Mikael Lönnborg studies Swedish investment into the financial sector in
the Baltic States (Estonia, Latvia and Lithuania). One of the most popular
responses to the growing integration of capital markets has been for finan-
cial institutions (especially banks and insurance companies), to adopt re-
gional integration strategies. The Baltic region is mooted as one such
financial region. This has important implications for the Baltic financial
system, for example through the diffusion of experiential knowledge to do-
mestic actors in the transition economies. Hence, it is a process where foreign investors meet an evolving institutional set-up with structural uncertainty and on the other hand domestic actors has to face international competition in an early phase of their development.

The paper is focused on four major Swedish banks that have all established some form of representation in the Baltic States. The driving forces behind the Swedish banks expansion, according to official statement, have been to follow their customer abroad as well as a mean to seek for new markets. In none of the cases the banks have stated that their expansion have been influenced by domestic competitors. This can be questioned because the presence of Swedish banks in the area has implicitly meant that the home-market competition has been exported to the Baltic States.

One striking feature is that only one of the banks has, except to international financial centres, to a large extent established business inside the European Union or on other mature capital markets. Thereby, it can be argued that investing in the Baltic’s can be a defensive way to sustain a sufficient growth to avoid take-overs from more solvent European competitors. So from this point of view, the expansion of Swedish banks to the Baltic States can be regarded not as demonstration of their financial strength but more as an indication of low competition power on the West European banking market.

A wider conclusion is that the rapid changes of the financial sectors in connection with privatisation, liberal legislation concerning inward FDI and financial crises have performed a situation where all Baltic States have a high concentration of foreign financial organisations. A positive effect of these events have been a successful transformation of the financial system but to be able to say anything about the long-term effects of a financial sector dominated by international actors, needs further research in the future.

3. Institutional and structural change in transition economies

The topic of institutional change and economics has undergone profound change and revival. Perhaps nowhere is this been more so than in the area of transition economics. In the early years of transition, there was an implicit assumption that markets were spontaneous creations, and all that was necessary for successful transition to a market-based economy was for the state to withdraw. In this context, the main debate seemed to be over the pace at which such a ‘transition’ could occur. On the one hand, those advocating a rapid pace of change (the so-called ‘shock therapy’ school) suggested that
rapid change was not only possible, but also necessary. It was seen to be critical to make a clean break with state-planning as quickly as possible to restore the price mechanism.\textsuperscript{12} Market processes would rapidly displace state planning structures, and although costs were anticipated (especially through a temporary output loss), it was argued that the sooner the process was undertaken, the lower the overall costs of transition would be. The alternative argument (or what became known as the ‘gradualist’ approach) contended that a slower rate of change was needed to allow markets time to adjust economic calculation to new types of pricing signals.\textsuperscript{13} The record of actual transition has shown that both arguments were wrong, or at least to some extent missed critical elements of the transition process. In many cases output and income falls were much deeper and more prolonged than predicted, unemployment has risen dramatically and poverty, tunnelling and corruption have all become widespread. In trying to explain the transition process in general and observed differences among transition countries it is not the particular design of and rate with which the initial reform measures (macroeconomic stabilisation, liberalisation and privatisation) were undertaken that seem to have greatest explanatory power. Rather the actual process is better explained if one also takes into account developments in what is broadly termed institution-building. Indeed, as recently noted by the World Bank, “…a key deficiency of the transition has been insufficient attention to building a market-friendly institutional framework”.\textsuperscript{14}

The missing element in the initial debates (and in the initial reforms) was that markets were not conceptualised as institutional mechanisms that require forms of state regulation and protection to operate. This refers of course not only to the role of the state in the creation and protection of property rights, but also to other important institutional mechanisms. One of the most important institutional characteristics affecting companies is the form in which the agency problem is structured. The agency problem is now normally discussed under the umbrella of corporate governance, which also encompasses other aspects of the corporate environment. The key institutions and actors in the corporate governance process are for instance known to affect the possibilities and ways firms access finance for investment – and thus indirectly also the potential for growth of the respective economies.

Two papers in this section deal with various aspects of institution-building. Hromkova and Olsson take a very broad approach, looking at the

\textsuperscript{13} Cf. Murrell (1991 and 1992); for a good overview of the debate, see Slay (1994).
\textsuperscript{14} World Bank (2002), p. xxi.
general issues and problems of the regulatory harmonisation with the European Union that is on-going in the majority of the European transition economies. They use the case of the Slovak Republic as a way of drawing out some of the key issues and problems in corporate governance for such countries. Olsson and Alasheyeva look at a more particular aspect of institution-building necessary to make equity markets a viable option for finance, namely the institutional and regulatory support for a transparent market. In the third paper of the section another important topic for transitional economies is explored, namely the macroeconomics of transition. Warr and Worner address this issue in a study of international trade and exchange rates in the Laos economy. They show international trade can generate pricing and output shocks on the domestic industry, which can render transition economies vulnerable to the so-called Dutch Disease. Tian and Gou, finally, approach the question of markets from the perspective of modern finance theory. In particular, they compare market efficiency tests for US and Chinese stock markets and find that profitable trading rules exist in both markets, although the results are sensitive to testing methods and transaction costs. They provide a perspective on markets not just as institutions but also as forums for price discovery and profit making.

* * *

Warr and Warner’s paper allows us to observe the process of transitional economic reform in the context of a meticulously analysed, international macroeconomic study of the Laos economy. In the late 1980s a program known as the New Economic Mechanism (NEM) was initiated in Laos. It represented a fundamental shift toward a market-oriented economy away from the socialist model introduced by the declaration of the Lao Peoples Democratic Republic (PDR) in 1975. Warr and Warner focus upon two key problem areas of this transitional process – agriculture and macroeconomic management – and the linkages between them.

The authors stress that market reforms have produced a Dutch Disease effect in Laos. Increased foreign investment (and the boom in neighbouring Thailand) induced a boom in services and construction, which attracted resources away from agriculture and resulted in a rise in the prices of non-tradable relative to tradable goods. Because agricultural commodities became more like tradable goods under the NEM, the reform process has itself resulted in a long-term decline in food production. As a consequence, government investment in agriculture increased substantially in the late 1990s because of concerns about the erosion of food self-sufficiency (despite Laos’ lack of comparative advantage in rice production).

The authors stress that the reform process was further complicated by the 1997 Asian crisis, which produced unique results in Laos. The crisis coin-
cided with a massive government-spending program, currency depreciation, reduced tariff revenues and therefore produced very large budget deficits. These were financed by means of an expansion of the money supply fueling already substantial inflationary pressures. Elsewhere in Asia the crisis produced recession and mild or no inflation. In Laos the crisis was marked by rapid inflation and no recession. Other countries swallowed restrictionist IMF medicine. The Lao government followed an expansionary policy.

A note of warning is sounded by the authors about the distinctive Laotian pathway into the world of the market. The civil servants directing the process of reform, some of them former *apparatchiks* privately distrustful of the NEM, have seen their real wages dramatically cut by inflation. Corruption is now a more serious problem than before the NEM, suggesting that the conditions for a period of domestic instability are probably forming.

Hromkova and Olsson explore the relationship between institutional factors (specifically, legal reform) and economic development in the context of the recent experience of the Slovak republic as an example of a transitional economy. The Slovak experience offers unique insights into this relationship because of the necessary rapidity of change in Slovakia. The Slovak case is further complicated by the necessity of a ‘second wave’ of institutional reform. Superimposed over the transition from socialism to capitalism is the transition to membership of the European Union. The authors describe this process as an example of “harmonising a national regulatory framework with an established supra-national framework”. After January 1st 1993 the situation became even more complicated. The ‘velvet divorce’ with the Czech Republic necessitated the establishment anew of the institutions of statehood.

The authors conclude that the frequency of legal change during the transitional period indicates that the legal framework has been fundamentally inadequate. This is seen as a consequence not only of the necessary haste of legal reform in response to rapid economic change, but also because the legal changes have been largely inorganic – they have not “grown from inside the system” but have been artificially introduced from outside it. It is postulated that amendment to existing legal arrangements has been preferred to re-codification because of the prohibitive complexity and impracticality of the latter. The analysis suggests that in the main law reform has responded to the exigencies of economic change rather than itself “initiating or leading” it.

Olsson and Alasheyeva’s paper examines in considerable detail the difficulties encountered in a number of Baltic, central and eastern European transitional economies, in establishing and administering EU stock market regulations requiring the disclosure of certain forms of equity ownership. It is stressed that this is an issue of critical importance for the success of the
transitional process because of the urgent need for transparency and informational efficiency in the infant capital markets given the extent of economic liberalization and privatisation.

The paper shows that the results of the implementation of Council Directive 88/627/EEC are mixed, with considerably varying degrees of success in the countries examined. The authors examine some of the possible reasons for the slow and varied pace of implementation. These include a range of factors such as: lack of government understanding of the meaning of the directive; government perception that the directive is unenforceable if implemented seriously; the corruption of the privatising process in some areas producing vested interests in non-disclosure; and variance in the legal traditions of the countries examined. Olsson and Alasheyeva caution that their explanatory framework and consequently their conclusions are provisional.

One of their most important findings is that ownership has become highly concentrated and seems to be increasing in all the countries studied. This high level of concentration is often exercised not so much through traditional legal means, but through pyramidal structures and through informal co-operation on the part of owners and directors. This highlights just how large the task of increasing market transparency, but also how important it is also.

Instead of focussing specifically on the dilemmas of recent transition, Tian and Guo’s paper looks at an issue that is of importance to both emerging and established financial markets, the issue of market efficiency. The paper presents results of research on tests for market efficiency in both a developed capital market (the US) and an emerging capital market (two stock exchanges in China). Rather than basing their analysis on the arbitrary selection of just a few simple technical trading rules, the authors test “a wide range of more elaborate rules of moving averages”. The consequently wider scope of their analysis yields results contrary to the findings of earlier work in the field, such as Brock, Lakonishok and LeBaron’s 1992 paper, which found significant predictive power in technical trading techniques.

Their analysis of extensive US equity data strongly supports the argument that technical analysis lacks predictive power and that the US equity market has been an overwhelmingly efficient market. On the other hand, potential excess returns were found in the Chinese stock markets in the period studied. However, adjusting for the higher cost of trading in these markets reduced excess returns to more marginal levels, suggesting that only informed traders could probably have earned excess returns. Tian and Guo’s important work also alerts us to the critical role that research methodology plays in determining the outcome of research into the vexed question of market efficiency.
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ANDERS ÖGREN

An overview of the international adjustment mechanism and the classical specie standard in Sweden, 1834-1913

1. Introduction

This paper discusses some perspectives and results from my licentiate thesis Expansion of the Money Supply, Competitive Note Issuance and the International Adjustment Mechanism: Sweden under the Silver and the Gold Standard, 1834-1913. The licentiate thesis focused on the contradiction between the task of supplying sufficient credits not to impede economic growth, and at the same time not endangering the specie standard, which functioned as the connection to international markets. Two forces emphasised in the licentiate thesis as important influences behind the expanding Swedish economy were foreign long term capital flows, and the growth of credit due to the expansion of the Swedish banking system.

The aim of the paper is to outline a study of how the international adjustment mechanism worked in Sweden under the classical specie standard 1834 until 1913. From this perspective two themes are discussed; how the specie standard could be maintained in Sweden at the same time as a rapid expansion in economic activity, and the changing and elastic relationship in the growing credit economy between reserves, the money supply and prices.

In 1834 silver was re-established as specie standard in Sweden after a break of twenty-five years. This was the beginning of a period of eighty years of a fixed exchange rate system, from 1834 until 1914. The change from a silver to a gold standard in 1873 was an un-dramatic adaptation to the European conditions of the time. According to Eichengreen and Flandreau, the fact that a country adhered to a convertible specie standard was more important for economic growth than was the choice over silver or gold

* For valuable comments I would like to thank Torbjörn Engdahl, Hilda Hellgren, Camilla Josephson, Håkan Lobell, Mikael Lönnborg, Mikael Olsson, and Michael Rafferty. I am also grateful to Marc Flandreau, and Lennart Schön for sending me data. None, of course, is in any way responsible for what follows in this article.
as specie standard, and subsequently the specie standard itself was fundamental for the economic growth of Sweden.\footnote{Eichengreen and Flandreau (1994), pp. 2-3, 6-8.}

One specific feature of the specie standard regards its role as an international adjustment mechanism in the context of a finite world stock of high powered money, silver or gold, to be used as reserves and basis for note issuance. The idea of the fixed stock of reserves has provided the basis for the explanations of how the adjustment mechanism in economical relations between countries was conducted.\footnote{Kenwood, A.G. and Lougheed, A.L. (1999), p.118, Triffin (1985), pp.121, 128-129, 133.}

As seen in the important research of Jonung, different theories and empirical research regarding the adjustment mechanism under the classical specie standard raise questions about the causality at work in this period. According to Jonung’s \textit{Studies in the Monetary History of Sweden} (1975), the money stock seemed to have impact on prices both in the long and in the short run, supporting the quantity theory.\footnote{Jonung (1975), pp. 191-195, 203, 208-211.}

This is in accordance with the price specie flow theory, which predicts that the money supply is determined by the balance of payments, and in agreement with the quantity theory, which predicts that changes in money supply directly affects domestic prices. Changes in domestic prices will in turn encourage or discourage exports, restoring imbalances in the current account. What is known in monetary policy terms as the ‘rules of the game’ meant that for this adjustment process to occur, monetary policy would tend to amplify the effects of the capital flows.\footnote{Bloomfield (1978), pp. 47-49, Bordo (1984), pp. 25-26, Gomes (1993), pp. 18-21.}

In 1984 Jonung published a paper on the Swedish experience under the gold standard and its possible following of ‘rules-of-the-game’, \textit{Swedish Experience under the Classical Gold standard, 1873-1914}. According to Jonung, Sweden was far from a pure gold standard case during this period, and the Riksbank did not follow any ‘rules of the game’. Moreover, the Swedish experience under the classical gold standard was well described within the theory of the monetary approach to the balance of payments.\footnote{Jonung (1984), pp. 389-393.}

In its most binding form, the monetary approach to the balance of payments assumes the law of one price, perfect international capital mobility, and price flexibility in all markets.\footnote{Although McCloskey and Zecher argues that the monetary approach can do without the law of one price (McCloskey and Zecher (1984), p. 122).} Changes in the reserves of the central banks are only illustrating that the domestic money market is not in equilib-

\footnote{Under the gold standard 1874-1913 the money stock increased with 5.2 per cent yearly and prices with only 0.2 per cent.}
rium, the balance of payments being one instrument for that adjustment to take place. The causality is the opposite of the causality in the price specie flow mechanism. Rising international prices will lead to increased demand for money, which in turn will lead to an eventual inflow of reserves. Monetary policy has little, or no effect, as in the case of prices also domestic interest rates and money incomes are ultimately set in the global arena.\(^{21}\)

Both the contradictions in the theories and the empirical observations highlight the problem of explaining the working of the classical specie standard as an international exchange rate system. The intention in this paper is to discuss observations regarding the international adjustment mechanism in Sweden in a manner that outlines specific questions for further exploration.

2. Keeping convertibility and importing capital

The question is what made Sweden successful in maintaining the specie standard? As seen in figure 1, the Swedish trade, represented by the current account, was not providing inflow of any foreign reserves.

Before the crisis of 1857, capital flows providing changes in foreign reserves occurred largely in the form of trade related capital movements. After the parliament in 1853/54 decided that Sweden should speed up the building of railroads, the major form of foreign capital flowing into Sweden was capital borrowed by the National Debt Office.\(^ {22}\) During the period 1834 to 1910, a total of nearly 1.8 billion kronor in bonds were issued outside of Sweden, to be compared with the total money supply in terms of M3 as late as in 1905.\(^ {23}\)


\(^{23}\) Flodström (1912), pp. 812-815, Schön (1989:2), pp. 243, 249, 255 The importance of foreign capital for the Swedish industrialisation has been a matter of debate. In 1947, a study of industrial financing in Sweden, 1830-1913 by Gårdlund, concluded that in this period, Swedish companies were nearly independent of foreign capital. The study of Gårdlund found rather small amounts of direct foreign credits in the industrial companies studied (Gårdlund (1947), p. 128). This interpretation has been revalidated primarily by Schön, pointing out the huge importance of foreign capital in the Swedish process of industrialisation. (Schön (1989:2), pp. 238-242).
Considering the size of Swedish foreign loans, and adherence to a specie standard, it seems something of a mystery that Sweden did not experience any major crises. Concern about the foreign debt really did not arise until in the early twentieth century in connection to an increase in emigration that disturbed the national pride.\textsuperscript{24} It has been estimated that by 1910, Swedes probably owed more to foreign countries than citizens of any other country in the world. Sixty years of chronic current account deficit had raised the foreign debt to approximately three quarters of the entire GDP.\textsuperscript{25}

Responsible for the official Swedish borrowing, the National Debt Office succeeded in importing large amounts of capital to Sweden. Until needed by the State, capital was placed by the National Debt Office in the domestic capital market, often as loans to banks and other financial actors. The Swedish central bank, the Riksbank, reacted to this situation, claiming that the changes in money supply by credits from the National Debt Office had impact on the Riksbank’s ability to maintain the specie standard.\textsuperscript{26}

Having the Riksbank responsible for the adherence to the specie standard, at the same time as another authority had responsibility for arranging the state’s official borrowing, was apparently confusing. But there was one ad-

\textsuperscript{24} It was only then that wealth in Sweden became a matter of official concern and evaluation, and in accordance with this, the size of the foreign debt was studied. This is why Swedish bond loans during the nineteenth century are well documented (see Flodström (1912), pp. 812-815).

\textsuperscript{25} Schön (2000), p. 270. Despite this, the National Debt Office the very same year launched a large bond loan on the foreign market to ease the constrained situation on the Swedish money market (Schön (2000), p. 262).

vantage with this system in the eyes of the parliament. If the Riksbank applied for larger loans abroad, as it did during the crisis of 1857, this damaged the reputation of the Swedish currency and endangered convertibility. If the National Debt Office did the same, this would not affect the Swedish currency in the same manner.27

The bond loans were aimed primarily at financing investments in domestic infrastructure, and the official reason for turning to foreign capital markets was that borrowing there was cheaper than within Sweden.28 But many of these bond loans were also made in connection to distressed situations on the Swedish money market. On a number of occasions the Riksbank in times of decreasing reserves involved itself with other Swedish actors planning foreign loans, most often the National Debt Office.29

The availability of foreign capital that could be used in times of decreasing reserves to defend international convertibility was probably important for preventing speculative attacks on the Swedish currency. Perhaps the mere knowledge of this made it unlikely that a speculative attack on the Swedish currency would succeed. At the same time, adherence to the specie standard probably made it easier and cheaper for Sweden to borrow abroad, and in that perspective the change to the gold standard in 1873 signalled to foreign lenders and investors that Sweden as a debtor country would honour its commitment to them.30 Thus, the specie standard can be viewed as having worked in two ways in the Swedish experience. Foreign capital became available to a higher extent, and was probably cheaper, than if Sweden had operated under a nonconvertible fiat standard. This foreign capital was also in itself a guarantee against speculative attacks on the Swedish currency.

According to Bayoumi and Eichengreen, adjustments in prices and quantities of output occurred more rapidly during the gold standard than in later exchange-rate regimes. Their conclusion supported the monetary approach to the balance of payments; under a commodity standard, such as the gold standard, money supply would adjust through the balance of payments to restore equilibrium to asset and commodity markets.31

27 Davidsson (1931), pp. 136, 141-142, 147, 149-150, 163-164.
28 Swedish interest rates were generally at a considerably higher level than in England and Germany. Lindahl, Dahlgren and Kock (1937:1), p. 274.
29 Schön (2000), pp. 262-263, Simonsson (1931), pp. 40-41, Ögren (1995), pp. 32-33, 35-36. Still the Riksbank and the National Debt Office in many respects competed over power in the same areas. In 1875, it was “decided” by the parliament that the Riksbank and the National Debt Office should consult one another in how to dispose the capital. This “decision” was made after some pressure from the Riksbank on the parliament to decide in the question of which actor that was responsible for the Swedish currency after all.
31 Bayoumi and Eichengreen (1995), pp. 7-11, 20-21. This study included seven countries, among them Sweden.
Countries exporting capital could protect themselves from exchange rate fluctuations in times of economic recessions by contracting capital exports. Debtor countries, such as Sweden, on the other hand should have experienced even larger fluctuations in the availability of capital. As a consequence, during economic recession debtor countries should have experienced convertibility problems.\textsuperscript{32} In the Swedish experience, fluctuations in business trends tended to have impact on trade activities.

\textit{Figure 2.} Annual change (\%) of Swedish exports and imports, 1835-1913

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure2.png}
\caption{Annual change (\%) of Swedish exports and imports, 1835-1913}
\end{figure}

\textit{Sources:} Lindahl et al. (1937:2), p. 585; Schön (1999)

In years of crises, imports declined more rapidly than exports, and during years of rapid economic growth imports increased rapidly.\textsuperscript{33} From a pure trade balance point of view the recessions seemed beneficial, but at the same time these recessions were probably linked to changed expectations about future prices, leading to diminishing prices for financial assets which when combined with more expensive credit, helped accentuate the effects of the recession.

According to Schön, who studied Swedish long-term borrowing, the lack of speculative attacks on the Swedish currency could partly be explained by

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
 & D(EXPORTS) & D(IMPORT) \\
\hline
D(GDPCV) & 0.30 & 0.76 \\
D(GDPVOL) & 0.17 & 0.52 \\
\hline
\end{tabular}
\caption{Correlation between changes in GDP measured in current value and volume.}
\end{table}


\textsuperscript{32} Triffin (1995), p.127
\textsuperscript{33} Between 1834 and 1913 yearly changes in imports to a larger extent than exports positively correlated with changes in GDP measured in current value and volume.
the low degree of information regarding the impact of foreign debts. This explanation focuses on one aspect of the working of the classical specie standard as such; that international convertibility was secured by the reserves of the central banks, and as long as notes were not issued to an extent that made reserves of inadequate size to cover these notes, other parts of the creation of the money stock was of no, or at least lesser, concern. The actions of central banks to preserve a ratio of reserves to notes were viewed as the critical prudential standard in an international context. As long as this was fulfilled some pressure on the fixed exchange rate was relieved, and this makes the changes of the reserves of importance despite their low impact in size. Clearly, changes in the size of the reserves was the indicator that signalled that action had to be taken by the Riksbank to preserve convertibility.

Even though it tried, the Riksbank could not insulate the country from the effects of international capital flows, especially once borrowing on foreign capital markets started to rise from the late 1850s onwards. What the Riksbank could and did do, was to guard the relationship between issued notes and the reserves that served as basis for the international convertibility.

Despite having responsibility for the specie standard, the Riksbank has been described as a ‘cold-blooded’ actor, destroying the domestic Swedish business life by systematically imposing the so-called ‘strangling system’ upon the Swedish credit market. These deflationary policies employed by the Riksbank, (which was seen to accentuate the recessionary phase of the business cycle), has led to the claim that the Riksbank, at least prior to the 1890s, due to a lack of knowledge, followed a single-minded policy of defending convertibility.

The classical specie standard worked, as with any fixed exchange rate regime, such that all other objectives of the monetary authorities had to stand behind the primary objective of maintaining international convertibility. If the money stock in circulation was by definition too large in relation to the reserves, reserves had to be increased or the money stock must decrease. Throughout the entire period of 1834 until 1913, from the first drain of reserves in 1837 until the 1907 to 1910 recession, the Riksbank interfered directly on the domestic credit market by ‘strangling credits’. It is true that from the 1870s onwards, the Riksbank tried to decrease its notes in circulation by raising the discount rate, but in most distressed situations it ended up

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36 Brisman (1931), pp. 189-191 Brisman did however not denote it strangling system after the 1870s, in the crisis of 1890 it was suddenly an expression of sound monetary policy.
having to decrease its notes in circulation directly by cancelling credit. Thus, the ‘strangling system’ was one option used over the entire period to succeed in the maintenance of the specie standard. The political situation of the time also made it possible to follow all demands to maintain the specie convertibility, and while doing so disregard other consequences inflicted upon the economy as fall in output and employment.

3. The Riksbank and the elasticity of reserves

Countries importing capital, such as Sweden, should have suffered contractions of credit (from the capital exporting countries) to an extent that would have drained reserves in times of economic distress. But, exchange rates were kept stable as in the Swedish case.

During the entire period 1834 until 1913, changes in the international business cycle affected the reserves of the Riksbank in a positive manner; i.e. as crises occurred in other countries these crises were illustrated in Sweden as decreasing reserves. Apparently it was possible that the reserves in different countries were diminishing at the same time, or growing.

One reason that a small capital importing country, such as Sweden, could escape some pressure during changes in international business cycles might be traced to the components of the Riksbank’s reserves. In theory, the specie standard worked through one finite world stock of high powered money, gold and silver, to be used as reserves, and the fixed relationship between the country’s holding of these reserves and the money supply. In reality, there was considerable elasticity in this system.

There were three ways in which the reserves of the Riksbank did not follow the ‘ideal’ specie standard model. First, during international economic recessions, the Riksbank could change the legal limitations for note issuance, by for instance accepting a lower than normal backing of its issued notes. Second, the Riksbank could hold assets that did not allow for note

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37 On the domestic arena, crises meant a scarcity of credit that during the more severe crises led to a complete stop in the provision of credits, no matter how good collaterals that were offered. This happened for instance in the crisis of 1878 and 1879, and shows that credit was not supplied to the extent demanded during all circumstances (Ögren (2000), p. 107).


39 The correlations between monthly changes in per cent of the reserves of Bank of England, Banque de France and the German Reichsbank for the period 1880 until 1913 were not negative. A small positive correlation was found between the reserves of the German Reichsbank and the Banque de France (0.190), and a stronger correlation between the German Reichsbank and the Bank of England (0.463), both these were significant at the 1 per cent level. No significant correlation was found between the reserves of Bank of England and Banque de France. (Flandreau (2000)).
issuance, but that could be transformed into reserves by selling them off in the financial markets, most notably Swedish state bonds. Third, the reserves also consisted of holdings other than silver or gold, most notably foreign state bonds.

Figure 3. The Riksbank’s reserve in current value (1000 Kr), and the reserves backing of its issued notes, 1834-1913

![Graph showing the Riksbank's reserve and the reserves backing of its issued notes, 1834-1913](image)

Source: Sveriges Riksbank (1931), pp. 54-71

Figure 3 above shows that the nominal size of Riksbank reserves was surprisingly stable during the period 1834 to 1901. Foreign loans that started to pour into Sweden from the late 1850s did not help consolidate the reserves of the Riksbank until the closing years of the century.

The first feature that made the relationship between the reserves and the money stock more elastic was the legal limitations for note issuance. During the business cycles the Riksbank could alter its issuance of notes within the legal instructions; that is, it could utilise its right to issue notes to different degrees during inflows or outflows of capital. Throughout most of the period of 1834 until 1913 the Riksbank allowed its backing of notes to increase as the size of the reserves increased, and vice versa.  

In 1872 the Riksbank established a fund consisting of holdings not counted as part of its official reserves, which was to be used to counteract

40 Correlations between percentile changes in the size of the reserves and the backing of notes were highly positive and significant at the 1 per cent level for both the silver and the gold standard period.
drains of the reserves in times of crisis. The existence of a special fund to employ in times of diminishing reserves theoretically hindered the price specie flow mechanism. On the other hand, it should be noted that besides ensuring convertibility, the Riksbank was also charged with ensuring stable domestic credit conditions. The Riksbank’s role in ensuring stable domestic credit was not as important as maintaining international convertibility, but under the classical specie standard the Riksbank did not adhere strictly to any ‘rules of the game’.

The fact that the Riksbank was the central bank in a small peripheral country possibly allowed it to make the reserves more elastic than the specie standard otherwise would have allowed. Credit instruments besides the theoretical finite world stock of specie, were used as parts of the reserves. At the same time as the Swedish state issued large bond loans on international capital markets, the Swedish Riksbank used bonds issued by the states in other countries operating under the specie standard, as part of its reserves from 1845 until 1912.

*Figure 4.* Foreign holdings in the reserves of the Riksbank in per cent of total reserves, 1845-1912

![Graph showing foreign holdings in the reserves of the Riksbank](image)

*Source:* Sveriges Riksbank (1931), pp. 54-71.

State bonds were not the only type of foreign asset held by the Riksbank. In addition, the Riksbank also had deposits at banks abroad, and from 1858 until 1870 it held foreign bills of exchange in its reserve system. In the Swedish experience, a transfer of purchasing power by the Riksbank investing in state bonds from any of the core countries of the specie standard would not force the Riksbank to lower its note issuance, since it simply was

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an exchange of one kind of reserve asset for another. If central banks in other countries did the same, as economies expanded together, the value of the items used as reserves, also expanded. An additional benefit of holding bonds and deposits was that by doing so the Riksbank earned interest on parts of its reserves.

4. Reserves, money supply and prices

There are two important features in the domestic creation of the money supply; first the amount of circulating base money to be used as deposits, and second the level of development of the financial system, in the sense of credit creation through deposits. The first part of this money supply can be referred to as M1, and consists of Riksbank and Enskilda bank notes held by the public.\textsuperscript{42} The size of M1 in conjunction with the level of development of the banking system should create the money supply in terms of M2 and M3, where M2 is M1 plus commercial bank deposits and M3 is M2 plus savings banks deposits. The degree of business activity among the Swedish savings banks on the credit market makes the measure M3 most appropriate in the Swedish case.\textsuperscript{43}

Figure 5 shows that from the early 1870s the money stock including deposits in commercial banks (M2) and in savings banks (M3) grew rapidly, with a second ‘take-off’ in 1895. The remarkable growth in money supply is illustrated by the fact that M3 per capita grew by nearly forty times in the period of 1834 until 1913. In part, this reflects the low starting point for credit money itself (the expansion was from thirteen kronor per capita in 1834 to over five hundred kronor in 1913).\textsuperscript{44} However, not all monetary aggregates underwent such an expansion. The money stock in terms of circulating notes as M1 grew less quickly (M1 was nearly three and a half times higher in 1913 than in 1834). This difference between a rapidly expanding M2 and M3 and a relatively slower growing M1 definitely underscores the importance of the banking system in the process of expanding the money supply during this process of rapid industrialisation.

\textsuperscript{42} One important feature of the Swedish money market during this period was the low and stable circulation of coins, and the circulation of notes can be used as a reliable measure of the money supply in terms of M1. For a discussion of how the Enskilda banks came to supply Sweden with base money, see Ögren (2000).

\textsuperscript{43} See Lilja (2000), Petersson (2000). The money stock 1871-1971 calculated in the study of Jonung was the measure M2, consisting of the volume of Enskilda and Riksbank notes held by the public plus deposits from the non-banking sector in commercial banks. Jonung (1975), pp. 208-211.

\textsuperscript{44} See Figure 5 and SCB (1955).
The stability in international exchange rates that was experienced under the classical specie period seems to have been related to instability in domestic consumer prices. Clearly consumer prices followed the Swedish business cycles in a way that could have been expected by the price specie flow mechanism. Periods of inflation were followed by periods of deflation, suggesting that the transfer of foreign reserves actually led to price changes. Problematic for the price specie flow theory is the observed simultaneous movement in prices, i.e. as prices fell or rose in Sweden, so did prices in the countries trading with Sweden.\footnote{Gomes (1996), pp. 166-167.}
One tendency supportive of the monetary approach to the balance of payments is the co-movements in prices between countries.46 Here it is expected that highly traded goods are more similar in their prices and price movements than less traded goods. Hence, wholesale prices should conform more closely to the Law of One Price than consumer prices, because consumer goods (e.g. housing) are not as internationally traded as wholesale goods.

Swedish wholesale prices showed a strong correlation with prices of its trading partners. Consumer prices indices were also correlated, but at a slightly lower level. Swedish consumer prices during the entire period of 1834 until 1913 followed German and Danish prices well, and that the im-

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impact of English prices came at the expense of French during the gold standard period. Consequently, during Sweden’s adherence to the silver standard, consumer prices moved more in accordance with France, Germany and Denmark, than England where the gold standard prevailed. The Swedish history of belonging to the ‘German economic bloc’ during the entire period was significant. From the adoption of the gold standard and onwards, Swedish consumer prices moved in accordance with the Danish to a remarkably high extent. This might be explained by Denmark and Sweden being neighbouring countries, but perhaps more significant was the Danish and Swedish establishment of the Scandinavian Currency Union (Skandinaviska Myntunionen) in connection with the switch from the silver to the gold standard in 1873, where also Norway joined in 1875.47

From the perspective of the monetary approach to the balance of payments, the results are generally supportive; especially that wholesale prices seem to a large extent to have been set on the world market. This suggests that the law of one price is a credible proposition. Also, consumer price indices followed each other, despite the large impact of non-tradable goods in these indices. The correlations definitely indicate a high degree of international integration, but this is not sufficient evidence for proving the monetary approach to the balance of payments to be valid in all respects.

Since the monetary approach to the balance of payments, and the quantity theory ascribe different causality to the adjustment mechanism, a first step to sort out the causality at work is to try a Vector Auto regression analysis on changes in reserves, money supply, and domestic prices. Since the test at this stage is carried out only with annual data, results are merely indicating a possible direction of causality.

The parameters in the test are Swedish Consumer Price Index, Sweden (CPI), Reserves of the Riksbank (RBRES), and money supply in M1, M2 and M3.48

47 The union made coins convertible at par, but did not include notes. In 1894 notes became convertible at par between Sweden and Norway, and in 1901 with Denmark. (Henriksen and Kårgård (1995), pp. 94-95). See also, Talia (2001).
48 When doing this test one should be aware that the Vector Auto Regression is not really testing causality but merely the predictive power of one variable towards another, or the so called Granger-causality (see Maddala and Kim (1998), pp. 188-189 or Ramanathan (1998), pp. 545-547). In the test t-values above 2 shows that there at the 5 % significance level is a casual relationship in the direction described. Dependent variables are shown as column entries. The goodness of fit value, R2, indicates how good the independent variables explains changes in the dependent variable.
**Figure 8:** Vector Auto Regression on the Consumer Price Index (CPI), Money Supply (M1DEF), (M2DEF), (M3DEF), and Riksbank Reserves (RBRESDEF), 1834-1913. 2 lags, variables deflated by the consumer price index and in logarithmic form

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* Denotes significant values at least at 5%


The outcome of the VAR test is puzzling. The monetary approach to the balance of payments could not account for the observed relationship between reserves, money supply and prices. In accordance with the monetary approach to the balance of payments, the money supply should change in line with demand, and reserves would then adjust to match this demand. Changes in the money supply affected changes in consumer prices. In fact,
changes in the reserves also preceded changes in the money supply (see figure 8 and Appendix). Subsequently, the quantity theory also seems to explain the working of the adjustment mechanism.

As already seen in figure 7, Swedish prices were internationally linked, supporting the monetary approach to the balance of payments. The main conclusion made from the causality testing at this stage is that the adjustment mechanism was more complex than described by either the specie flow mechanism or the monetary approach to the balance of payments. A question discussed in embryo in the licentiate thesis was whether the causality could be explained by international business cycles moving in parallel during the specie standard era. Triffin for instance concluded that the nineteenth century is better characterised as the century of credit money than of the gold standard. He argued that it was a period when business cycles in different countries moved together rather than counteracting each other.\textsuperscript{49} In Sweden, the international adjustment mechanism seemed to work so that credit expanded along with those of other countries, and so that it was linked to an international business cycle. Perhaps money supply, credit and prices all changed in harmony? If so, the fact that the classical specie standard period was a period of globally expanding credit was perhaps the more important factor explaining its success as a system, as well as accounting for the workings of the international adjustment mechanism. These are certainly interesting questions for further exploration.

5. Concluding discussion

The Swedish experience of the classical specie standard between 1834 and 1913 may be divided into two distinct periods, but these are not the periods of the silver and gold standards. Rather, these periods can be divided into (from 1834) a ‘current account’ phase, and (from 1860) a period where capital imports and the developed banking system supervene. The inflows of long-term capital over the period not only allowed Sweden to expand its economy, but also (perhaps paradoxically) served to underpin the specie standard.

One factor relevant for the Swedish case was that it could use foreign assets in its reserves. This made the stock of reserves somewhat more elastic than would otherwise have been the case.

In the Swedish case different stages of the business cycle were expressed in differences in economic activity through the trade balance. During economic booms, both imports as well as exports grew rapidly, but tended to

\textsuperscript{49} Triffin (1985), pp. 121, 128-129, 133.
result in a more rapid import growth. The resulting trade deficit was funded from long-term capital inflows.

Even though trying to counteract the effects of international business flows, the Riksbank could do no more than preserve the ratio of reserves to notes. This, in addition to the availability of foreign credit seemed to be enough for maintaining convertibility. Nevertheless, the effects of international crises in Sweden were often quite severe.

Finally, the problem of establishing causality in the adjustment mechanism raises important questions about the role of credit expansion under the classical specie standard and how this expansion affected convertibility and the operation of international adjustment mechanism? While these are questions for future research, the results of this study suggest that answering them would provide new insights into this period and the competing theories used to explain it.

Sources and Literature

Sources


Riksdagstryck [Parliamentary Publications] BaU Bankutskottet 6:e Samlingen [Standing Committee on Banking]: 1859/1860


**Literature**


Gomes, L. (1993), The International Adjustment Mechanism From the Gold Standard to the EMS. St Martins Press Inc. N.Y., USA


Jonung, L. (1975), Studies in the Monetary History of Sweden. UCLA, USA.


### Appendix: The Vector Autoregression Analysis

Complete read out from the VAR test on causal relationship between Consumer Prices, Reserves and Money Supply for sample 1834 – 1913

#### Vector Autoregression Estimates

**Sample (adjusted):** 1837–1913  
**Included observations:** 77 after adjusting endpoints  
**Standard errors in ( ) & t-statistics in [ ]**

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**Summary Statistics:**

- **R-squared:** 0.489402, **Adj. R-squared:** 0.412038, **Sum sq. resid:** 0.065506, **S.E. equation:** 0.031504, **F-statistic:** 6.326016, **Akaike AIC:** -3.945831, **Schwarz SC:** -3.611001, **Mean dependent:** 0.005380, **S.D. dependent:** 0.041086
- **Log likelihood:** 162.9145, **Akaike AIC:** -3.945831, **Schwarz SC:** -3.611001, **Mean dependent:** 0.005380, **S.D. dependent:** 0.041086
- **R-squared:** 0.489402, **Adj. R-squared:** 0.412038, **Sum sq. resid:** 0.065506, **S.E. equation:** 0.031504, **F-statistic:** 6.326016, **Akaike AIC:** -3.945831, **Schwarz SC:** -3.611001, **Mean dependent:** 0.005380, **S.D. dependent:** 0.041086
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Log Likelihood (d.f. adjusted) 600.8268
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Residual Normality Tests

Orthogonalization: Cholesky (Lutkepohl)

H0: residuals are multivariate normal
Sample: 1834 1913
Included observations: 77

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Test for Serial Correlation

VAR Residual Serial Correlation LM Tests

H0: no serial correlation at lag order h
Sample: 1834 1913
Included observations: 77

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Probs from chi-square with 25 df.
The Break-up of the Scandinavian Currency Union 1914-1924: a preliminary analysis

1. Introduction

"Two main questions face students of monetary unions: why are they formed and why do they break apart?"\(^{50}\) This paper is an explorative study, later to be extended and incorporated into my dissertation thesis on the Scandinavian Currency Union.\(^{51}\) The overall aim of this paper is to establish how and why the Scandinavian Currency Union came to an end. The break-up of the union was a gradual process, triggered initially by the outbreak of World War I in 1914, and culminating, as we will see, by the formal cancellation of the last remaining part of the union in 1924. This study reveals the main events and mechanisms at work during those ten years.

The paper as such is closely related to studies of monetary regimes and monetary regime switches, and the thesis starts by presenting a definition of the somewhat diffuse term monetary regime. To find a definition for the term monetary regime we can, as suggested by Barry Eichengreen, subdivide the term into its two components.\(^{52}\) Political scientists have defined a regime as “the norms, rules and procedures that guide the behaviour of states and other important actors”.\(^{53}\) Stephen Krasner offers another perspective. According to him a regime is the “principles, norms, rules, and decision-making procedures around which actors expectations converge in a given issue-area”.\(^ {54}\) In this case the actors are the Central Banks and governments of the three Scandinavian states and the issue-area is the one of monetary matters. Such an interpretation turns our attention to the other component of the term to be defined i.e. the term monetary. Monetary is derived from the word money. When Eichengreen for instance discusses the

\(^{50}\) Bergman et al. (1993), p. 507.
\(^{51}\) Talia (1999) [dissertation thesis plan].
\(^{54}\) Krasner (1982), p. 185.
term he does so by stressing the three basic functions of money suggested by economic theory – money as a store of value, a medium of exchange and a unit of account. A monetary regime, thus, “[is] a set of rules or procedures affecting money’s ability to provide one or more of these functions”.

Put simply, a switch from a fixed to a floating currency, which we all know affects a currency’s ability to act as a store of value, is an example of a monetary regime transformation. It can be seen, in the search for a definition of the term monetary regime, that it is to be found somewhere in the twilight between political science and economic theory.

The institutional approach is a tradition that has proven to be fruitful when dealing with issue areas that cross the boundaries between economics and politics. One of the most influential institutionalist scholars in recent years has been Douglass C. North. North acknowledges the importance of the institutional framework for a country’s economic performance. The norms, rules, and procedures are, according to North, the formal and informal institutions governing the behaviour of the actors.

One of the first objectives of this paper will be to determine the most important rules and regulations governing the monetary union. I will also determine the main actors within this institutional structure. The main subject of this paper is, however institutional change, and so, it will not be enough to establish rules that govern periods of stability. The outbreak of war constituted a major change of the institutional framework within which the three countries were working. Thus the paper concentrates on a situation where an existing institutional framework is rendered unstable.

2. The institutional setting

The Scandinavian Currency Union was formed in 1873-1875 and worked fairly smoothly until 1914. The period 1873-1914 coincides broadly with the classical gold standard period (1880-1914). This was the heyday of the gold standard period. During this period Western countries enjoyed steady economic growth, stability in exchange rates, and low inflation.

The fact that all of the Scandinavian countries were part of the gold standard system makes it relevant to take a closer look at what the gold standard meant for the economies at the time, and how the gold standard worked.

The other important part of the institutional framework was the rules and regulations of the union as such; that is the treaty signed by the three coun-

tries in 1873-1875; and later additions to it. The main parts of the treaty, i.e. the legal framework of the union, are presented below.

2.1 The rules of the game: currency union and gold standard

The classical gold standard was based on three components: (i) free export and import of gold; (ii) the right to redeem notes for a fixed amount of gold; and (iii) the fixed relationship between the size of the gold reserve and the amount of circulating notes.

An introduction to basic concepts and functions of the classical gold standard system is given by David Hume’s classical account on the balance of trade from 1752. In this essay Hume revealed the logic behind what was later to be called the price-specie-flow mechanism. According to this view the gold standard worked as a self-adjusting system. Relative price movements as well as actual physical movements of gold between countries restored the balance of trade equilibrium. Hume explains this mechanism by a thought experiment. Suppose that the gold in a country, and here he refers to the British case, were multiplied five-fold in a night. What would happen? Hume, who was not unfamiliar with the quantity theory of money, states that the prices of labour and commodities then would rise to an ‘exorbitant height’. The result would then be that no neighbouring country could afford to buy commodities from Great Britain, while on the other hand their commodities would be relatively cheap for the inhabitants of Great Britain. Great Britain would therefore increase its imports from neighbouring countries, while the demand for the expensive British products would fall. The result is an outflow of gold from Great Britain. This outflow would lower the size of the gold reserve of the country and since the money stock of a gold standard country is directly related to the size of the reserves, the decrease in gold reserves would lead to a decrease in the country’s money stock. The outflow of gold and decrease in the country’s money stock would have the reverse effect on prices, so that British prices would fall until a new equilibrium is established between the price levels of Great Britain and her neighbours.

This is a simplified and idealised description of the mechanisms of the gold standard. The Hume approach to the adjustment mechanism of the gold standard through a price-specie-flow mechanism has been questioned and modified by several scholars on the gold standard. However, the notion of the gold standard as a self-adjusting system has had a powerful and almost mythological influence on the gold standard theory. There has been a debate

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58 Hume (1752).
59 Ibid., p. 41.
on whether the adjustment mechanism worked through the balance of trade (Mill), through flows of short-term capital in response to changes in interest rates (Marshall), or through changes in incomes (Ford and Ohlin). Eichengreen, however, argues that the disagreement is merely a superficial one, and that the competing models of the adjustment mechanism in fact are entirely compatible and that they only need to be combined to provide a more complete picture of how the gold standard worked. The self-equilibrating mechanism was important for the creation of a uniform monetary policy within the union; and a uniform monetary policy was, as we will see, a prerequisite in a union without a common central bank.

The monetary union

In the beginning of the 1870’s the three Scandinavian countries signed a treaty that formed the legal framework of the Scandinavian Currency Union. The essence of the treaty and thus the union can be summarised as follows:

- The Krona was adopted as a unit of account and it was divided into one hundred Öre.
- Gold was adopted as a standard and thereby formed the basis of the currency system.
- Anyone could convert gold into Scandinavian Kronor or Scandinavian Kronor into gold at any of the three Central Banks at a defined rate. The main coins where the 10 and the 20 krona pieces. The 10 krona piece contained 4.032258 grams of pure gold, and the 20 krona piece contained 8.064516 grams of pure gold.
- The Central Banks were obliged to accept gold for issuance at the defined rate.
- The Scandinavian Kronor (gold coins, token coins of silver, and later also bank notes) was legal tender for anyone and to any amount within all of the three Scandinavian countries.

The Scandinavian Currency Union was later extended by the introduction of a formal clearing mechanism in 1885. This arrangement permitted each central bank to draw drafts on the others at par in settlement of international balances. Furthermore, in 1901 the union was extended to include the circulation of bank notes between the three states.

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62 Triffin (1964), Whale (1985:1937), Williamson (1964), McCloskey and Zecher (1985:1976) have challenged the view that money supply had a connection to the real economy by postulating a mechanism whereby balance of payments deficits or surpluses equilibrated the money market.
63 By World War I informal institutions were also an important part of the operation of the union. These are not discussed in this paper, but will be considered in future work.
2.2. The players

The most important players in the union were the Parliaments of the three countries and their Central Banks. The Swedish Central Bank (the Riksbank) interacted frequently and freely with the Central Banks of their neighbouring countries, Nationalbanken in Denmark and Norges bank in Norway.

There is a problem in dealing with parliaments and central banks as uniform agents. Internal differences of opinions and power struggles are the order of the day for Parliaments and Central Banks. If the level of analysis in the paper was the national one, we would have been obliged to take this into account. In this paper however, the level of analysis is the Scandinavian Union, and we assume that when the players of the three countries are acting in the Scandinavian arena they do so as uniform entities.

3. Three nails in the Scandinavian Currency Unions coffin

The outbreak of World War I in August 1914 and its subsequent development on the continent were events followed with intense interest in the Scandinavian countries. While the Nordic countries were able to stay out of the conflict, this does not in any way imply that they were unaffected by the outbreak of, and course of the war. The outbreak of war marked the beginning of a sort of ‘three-stage rocket’ that would lead to the dissolution of the Scandinavian currency union. Three major events would act as nails in the SCU’s coffin and the story about the break-up of the Scandinavian Currency Union starts on the second of August 1914.

3.1 Suspension of convertibility and export prohibition: the first nail

The Scandinavian Currency union did, as we have seen, cover bank notes. One of the prerequisites for a system with bank notes was the common and widespread trust that the seemingly worthless pieces of paper (fiat money) at any time could be exchanged for gold at the Central Banks of the three countries. The Scandinavian Central Banks always kept gold in its vaults as a backing for the system. This pile of gold is better known as the gold reserve; and the development of the gold reserves in association with the outbreak of the war would prove to be the first nail in the SCU’s coffin. Figure 1 shows the escalating outflow of gold from the Swedish Riksbank’s gold reserve in association with the outbreak of war.
Figure 1. Notes presented for exchange at the Central Bank, 29 July-1 August, 1914

Source: Calculations made on basis of the information given in the government bill no: 268, in 1914.

Figure 1 shows that the events on the continent sparked a run on the Riksbank’s gold reserves. This signalled a loss of trust in the Swedish notes. The public now chose the lesser uncertainty of gold over the greater uncertainty of pieces of paper. This led to a reduction in the Riksbank’s gold reserves.64

The Scandinavian Central Banks, as guarantors of the viability of the financial system, followed this development with concern. In the next section we will see how the Riksbank’s board of directors acted, look at the reasons why they acted as they did, and the consequences of their actions.

The Riksbank suspends convertibility

On the second of August 1914 the Riksbank’s Board of directors sent a written communication to the Standard committee of banking. The Board drew attention to the reduction in Swedish gold reserves (Figure 1) and expressed its concern over the last day’s ‘extraordinary’ development. The board also elaborated a response to the events and made the following suggestion:

“There are reasons to believe that the gold outflow from the Riksbank during the last days have not yet reached an end; and as the gold re-

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64 The gold standard in Sweden (and elsewhere) was always vulnerable in some ways as the backing was not one to one, but a ratio of the notes in circulation. For a discussion of the Swedish case, see Ögren (2000).
serve of the Riksbank, during the current political and financial circumstances, should not be allowed to shrink any further, the board of directors are of the opinion that measures to protect the gold reserve immediately have to be taken […]. After a long scrutiny of all of the issues affecting circumstances, the board has found that the only way of giving the reserve an immediate and effective protection is to suspend the convertibility of banknotes into gold.  

Apparently the Riksbank board of directors wanted to protect the gold reserves, and the best protection would be immediate suspension of the convertibility into gold. This is a drastic, but not unusual, measure in case of a war. The Riksbank had lost nearly 2.7 million Kronor in only four days, representing 2.6 per cent of the total gold reserve at the time. Whether or not the suspension of convertibility in 1914 was an overreaction has been debated right up until recent times. Haavisto and Jonung (1995), for instance, offer the following description of the events following the outbreak of the war:

“No financial panics in terms of gold outflows or runs on banks occurred […] Therefore, the decisions by the Central Banks to suspend the gold convertibility should be explained by excessive precautionary motives.”

It seems that there definitely was an outflow of gold from the Riksbank due to the outbreak of the war. Whether or not 2.6 per cent can be defined as a run or not is hard to say. However, one might expect that the outflow could have been larger if the Riksbank had not acted firmly and swiftly.

The suspension of convertibility undoubtedly meant that one of the fundamental parts of the 1873-1875 agreement between Denmark, Norway, and Sweden was abandoned. It also marked the Swedish withdrawal from the international gold standard system. Why then was the protection of the gold reserve of such importance that it triggered such extreme measures? The board of directors justified their recommendation in the following manner:

“The gold reserve of the Riksbank is the financial backbone of the country and its further demise could under the current circumstances undoubtedly, have fatal consequences for the ability to meet demands posed on the state by trade and industry.”

65 SPP. (1914), Governmental bill no: 268, p. 3-4 [translation from Swedish by the author].
66 The outflow added up to 2.667 million skr and the gold reserve in August 1914 was 103.243 million. The outflow thus constituted 2.6 per cent of the gold reserve at the time.
68 SPP. (1914), Governmental bill no: 268, p. 3 [translation from Swedish by the author].
The question was subjected to the scrutiny of the Banking Committee and later presented to the Parliament. The proposition was accepted in both of the chambers without discussion.

Suspension of convertibility in Norway and Denmark

Denmark and Norway had a similar experience, as did Sweden. Both countries experienced substantial reductions in gold reserves in the months following the outbreak of war.

Figure 2. Norwegian and Danish gold reserves in millions of crowns (1914)

![Norwegian and Danish gold reserves in millions of crowns (1914)](image)

Source: Ekonomisk tidskrift, statistiska medelanden, 1914

During the days preceding the outbreak and immediately after it, the two countries central banks faced the same problems as did their Swedish neighbour, and the response was strikingly uniform.

When the board of directors of the Danish central bank arrived at work on Saturday the 1st of August 1914, they were met by a crowd of people rounded up in lines by the police. The people demanded to get their notes changed into gold. The reply of the Danish Central Bank was a temporary suspension of convertibility as dictated in the Sunday law of the 2nd of August 1914. The Norwegians had a similar experience but waited to declare their notes inconvertible for two more days until the 4th of August 1914.

The suspension of the convertibility in the Scandinavian countries was prolonged several times during the following ten years and to further safe-

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69 Ussing (1926), p. 60
guard the gold reserves the three countries added an export prohibition on gold. The prohibition on export of gold put one of the fundamental parts of the gold standard system out of play; that is, the free movement of gold between gold standard countries. The flow of gold between the countries was an important prerequisite for stability in exchange rates between gold standard countries and the effects of this prohibition is made evident in the next section.

Suspension of convertibility and export prohibition on gold effectively ended the stabilising function inherent in the gold standard system and furthermore it put the straightjacket function on monetary policy out of play.

3.2 Swedish trade surplus and divergence of exchange rate within the union: the second nail

The outbreak of the war made it impossible to convert banknotes to gold. The suspension of convertibility was, as already pointed out, a hard blow to the Scandinavian Currency Union. However, at the end of 1915 the Swedish Riksbank decided that the time had come to restore Swedish convertibility into gold; this return to gold would not however last for very long.

The balance of trade 1913-1924

The war had a substantial impact on international trade in general, and on trade in the neutral Scandinavian countries in particular. Most striking was the effects on the Swedish economy that turned a long history of trade deficits into surpluses in 1914, a situation that was maintained during the whole war (see Figure 3). Denmark and Norway, however, were not able to improve their balance of trade as Sweden did. Norway in fact increased their trade deficit continuously during the war.

The Swedish experience can largely be explained by the Swedish abundance of resources crucial for the fighting parties (iron ore and forests), and that Swedish imports were reduced by its reserved attitude towards the Entente countries. This also constituted an important difference between the Scandinavian countries as Denmark and Norway had a more positive and open relationship with the Entente countries, and in that way maintained their imports from those countries.\textsuperscript{70}

\textsuperscript{70} Ussing (1926), p. 87
The evidence in Figure 3 reveals that the improved balance of trade, associated with the increasing demand for Swedish goods, helped the Swedish Krona appreciate over its former gold parity, in the beginning of 1916. This started an inflow of gold into Sweden and between early December 1915 and February 1916 the Riksbank’s gold reserves increased from 113 to 160 million kronor (see Appendix 1). However, the inflow of gold was not sufficient to push the Swedish Krona back to par.

During the gold standard era, exchange rates between participating countries had been fairly stable. Exchange rates moved within the limits set by the upper and lower gold points. What happened in the beginning of 1916 was therefore a sign that the mechanisms of the gold standard were now inoperative. What would have been the reaction if there hadn’t been a suspension of convertibility or an export prohibition on gold? The increased demand for Swedish products resulted in an increased demand for Swedish currency. In the importing country, say Germany, rates on Swedish kronor would start to rise. However, the appreciation of Swedish kronor would only continue to a certain and easily defined point, the upper gold point. After this point had been reached (allowing for transport costs) it would have been cheaper for the importer to pay for the transportation of gold to Sweden, and have it exchanged for Swedish coins or notes at the Swedish Riksbank. One of the cornerstones of the gold standard system was, as
noted above, that Central Banks of the participating countries had committed themselves to always accept gold at a set rate and that there were no restrictions on imports and exports of gold between the participating countries.

However, after the outbreak of World War I these prerequisites for stable exchange rates disappeared. Most of the countries had suspended convertibility to protect their gold reserves at the outbreak of the war. Furthermore, most countries adopted an export prohibition policy for gold. In Germany, where the Mark had been substantially depreciated, the Minister of Finance held a speech for the German parliament on the 10th of March 1915. He declared that the low price of the Mark could have been regulated by gold shipments abroad but that the extraordinary situation made a strong gold reserve more important than the protection of the value on German Reichmarks abroad.\textsuperscript{71}

In addition, the war itself made gold shipping more risky and difficult, and therefore more costly. Another explanation for the appreciating krona is thus that because gold transports did not work as smoothly as in the pre-war era, the gap between the upper and lower gold points had widened, thus allowing for larger movements in exchange rates. The effects of this development are evident in Figure 4.

Figure 4. Exchange rates of the Swedish krona, 1913-1924 (deviation from pre-war par in %)

\textit{Source:} Calculations made on basis of information given in Sveriges Riksbank 1668-1918-1924: Bankens tillkomst och verksamhet. Del V.

During 1915, the Danish and Norwegian Kronor started to fall in relation to the Swedish Krona (see Figure 4). During 1915 the Danish Krona had

\textsuperscript{71} Östling (1945), p. 27
fallen to 97 per cent, and the Norwegian to 98 per cent in relation to the earlier exchange rate (par).

Private arbitrage opportunities

The divergence of exchange rates within the union produced a somewhat absurd situation. Scandinavian Kronor, that is Kronor issued in Denmark, Norway and Sweden, had, *de jure*, the same value within the Scandinavian region. *De facto*, however, the Swedish Krona was valued higher than the other two. This triggered the start of shipments of Danish and Norwegian notes to Sweden. According to the Yearbook of 1915, the Swedish Riksbank surplus of Danish and Norwegian notes had risen from 44.9 million Kronor in 1914 to 72.3 million in 1915. This is explained in the following manner by the board of directors:

“In Denmark it became more profitable to hoard the Swedish notes […] And to use their Danish notes”.  

The Danish public hoarded Swedish notes and used Danish notes for doing business in Sweden. That is because the less valuable Danish notes could be used at par thanks to the 1901 agreement. This behaviour is known to economists as Gresham’s law.

As the Riksbank still was adhering to the old gold standard rule dictating that the Central Bank was supposed to receive gold for redemption into notes at a fixed rate the inflow of notes was not the only problem facing the Swedish Riksbank. Because of the fact that the Swedish krona had appreciated not only in relation to its neighbouring currencies but also in relation to gold they had to deal with, a steady inflow of gold was presented to the Riksbank to be redeemed into Swedish notes. The standard committee of banking was worried by this development, as the Swedish Riksbank made a considerable loss buying gold at the old parity price; i.e. at a price considerably higher than the world market price of gold in terms of Swedish Kronor at the time. The dollar was fixed against gold during the whole war period and is therefore a good indicator on how the Swedish Krona was priced against gold during the war. In figure 4 it is evident that the Swedish Krona had been strengthening against gold during this period.

The board of the directors described these events in the following manner:

“In this way they have been able to acquire Swedish Kronor at par, and thereby they have avoided to pay the higher appreciated rate on Swedish Kronor currently running on the currency markets in Copen-

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72 SYR. (1915), p. 16 [translation from Swedish by the author].
hagen and Oslo. In other words they have transferred the rate loss to the Riksbank. A loss that the trader would have been forced to carry if the Scandinavian Currency Treaty of 1873 had not existed.”

Of course Sweden was the country most uncomfortable with this situation and on the 8th of February 1916, the Swedish Riksdag declared that the Riksbank was no longer obliged to accept gold for issuing of coins or for exchanging them for notes. This action was called the gold blockage (guldspärrningen), and together with the export prohibition it effectively and finally de-linked Sweden from the gold standard system. However, to make this blockage efficient Sweden had to convince the other two Scandinavian countries to follow her example and if possible get the approval for a modification in the Treaty of 1873. The Board of directors therefore sought to find an agreement with the other two countries to suspend article IX of the 1873 covenant. This article stipulated that gold coins that had been minted in accordance with the Treaty of 1873 were legal tender in all three countries, regardless of where they had been minted.

The other two countries reluctantly went to Stockholm for a Central Bank meeting on the 23-24th of February 1916. On the 15 and 17th of April, Denmark and Norway, respectively, issued laws that released their Central Banks from their duty to buy gold and the public was prohibited to issue Scandinavian gold coins. The three countries also reached an agreement on how gold export licences were going to be distributed. The general idea was that a licence should only be granted if the receiving central bank gave its approval. A gold export prohibition had been established in all of the countries in 1914. Thanks to this, the problems of public shipping of gold seemed to be solved. However, as we shall see the problems of gold shipping were not entirely taken care of yet.

The Central Banks and the mysterious gold shipping

The clearing agreement of 1885 stipulated that settlements of debt on the respective accounts should be settled either in foreign currency or Scandinavian gold coins. This opened an opportunity for free-riding within the union. During the war the inter-Scandinavian balance of trade had shifted in favour of Sweden, and in addition to this, the speculative inflows of Danish and Norwegian bank notes had enabled Sweden to run surpluses on the clearing accounts. Denmark and Norway had a choice to settle their debt either in a foreign currency or by sending Scandinavian gold coins. The Danish and Norwegian Central Banks thus had the choice of buying gold, at
the cheap world market price, turning it into Scandinavian coins at their mints, and shipping the coins to Sweden where in accordance with the covenant of 1873 they could be used at their pre-war par rate. This was possible as the prohibition of issuing and exporting Scandinavian gold coins only applied to the public. From ultimo July 1916 to ultimo July 1917 the part of the Riksbank’s reserves consisting of Scandinavian gold coins rose by 31.2 million Skr. The largest part of these gold coins were minted in Denmark; Norway had stopped issuing Scandinavian gold coins at this time. It was thus not surprising that Denmark was the target for accusations of disloyal or unfair behaviour by Swedish economists.

The prominent Swedish economist Gustav Cassel was the first to comment on the Danish issuing practice in his book *Dyrtid och Sedelöverflöd*.\(^{75}\) The critique was picked up and sharpened by the Danish Professor Axel Nielsen, who accused his own Central Bank of acting disloyally and taking advantage of the opportunities given by the convention.

The Danish central bank manager Ussing responded to the critique in his book *Nationalbanken 1914-1924*.\(^{76}\) Ussing explained that the Danish coins had been sent by the Norwegian central bank. Apparently the Norwegians were creditors to the Danes and therefore had been paid 18 million Scandinavian gold coins by the Danish Central Bank to cover their surpluses; the Norwegian central bank later used these gold coins to pay off their debt in the Riksbank.

The Riksbank was most uncomfortable with this situation, as the Riksbank (thanks to the strongly appreciated Krona) could have bought the gold much cheaper elsewhere. On the 19\(^{th}\) of January 1917 the Swedish Riksbank wrote to Norges Bank and asked them to stop their payments in Scandinavian gold coins. The Norwegians, however, stuck to their practice and denied the Swedish request. Sweden called for another central bank meeting with the intention to strongly modify the Scandinavian Treaty of 1873. At the meeting in Stockholm, held between the 17-19\(^{th}\) of April 1917, participants from the different Central Banks discussed this issue. After Swedish threats to unilaterally exit the union, the three countries agreed to strictly abide to the gold export prohibition when it came to Scandinavian gold coins, and on the 13\(^{th}\) of July the proposition had been ratified in all of the Scandinavian countries.\(^{77}\)

The Scandinavian Currency Union had now lost most of its functions and in effect had ceased to work. However, one part of the covenant was still

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\(^{75}\) Cassel (1917).
\(^{76}\) Ussing (1926), p. 101-111.
\(^{77}\) Östlind (1945), p. 42-45.
lingering as a historical anomaly. This part was the one regulating the status of the token coins within the union.

3.3 The smuggling of token coins within the union: the third and final nail

After that the problem with the shipments of gold coins was taken care of, the situation within the ‘union’ stabilised for a short while. But the problems were slowly approaching and yet again they were due to the arbitrage opportunities given by the discrepancy between the actual value of the different currencies and the *de jure* value as dictated in the union covenant. The opportunity to exploit these discrepancies still remained thanks to the remaining part of the union – the covenant on the token coins.

The treaty of 1873 stated that token coins of silver were legal tender throughout the union. This was the remaining element of the union, and it lingered as a problematic anachronism. Because of the rapid depreciation of the Norwegian and Danish currencies, incentives were created for exporting their token coins to Sweden. Figure 5 consequently shows that between 1920 and 1922, the export of Norwegian and Danish token coins to Sweden increased dramatically.

*Figure 5.* The value of Scandinavian token coins in the three Scandinavian central banks, 1916-1925

![Graph showing the value of Scandinavian token coins in the three Scandinavian central banks, 1916-1925.](source)


*Note:* In Norway and Sweden the values are from the 31 December, in Denmark they are from the 31 July each year.
Figure 5 shows that the value of Scandinavian token coins of the Riksbank increased from 2.7 to 19.3 millions from 1920 to 1922. Figure 5 also reveals that in 1923 the Swedish Riksbank started to send the Scandinavian token coins back to their country of origin in exchange for gold, and the value of Scandinavian token coins in the Danish and Norwegian central banks started to increase rapidly. This dramatic development was discussed at a conference held in Kristiania on the 29-31st of October 1923. The delegates from the three countries agreed on proposing to its respective governments that the last part of the Scandinavian currency union should be cancelled. The situation was described in the following manner:

“Since shortly after the outbreak of the world war the three countries suspended the convertibility of their banknotes into gold and prohibited the export of gold, exchange rate differences between Danish, Norwegian and Swedish Kronor have occurred. Today the considerable differences between the currencies have triggered a smuggling of token coins that are causing inconveniences for our neighbouring countries, as they are obliged to convert the coins into gold at the former par rate, according to the covenant of 1873 (§XI), when the coins are sent back by the Swedish treasury administration.”

Apparently none of the countries seemed to gain from the situation and the countries’ respective governments soon agreed on giving up the last parts of the 1873 covenant. In 1924, a government bill dealing with the cancellation of Scandinavian token coins as legal tender in Sweden reached the Swedish parliament. The Swedish decision was taken on the 11th of April 1924, and it was put into action on the 6th of October the same year. At that time, the Scandinavian Currency Union ceased to exist.

4. Concluding remarks and an outline for future research

The decline of the Scandinavian Currency Union was a lengthy process that went on for ten years. In this paper we have established three central events that contributed to the break up: (i) the suspension of convertibility with an export prohibition on gold; (ii) exchange rate tensions within the union; and (iii) the smuggling of Scandinavian token coins.

Which were the main mechanisms in action? To start with, the suspension of convertibility together with the export prohibition put the workings of the gold standard out of play. The improved balance of trade for Sweden during the war years was not adjusted by any equilibrating gold flows, and

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78 Kristiania was at the time the name of current-day Oslo.
79 SPP. (1924), Governmental bill no: 11, p. 6 [translation from Swedish by the author].
thus permitted the Swedish Kronor to strengthen in relation to the Norwegian and Danish. This situation and the rules of the 1873 Treaty, requiring that Scandinavian Kronor were to be traded at par within the union, opened up arbitrage opportunities for Central Banks and private actors. Soon Danish and Norwegian notes and gold started to flow into Sweden. This was handled by an agreement by the central banks to strictly abide to the export prohibition clauses already at place in the respective countries. In this way the Riksbank managed to stop the inflow of notes and gold. However, as the exchange-rate differential widened further during the post-war period, the last remaining element of the now heavily disarmed union started to cause problems. Token coins, that still had the status of legal tender in all of the Scandinavian countries as stipulated in the 1873 agreement, were now being smuggled from Denmark and Norway to Sweden. These token coins were later sent back by the Swedish Riksbank to Norwegian and Danish Central Banks to be changed into gold which of course caused them considerable losses. None of the countries seemed to gain from the situation and their governments soon agreed on giving up the last part of the 1873 agreement in 1924.

What are the contributions of this paper? One of the contributions is that it sharpens the picture over what happened in the aftermath of World War I. Not only do we now have a definite date of the termination of the Scandinavian Currency Union, there is also now a more credible overview of the break-up process and the mechanisms at work.

The paper points to the fact that the three countries conducted different trading policies during the war and that the currency area therefore faced an asymmetric shock that required an exchange-rate adjustment. However, we can also conclude that the international gold standard system was a crucial prerequisite for the successful working of the Scandinavian Currency Union. In the absence of a common central bank the gold standard provided a strait-jacket on monetary policy and the adjustment mechanism to handle trade shocks, both crucial for obtaining stability in exchange rates.

Perhaps the main contribution of this paper, however, is not the answers it provides, but the questions that it raises. One of those questions is why the union remained as long as it did even though it seemed to do more harm than good, after the suspension of convertibility. The remainder of the section discusses possible approaches or answers to this question.

Why did the union remain as long as it did even though it seemed to do more harm than good? The question is not very different from one posed by North: “How do we account for the survival of economies with persistently poor performance over long periods of time?”80 To answer this question

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80 North (1990), p. 92.
North introduces the term path dependence. This terminology is partly adapted from studies in technological change and technological lock-in and transferred to North’s theory on institutions and institutional change. The logic is quite straightforward. In a world without transaction costs, i.e. contractual costs, information costs and so on, a situation with long-run inefficiency is impossible. In the real world however, there are contractual costs and information is not costless, which implies that there are considerable set-up costs connected to the institutional framework. This is why we get institutional lock-in and path dependence. The case of the decline and fall of the Scandinavian Currency Union is a possible example of North’s path dependence or institutional lock-in.

The fact that the costs of setting up the union were considerable, combined with the notion that everything soon was going to return to normal (i.e. the return to the gold standard), provides a powerful explanation as to why the union was maintained so long even though it was doing more harm than good.

Another important notion is that even though the actions of the three countries’ Parliaments and Central banks can seem irrational when studying them with the benefit of hindsight, to fully understand a historic event we have to make an imaginary journey back to the time of the events we are studying. On the 1st of August 1914 the future is a tabula rasa and the only thing guiding the actors through this unexplored land was their experience. So what was the experience of a central banker at the time for the outbreak of World War I? The three Scandinavian countries adopted the gold standard in the 1870’s and since then they had experienced a period of approximately forty years of low inflation, steady growth and fixed exchange rates. During this period central bankers learned how to operate and manage the gold standard. One of the key benefits of the gold standard was that it provided a stable nominal anchor and a commitment mechanism to ensure that monetary authorities followed time consistent policies. Thus the gold standard was a system to maintain and provide stability. Three main rules guided their behaviour: (i) free export and import of gold; (ii) the keeping of a fixed relationship between the size of the gold reserve and the amount of circulating notes; and (iii) guaranteeing the right to redeem notes for a fixed amount of gold. In 1914 these rules changed, and they changed rapidly. Within a couple of months, central bankers found themselves acting in a completely new environment where old maps were proving inadequate. The fact that central bankers were unfamiliar with how to handle a paper standard made them unable to foresee the problems that later occurred. It is evident that Central Banking during this period was an art, not a science, and that it was an art conducted on a day-to-day basis, without prospects of foreseeing the future with any precision. Central bankers tackled problems
as they occurred and often the problems had been caused by themselves in their attempts to come to turn with some acute problem at an earlier point.

In a broader perspective the fall of the Scandinavian Currency Union provides an example of the difficulties of setting up and maintaining institutions created to provide stability in a world characterised by continuous change. It raises the question of whether it is possible to find institutions that both provide stability and handle flexibility over the long term?

Another angle on this issue is to establish who gained from the situation and how much. With this perspective, the Norwegian and Danish reluctance to cancel the treaty of 1873 could be explained by the fact that they had most to gain from the situation at hand.

All of these three proposed possible approaches need to be examined more closely and I will elaborate upon them further in a future study on the break-up of the Scandinavian Currency Union.81

References


Denmark. Danish Parliamentary Print (DPP), Rigsdagstidene, Copenhagen, 1914-1924.


Ekonomisk Tidskrift, Statistiska meddelanden (ET:s), Stockholm, 1914-1924


81 My next step will be a more detailed study on the causes and forces behind the divergence of exchange rates within the union. Is this to the larger part explained by the differences in trade policy between the countries or does monetary policy matter more? A more detailed quantitative study will be conducted on the development of internal balance of trade of the union; but also on the discount rate policy, coverage on circulating notes and inflation rates within the union. The largest part of the data collection has already been done.


Yearbook of the Riksbank (SYR), 1914-1924, (Riksbankens årsberättelser 1914-1924)
Money and Finance in Transition: Research in contemporary and historical finance

Appendix: Scandinavian gold reserves and notes in
circulation (monthly data in million kroner)
Year-Month

Swedish Gold
Reserve

Norwegian
Gold Reserve

Danish Gold
Reserve

Swedish Notes Norwegian
in Circulation Notes in Circulation

Danish Notes
in Circulation

1914-jan
1914-feb
1914-mar
1914-april
1914-maj
1914-juni
1914-juli
1914-aug
1914-sept
1914-okt
1914-nov
1914-dec
1915-jan
1915-feb
1915-mar
1915-april
1915-maj
1915-juni
1915-juli
1915-aug
1915-sept
1915-okt
1915-nov
1915-dec
1916-jan
1916-feb
1916-mar
1916-april
1916-maj
1916-juni
1916-juli
1916-aug
1916-sept
1916-okt
1916-nov
1916-dec
1917-jan
1917-feb
1917-mar
1917-april
1917-maj
1917-juni
1917-juli
1917-aug
1917-sept

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104.165
104.134
104.918
105.4298
103.9745
103.2429
103.4504
103.941
104.429
108.5373
105.592
113.1654
113.3404
113.4256
113.4434
113.4509
113.4015
113.4015
113.4148
113.3765
113.2945
124.5715
142.278
160.9077
160.813
164.9906
166.3105
166.1314
165.9176
165.7578
170.9469
177.9519
182.3804
183.5196
186.5823
191.3738
193.1729
194.281
202.9414
202.7012
204.6381
204.5012
214.5543

72.84
71.126
67.795
73.1
74.088
79.827
81.717
78.691
70.019
70.045
72.591
69.65
74.961
82.066
99.381
106.701
116.038
122.311
125.839
130.904
130.087
136.066
133.462
131.928
123.292
134.045
153.493
205.697
216.638
216.877
114.821
114.836
113.874
111.216
110.079
123.237
121.185
125.12
131.176
130.05
129.977
129.909
129.846
129.656
122.594

76.203
77.942
79.875
79.337
82.025
82.172
78.341
74.706
72.771
72.212
81.35
94.827
104.794
104.869
107.135
107.152
107.047
107.093
107.029
107.023
106.704
106.496
106.763
111.318
111.446
119.857
132.613
139.562
144.239
151.579
161.455
161.098
155.644
150.121
145.369
159.877
162.351
164.794
164.183
172.71
179.921
197.349
195.113
194.295
190.517

205.296
213.872
233.146
219.1837
226.5554
238.9713
228.4327
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294.5804
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292.3875
278.3769
275.5407
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*Source: Ekonomisk Tidsskrift 1914-1920 (Statistiska medelanden)*
1. Introduction

In the first part of the twentieth century, up to the second world war, Australia’s monetary policy was governed by what is known as the Sterling Exchange Standard (SES). The major feature of this mechanism was that the Australian banks held reserves in London (the so-called London Funds of the banks) which tended to govern their internal lending. Therefore, any factor, such as a current account deficit, that reduced the London Funds would lead to a contraction in domestic lending, economic activity and imports. Therefore, the Standard functioned partly as an automatic mechanism that achieved external and internal balance in a fixed exchange rate environment.

The purpose of this paper is to re-evaluate the role of this mechanism using techniques that were not available to the economists of that time. The first step is to provide an exposition of the mechanism. It appears that it was not effective as a re-equilibrating mechanism and the reasons for its ineffectiveness are explored. It arose basically from the looseness of the arrangement and, in particular, the often slow and variable reactions of major players – the banks and the monetary authorities. In addition, Australia adopted over the relevant period a wages policy that prevented the mechanism from functioning in the way expected by the economists of the time.

The second step is to carry out an analysis of the formation of the money supply (M3) in Australia and the sources of monetary growth. This analysis will provide some information on the extent to which the SES played a role in this process.

The third step in the analysis is to construct an annual macro-econometric model of the Australian economy over the period 1901–1939. Simulation of this model allows us to evaluate the impact of the SES and, moreover, to carry out counterfactual experiments in which the SES is strengthened. The construction of this model also allows tests to be carried out which provide evidence on two additional questions. The first of these is the stability of the estimated relations over the period studied. There were significant events
over the period, most notably the first world war, and it is possible that these events had lasting structural effects. Secondly, the model provides some additional information on the sources of the depression in Australia and the relative merits of alternative policies for dealing with it.

2. How the Sterling Exchange Standard Worked

The SES was analysed at the time for New Zealand by Tocker (1924) and his analysis was extended to Australia by Copland (1925). Further refinements were provided by Isles (1931), Wilson (1931) and Isles (1932). Modern treatments are given in Schedvin (1970, pp. 76-87) and Schedvin (1973). Schedvin (1973, p. 601) notes that Australia was under a predominantly SES system from the middle of the first decade of the 1900s up to the abandonment of gold payments at the end of 1929 and then under a full SES in the 1930s.

Figure 1. Sterling Exchange Standard

A schematic version of the SES model is provided in Figure 1. One difference between this Figure (and the later analysis) and the earlier discussions is that attention is focussed on the money supply rather than bank lending. This change in emphasis gives the model more a monetarist flavour than was present in the earlier discussions.

As already noted, the key variable is the London Funds of the Australian banks. Changes in these balances are, in simple terms, equal to exports minus imports minus net income paid overseas plus capital inflow. Schedvin
The Sterling Exchange Standard in Australia 1900-1939

(1973, p. 592) noted that the London Funds served a dual purpose for the banks – they provided a reserve against British liabilities but they were also treated as part of the banks’ overall reserve structure. He also asserts:

“In determining lending policy, banks were concerned primarily about the state of London cash balances” (Schedvin (1973, p. 592).

However, since the London Funds did not constitute part of their Australian balance sheets, the banks could only expand lending if their Australian reserves were expanded to accommodate the increase or if they permitted their reserve ratios to decline. The first of these possibilities is tested by the following regression estimated from annual data for 1902 to 1939 which was obtained from Butlin (1977).

\[
\Delta \text{BCB}_t = 1.860 + 0.2600 \text{CIR}_t - 0.0873 \Delta Y_t \quad \bar{R}^2 = 0.476
\]
\[
(1.49) \quad (2.81*) \quad (2.74*) \quad d = 2.60
\]

Where: \( \text{BCB}_t \) = cash balance of trading and savings banks (obtained from Butlin, Hall and White (1971))
\( \text{CIR}_t \) = the change in London Funds
\( \Delta Y_t \) = Gross domestic product (nominal terms)

\( \bar{R}^2 \) is the adjusted coefficient of determination and \( d \) is the Durbin-Watson statistic. The figures under the coefficients are standard errors. One asterisk indicates that the coefficient is significant at the five per cent level. The change in income term (\( \Delta Y_t \)) has been included to take account of demand pressures on the amount of cash available. When income is high, cash will drain out of the banks to be used by the public.

The equation shows the bank reserves tended to increase when London Funds increased. However, on average, bank reserves changed by only about 25 per cent of the change in London Funds. More importantly, the CUSUM OF SQUARES test indicates that the equation is highly unstable.

In considering the period 1870 to 1913, Dick et al. (1996) posited an alternative adjustment mechanism to the one represented in Figure 1. It was based on a portfolio balance theory and involved a money supply that was demand determined. The demand for money depended on domestic and overseas variables and overseas reserves adjusted to allow the money supply to be equal to this demand. This model would not be as appropriate in the period of this study because the major event that occurred in it was the fall in export volumes and the drying up of capital flows at the end of the twenties. Moreover, for the period covered by this study, a Granger Causality test of the change in \( \Delta M3 \) and the change in London Funds (\( \text{CIR} \)) rejects the null hypothesis that \( \text{CIR} \) does not cause \( \Delta M3 \), but accepts the null hy-
pthesis that \( \Delta M3 \) does not cause \( CIR \). This accords with the conclusions of Pope (1993) who found that it was the supply side components of monetary growth that gave consistently significant results rather than the demand side components.

The approach adopted in this paper is to assume that the money supply is determined. Empirical evidence on this relationship is provided by the following equation explaining the change in \( M3 \):

\[
\Delta M_{3t} = 25.305 + 0.368CIR_t + 6.66^{**} \quad R^2 = 0.206 \quad d = 1.86
\]

Two asterisks attached to a standard error indicate that the coefficient is significant at the one per cent level.

This equation satisfies the CUSUM OF SQUARES test. However, the impression created by this result is contradicted by the calculation of the recursive regression coefficients for the equation given above. The estimates for the coefficient of \( CIR \) are given in Figure 2. They show considerable variation until 1930 when there appears to have been a sharp increase in the coefficients. Examination of these results and the residuals from the earlier regression suggested the following equation:

The dummy variables \( D_{19} \) and \( D_{20} \) take the value unity in 1919 and 1920, respectively, and zero otherwise. They suggest that the equation underestimated growth in those years. \( D_{30} \) takes the value unity in the years 1930 to 1939 and zero otherwise. Therefore, the equation validates the suggestion that the coefficient shifted upwards in the nineteen thirties. Schedvin (1970) and (1973) argues that the banks reduced their target reserve ratios in the thirties. As a result, they somewhat mitigated the effects of the depression. The equation also suggests that there is a lag in the reaction of the money supply to changes in the banks’ London Funds. This lag would have weakened the SES in its role as an automatic adjustment mechanism.

The next step in the SES was that the change in monetary conditions would have an effect on the economy. The earlier treatments of the Standard focussed on its impact on prices. A more modern treatment would also have assumed an effect on aggregate expenditure and employment.
Assume that an increase in the current account deficit leads to a fall in London Funds. The banks react by reducing their lending which leads to a fall in the money supply and, therefore, domestic prices. This change makes imports relatively more expensive and discourages them. Australian exports are relatively less expensive and they will tend to increase. The current account deficit will fall and the London Funds will be restored to a satisfactory level. In this way, the SES could act as a self-stabilising device which would, amongst other effects, allow the fixed exchange rate to be sustained without speculative pressures arising.

However, Schedvin (1970, p. 77) argued that the SES “did not amount to a general credit policy designed to influence the general level of activity, or even to correct balance of payments disequilibria.” He pointed out that it depended on banks’ decisions on the reserve ratios that were prudent and that these decisions did not occur rapidly and involved considerable flexibility. Thus, a bank might absorb a significant change in its London Funds before it reacted by changing its domestic credit policy. Schedvin’s view is supported by the lag in reactions found in the equation reported above. As he suggests (Schedvin (1970, p. 78): “it was, however, a clumsy and chancy system, and its insensitivity proved to be its principal weakness as well as its main virtue, for it was too slow to react to sudden changes in the trade balance.”
3. The Institutional Setting of the Sterling Exchange System

In the period covered by this study, most Australian workers had a minimum award wage rate. This rate was determined by judicial decisions and it was not flexible. Therefore, it represented an impediment to the workings of the SES. Assume, for example, that the banks lost London Funds and contracted their domestic lending. The mechanism requires a fall in Australian prices which will discourage imports and encourage exports. However, the presence of award wage rates creates a resistance to price reductions. To the extent that prices cannot fall, the contractionary pressures would be directed through expenditure and, ultimately, through unemployment. Indeed, it seems likely that the unemployment rate played an important role in the workings of the SES mechanism. Lower expenditure and higher unemployment might have had the effect of reducing a current account deficit.

Some light can be thrown on the role of wages over the period of interest and on some of the results to be discussed below by calculating a proxy for the share of profits in Australian national income. First, a proxy for the wages share (WS) was calculated on the basis of the following equation:

$$\text{WS} = \frac{100\omega \cdot E}{Y}$$

where:
- $\omega$ is the average wage rate
- $Y$ is nominal output
- $E$ is employment
- PROD is a measure of labour productivity

The measures for the first three variables were average weekly earnings, GDP minus defence spending and civilian employment which were obtained from Butlin (1977). Then the profit share (PS) was calculated as $(100 - \text{WS})$. Note that an arbitrary starting point had to be taken for PS.

The data for PS is shown in Figure 3. The most notable characteristic obvious from this Figure is the sharp fall in the proxy for the profit share in the nineteen twenties. Over that period, award wages and average earnings were growing significantly more rapidly than labour productivity. Most of this growth occurred at the beginning of the decade. Award wages grew by 12.3 per cent in 1920 and 20.1 per cent in 1921. Therefore, Australia entered the depression with a ‘wages overhang’ (an accumulation of wage increases
above productivity gains) and, equivalently, a low share of profits in the national income. This result contradicts the explicit conclusion of Gregory, Ho and McDermott (1988, p. 244) that ‘real wage gaps’ were not a promising approach to explaining unemployment during the depression.

Figure 3. A proxy for the profit share in Australia, 1901-1939

Source: Derived from Butlin 1977

The importance of the ‘profit share’ in determining the unemployment rate is illustrated by the following equation which is a version of the one used in the model reported below in which the real wages variable has been replaced by PS.

\[
\log UR = 22.75 + 0.688 \log UR_{t-1} - 2.512 \log RY - 0.525 \log PS \\
+ 0.0486t - 0.480D08 + 0.809D13 + 0.319D15
\]

\[
\begin{array}{l}
\quad (4.60^{**})
\quad (8.29^{**})
\quad (4.24^{**})
\quad (3.35^{**})
\end{array}
\]

\[
\begin{array}{l}
\quad (3.68^{**})
\quad (2.35^{*})
\quad (3.80^{**})
\quad (1.54)
\end{array}
\]

\[ R^2 = 0.876 \]

\[ d = 2.15 \]

UR is the unemployment rate
RY is GDP at constant prices
D08 equal unity in 1908, zero otherwise
D13 equals unity in 1913, zero otherwise
D15 equals unity in 1915, zero otherwise

The equation suggests that the only reason that the low ‘profit share’ at the end of the twenties did not produce a high unemployment rate was strong GDP growth at the time. The equation also shows a substantial lag in the reaction of the unemployment rate to changes in its determinants. Insofar as
the SES relied on changes in unemployment, this lag would reduce the effectiveness of the SES in removing short-term imbalances.

4. Money formation analysis

Money formation analysis is often used to identify the sources of monetary growth in Australia. This analysis is based on a rearrangement of some basic monetary identities:

- \( BA \) = Bank advances (lending)
- \( BD \) = Bank deposits
- \( BG \) = Bank holdings of government securities
- \( BNC \) = Cash in the hands of the banks
- \( Df \) = Australian government deficits
- \( OBAL \) = Other assets and liabilities of banks
- \( OG \) = Overseas holdings of government securities
- \( PG \) = Public holidays of government securities
- \( PNC \) = Cash in the hands of the public

Now,
\[
M3 = BD + PNC = BA + BG + BNC + OBAL + PNC
\]

The budget deficit must be financed. Therefore:
\[
Df = \Delta BG + \Delta PG + \Delta PNC + \Delta BNC + \Delta OG
\]

If we use this equation to eliminate \( BG \) from the equation for \( \Delta M3 \), we obtain the money formation identity:
\[
\Delta M3 = Df + \Delta BA – \Delta PG – \Delta OG + \Delta OBAL
\]

One problem with applying this identity is that we do not have a series for the deficit. A proxy for it, called DEFICIT, can be obtained from the identity itself and this measure is shown in Figure 3. It shows, not surprisingly, that the deficit was high during the first world war. However, some large values also occurred in the nineteen twenties. There was a small deficit in 1929 followed by a surplus in 1930. These were followed by two moderately sized deficits in 1931 and 1932. All in all, the onset of the depression appears to have promoted a restrictive rather than an expansionary budgetary policy.

It is possible that movements in the budget deficit were partly endogenous, particularly in the early depression period. However, both Granger Causality and regression analysis failed to detect any relationship between the DEFICIT measure and the unemployment rate or real expenditure.
Figure 4. A proxy for the Australian budget deficit, 1901-1939

Table 1 indicates the sources of monetary growth in Australia over the sample period. The deficit was the major source of monetary growth throughout the whole period. In the years 1910 to 1930, the effects of the deficit were offset by sales of government securities overseas and to the public. The deficit appears to have been a little lower in the thirties than it had been in the previous two decades, but there was also a fall in sales of securities to the public and a sharp reduction in the sale of securities offshore which meant that monetary growth over the thirties was only a little lower than it had been in the twenties.

Monetary growth was very low at the beginning of the thirties and a major factor contributing to this lower growth was the reduction in bank lending. Over the thirties, the increase in bank lending was less than one quarter of its increase in the twenties. As noted already, banks reduced their reserve ratios at the beginning of the depression, but this change was not sufficient to maintain the rate of increase of bank lending.
Table 1. Sources of monetary growth in Australia, 1901-1939

<table>
<thead>
<tr>
<th>YEAR</th>
<th>ΔM3</th>
<th>DEFICIT</th>
<th>ΔOG</th>
<th>ΔBA</th>
<th>ΔBOAL</th>
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5. The Econometric Model

An econometric model of the Australian economy is presented in Table 2 which also includes a definition of the variables included in it. This model is similar to those developed in Valentine (1987) and Valentine (1988). A structural model has been used because of the desire to obtain information on the workings of the SES. The structure of the model is a more complex version of the one described in Figure 1. Before evaluating the model, it is necessary to make some comments about the individual equations.

The desire to determine the form of structural relationships and the ways in which they interacted was the major reason why this study did not adopt the cointegration approach. Most of the series are integrated to order one (I(1)). In such situations, regressions in levels can produce spurious results. When variables are I(1), there is a possibility that at least one cointegrating
relationship exists amongst the variables. The existence of this relationship creates restrictions that can be used to improve the efficiency of the estimates.

Series which are I(1) can be converted into stationary (I(0)) series by first differencing. Many of the equations in the model are in first difference form. Taking account of the restrictions arising from the existence of a cointegrating relationship produces more efficient estimates than an unrestricted equation in first differences (see Pagan and Wickens (1989) and Campbell and Perron (1991)). Nevertheless, first differencing does remove the ‘spurious relationship’ problem.

The model has been estimated by Three Stage Least Squares. This method of estimation takes account of the simultaneity of the relationships and correlation amongst disturbances in difference equations. The latter characteristic increases the efficiency of the estimates.

The expenditure equation shows that expenditure depended on monetary growth, the increase in export prices, government expenditure and Tobin’s Q. Tobin’s Q is the ratio of the value of existing capital (proxied by share prices) to the price of new capital (the implicit deflator of Gross Private Capital Formation) and it is expected that business investment will increase with it. The money supply equation has been discussed above.

The share price equation has Australian share prices depending on overseas share prices, providing a link with the global economy not encompassed in the discussions of the SES, monetary growth and the fundamental determinants of profits – the prices of the final product and wage rates.

Product prices are determined by monetary growth, the state of the economy as represented by the unemployment rate and award wages. The formulation adopted favours allows us to consider the effect of award wages on the SES. The equation for the prices of capital goods has a similar form.

The import equation has a standard form. Imports are determined by expenditure, the unemployment rate and domestic prices relative to overseas prices. There is no lag in the equation which would improve the workings of the SES.

The equation explaining the unemployment rate shows that it was strongly negatively affected by real wages and strongly positively affected by real income. There was an upward trend in unemployment, possibly due to the effects of technological progress. There is also a fairly long lag in the reaction of the unemployment rate to changes in the variables determining it. Gregory, Ho and McDermott (1988, p. 231) argued that there was little ‘hidden unemployment’ in the depression period. They base this conclusion on their finding that labour productivity was approximately constant over 1927 to 1939. However, Forster (1988, p. 297) cites some evidence of ‘work rationing’ in the depression period. The equation in the Table pro-
vides a little bit of evidence on this question. The coefficients show a higher level of sensitivity to output and wage rates than obtained from a similar equation estimated for the period 1965-1992 (Valentine (1993)) supporting the view that there was less labour hoarding in the pre-war period than occurred in the post-war period.

The equations for imports and the unemployment rate have been estimated in level terms which, since the variables are I(1), raises some questions about the validity of these relationships. In order to test this possibility, the equations were re-estimated in first differences. The transformation made little difference to the coefficients and their significance except that the variable (P/ER.PUK) became insignificant in the import equation.

Table 2. A model of the Australian economy 1901-1939; behavioural relations (three-stage least squares estimates)82

EXPENDITURE

\[ \Delta E = -20.19 - 0.311 \Delta E_{t-1} + 0.291 \Delta M3 + 1.093 \Delta M3_{t-1} \]
\[ (1.48) \quad (4.05**) \quad (0.86) \quad (3.31**) \]
\[ + 573.1 \Delta PX + 4.006 \Delta G + 1.733 \Delta Q_{t-1} + 133.4 \Delta D19 \]
\[ (2.47*) \quad (5.19**) \quad (4.20**) \quad (2.85**) \]
\[ - 126.3 \Delta D2021 \]
\[ (3.91**) \quad R^2 = 0.990 \quad d = 2.07 \]

MONEY SUPPLY

\[ \Delta M3 = 24.8 + 0.2556 \Delta CIR_{t-1} + 0.6078 \Delta D30.CIR + 27.8 \Delta D20 \]
\[ (8.45**) \quad (3.06**) \quad (5.39**) \quad (1.62) \]
\[ + 52.4 \Delta D19 \]
\[ (3.10**) \quad R^2 = 0.997 \quad d = 1.92 \]

82 Note: \( \bar{R}^2 \) is the adjusted coefficient of determination. In the equations for E, M3, S, P and PI, \( R^2 \) is calculated using the level (rather than the change in the level) as the dependent variable.

Numbers under the coefficients are t-statistics. One asterisk indicates that the t-statistic is significant at the five per cent level, and two asterisks indicate that it is significant at the one per cent level.

Years are financial years. For example, 1901 refers to the financial year 1900/01.
SHARE PRICES

\[ \Delta S = 1.361 + 0.0443 \Delta DOW + 0.0499 \Delta M3 + 36.6 \Delta P \]
\[ (1.96) \quad (4.08**) \quad (2.60*) \quad (0.75) \]
\[ - 142.5 \Delta MW - 4.32 DW1 - 5.98 D293031 \]
\[ (2.96**) \quad (3.17**) \quad (3.44**) \]
\[ R^2 = 0.974 \quad d = 1.95 \]

PRICES

\[ \Delta P = -0.00286 + 0.000159 \Delta M3 + 0.1365 \Delta PX + 0.455 \Delta MW \]
\[ (2.04*) \quad (4.14**) \quad (4.89**) \quad (4.19**) \]
\[ + 0.0145 D15 + 0.0218 D2021 \]
\[ (2.60**) \quad (5.28**) \]
\[ R^2 = 0.986 \quad d = 2.25 \]

PRICES OF CAPITAL GOODS

\[ \Delta PI = -0.000113 + 0.238 \Delta MW + 0.077 \Delta PX + 0.0242 DW1 \]
\[ (0.10) \quad (2.01*) \quad (2.69**) \quad (7.51**) \]
\[ + 0.0299 D20 - 0.049 D39 \]
\[ (4.80**) \quad (8.34**) \]
\[ R^2 = 0.988 \quad d = 1.97 \]
imports

\[ M = -78.6 + 0.180 RY + 2951(P / ER.PUK) - 24.4UR \]
\[ (0.66) (18.96**) (2.30*) (7.99**) \]
\[ + 457.7D21 \]
\[ (6.76**) \]
\[ R^2 = 0.926 \]
\[ d = 2.00 \]

unemployment

\[ \log UR = 23.4 + 0.488 \log UR_{t-1} + 2.124 \log (MW / P) \]
\[ (7.28**) (7.70**) (7.16**) \]
\[ - 2.698 \log RY + 0.0566t - 0.468D08 + 0.705D13 \]
\[ (7.01**) (6.77**) (3.65**) (5.04**) \]
\[ + 0.475D15 \]
\[ (3.59**) \]
\[ R^2 = 0.894 \]
\[ d = 1.94 \]

5.1 Identities

Income identity \[ Y = E - M + E \]
Real income \[ RY = Y / P \]
\[ Q = S / PI \]
Imports \[ MS = RIM.P \]
Change in Reserves \[ CIR = ES - MS - NPIPA + PB + IPCI \]

5.2 Endogenous variables

\[ CIR = \text{Change in International Reserves} \]
\[ E = \text{Domestic Expenditure} \]
\[ M3 = \text{Money Supply (Bank Deposits plus Currency in Circulation)} \]
\[ MS = \text{Imports} \]
\[ P = \text{Implicit Deflator of Gross Domestic Product} \]
\[ PI = \text{Implicit Deflator of Gross Private Capital Formation} \]
\[ Q = \text{Tobin’s Q} \]
\[ RIM = \text{Imports at Constant Prices} \]
\[ RY = \text{Gross Domestic Product in Constant Prices} \]
\[ S = \text{All Ordinaries Share Price Index} \]
\[ UR = \text{Unemployment Rate} \]
\[ Y = \text{Gross Domestic Product} \]
5.3 Exogenous variables

- \( D_{08} = 1 \) in 1908, 0 otherwise
- \( D_{13} = 1 \) in 1913, 0 otherwise
- \( D_{15} = 1 \) in 1915, 0 otherwise
- \( D_{19} = 1 \) in 1919, 0 otherwise
- \( D_{20} = 1 \) in 1920, 0 otherwise
- \( D_{21} = 1 \) in 1921, 0 otherwise
- \( D_{2021} = 1 \) in 1920, -1 in 1921, 0 otherwise
- \( D_{25} = 1 \) in 1925, 0 otherwise
- \( D_{293031} = 1 \) in 1929, 1930 and 1931, 0 otherwise
- \( D_{39} = 1 \) in 1939, 0 otherwise
- \( DOW = \) Dow Jones Index
- \( DW_{1} = 1 \) in 1915, 1916, 1917 and 1918, 0 otherwise
- \( ES = \) Exports
- \( ER = £A/£S \) Exchange Rate
- \( G = \) Public Expenditure
- \( MW = \) Male Adult Wage
- \( PUK = \) Price Deflator of UK Gross Domestic Product
- \( PX = \) Implicit Deflator of Exports
- \( t = \) Time Trend Beginning in 1901

6. Results

The model is very accurate in predicting the variables in a static simulation using the actual values of lagged endogenous variables. However, the most stringent test to which a model can be subjected is a dynamic simulation in which lagged values of the endogenous variables are replaced by the values obtained from the solution. The technique takes account of the possibility that errors become cumulative.

*Figure 5. Expenditure and forecast expenditure*
Figures 5 and 6 above show the solutions for expenditure and the unemployment rate. The model tracks expenditure well. The correlation coefficient between the actual and forecast errors is 0.993 and there is no average bias. In the case of the unemployment rate, the correlation coefficient is 0.918, but the forecasts tend to underestimate the actual values. In both cases, there is considerable first-order autocorrelation in the forecast errors.

The instability in the M3 equation has already been discussed. The other equations include a number of dummy variables which indicate that there was also some instability in them. Many of the dummies relate to the first world war or the economically disturbed period following it. However, the overall conclusion from this model is that the War had only a temporary effect on the relationships which hold reasonably well over the whole period. Some of the other dummy variables may reflect data problems rather than actual shifts in the relationships. For example, D2021 in the expenditure equation could be picking up an underestimate in one year followed by an equivalent overestimate in the following year.

The model can be used to throw some light on the questions raised earlier in this paper. First, it was simulated setting the coefficient of D30.CIR equal to zero in the M3 equation. In other words, the simulation examines what would have happened if the banks had not increased their reaction to changes in London Funds in the thirties. The result was a slightly lower unemployment rate over the thirties. This indicates that the unrestricted workings of the SES would have made the depression a little deeper.

The second counter-factual simulation incorporated the change mentioned in the previous paragraph, but also replaced CIRt-1 with CIR (removing the lag in reactions) and increased its coefficient. In all, these
changes produced a stronger SES than the one that existed in reality. The result was a somewhat more stable current account deficit. However, whenever the current account deficit was reduced, it was at the expense of lower expenditure and a higher unemployment rate. This result illustrates the important role that expenditure and unemployment played in the adjustments promoted by SES.

The third counterfactual experiment was an attempt to approximate the effect of wage flexibility by assuming that award wages change according to the following equation:

$$MW = MW_{t-1} + 0.001(UR-6)$$

Award wages are reduced whenever the unemployment rate is above 6 per cent and increased whenever the unemployment rate is below that figure. Gregory, Ho and McDermott (1988) argued that the system of award wages in force in Australia over the depression gave the country greater nominal wage flexibility (the basic wage was reduced by 10% in 1931) than existed in other countries. However, they also argued that this nominal wage flexibility did not convert into real wage flexibility. The real wage remained fairly constant in the period they were discussing. What was missing in this period was a response of wages to unemployment such as the one embodied in the equation adopted here.

Figure 7 shows the effect on the unemployment rate resulting from the introduction of this equation. $URF$ is the unemployment rate resulting from the dynamic simulation of the basic model, and $URG$ is the unemployment rate that is produced by a dynamic simulation of the model incorporating the wage flexibility equation. It made little difference up to 1920, but reduced the unemployment rate substantially after that year. This result reflects the effect of the strong wages growth over the twenties. It is clear that much of the high unemployment rate during the depression resulted from the wages overhang that existed at its beginning. Figure 8 indicates the effect on real wages of this change. $RMW$ is actual real award wages, and $RMWG$ is real award wages resulting from the counter-factual simulation. It shows that real wages would have been much lower over the twenties, but that further reductions would not have been required in the thirties.
Figure 7. Unemployment rate: initial solution and resulting from wage flexibility

Figure 8. Actual real wages and real wages under a flexible wages system

7. Conclusions

This paper has discussed the role of SES in the process of external adjustment in Australia over the period 1901 to 1939. The analysis reconfirmed the prevailing view that the SES was not particularly effective and could hardly be regarded as a self-equilibrating mechanism. Strengthening the mechanism would have made it more effective, but then it appears that the major channels through which it would have achieved balance are variations
in the unemployment rate and aggregate expenditure. Strengthening of the SES could have resulted in a deeper depression in the thirties.

This study also confirms the important role of wages policy in the depression. In particular, it focuses attention on the sharp increase in wages over the twenties. Australia entered the depression with a ‘wages overhang’ resulting from the increase in wages in excess of productivity growth over the twenties. The high unemployment rate of the thirties can be largely attributed to this overhang.

References


The ‘special’ relationship between finance and industry in Britain – exceptionalism or nationalism?

1. Introduction

This paper presents a critical examination of the widely argued thesis that the provision of international financial services by the British financial sector has played an important part in retarding the long-run development of the British economy. As such the paper engages some of the key arguments of the debate about British industrial decline. The paper develops and adds to arguments presented in earlier work (Nalson 1993) the focus of which was a critique of the explanatory model of British economic development devised by Perry Anderson and Tom Nairn, amplified at the level of cultural analysis by Martin Wiener.83 I have retained the original focus on long-term economic change and consider, in outline, the relationship between finance and industry in Britain from the nineteenth century to the 1970s.

Before I even begin to unpack the key ideas and concepts of what can be termed the ‘City hegemony’ thesis, we need to consider exactly what the thesis has to explain, given the recent performance and current strength of the British economy. Much of the literature on the so-called ‘British disease’, which reached a high point of intensity in the 1960s and 70s, implied a degree of economic decrepitude which belies an economy that in May 2000 became the fourth largest economy in the world (The Economist, May 23, 2000). The British economy has moved on since the high point of the debate, which occurred, not coincidentally, at the same time as the end of the long post-WW2 economic boom.

Cultural arguments on the pessimistic side of the British disease debate have fared even worse than some of the darker empirical projections from the 1960s and 70s. Cultural theorists such as Anderson and Wiener argued that the process of decline in Britain was the result of a protracted and complex process of cultural determination. They went even further than their

83 The principal texts are; Anderson (1965); Anderson (1987); Nairn (1972; 1964); Nairn (1964); Nairn (1977); Nairn (1979); Nairn (1990); Wiener (1981).
colleagues on the pessimistic side. Rather than merely diagnosing terminal industrial decline, the standard argument of the extreme pessimists, they presented an image of British capitalist development in which the British economy was depicted as barely an example of industrial capitalism at all. Both Anderson and Wiener presented the British economy as beholden to an all-pervasive anti-industrial ethos generated by the early development of a commercially oriented capitalism before the advent of industrial capitalism, or what passed for it in Britain. The success of this ‘premature’ capitalist development in Britain, locked a pre-industrial land-owning elite and its financial auxiliaries into power, its position consolidated firstly by the outstanding success of capitalist agriculture and colonial expansion, and then by the riches generated by the City of London. Financial and industrial activities are viewed as conceptually distinct in this thesis. In Britain, it is argued, industrial and financial capital develop along essentially different pathways, socially and culturally, the latter dominating the former both politically and in terms of wealth generation (the City hegemony thesis). Anderson and Wiener go so far as to depict the first industrial revolution as something of a sideshow occurring in the far north causing minimal distraction from the main game - the triumphal progress of the southern financial and commercial patricianate. Because the British industrial bourgeoisie never throws off the aristocratic yoke as was the case in France, British culture and society retain various ‘aristocratic’ influences such as, amateurism, nepotism, disinterest in technical education and disdain for industry, including disinterest in the systematic application of science to industrial development. Finance remains detached from national industrial development, aristocrats colonize the City and its energies are directed overseas, especially in the era of ‘new imperialism’ in the decades prior to the First World War. The Anderson/Nairn position draws the conclusion that British capitalism represents a fundamental exceptionalism, set in concrete by hegemonic social and cultural processes, differing substantially from what they consider to be more orthodox (and successful) cases of capitalist development such as France and Germany.

The degree and permanence of cultural and social ossification argued for by Anderson et al. is difficult to sustain in the light of Britain’s recent economic performance. I do not intend to present too sanguine a view of the current state of the British economy, which like any other advanced industrialized economy, has its strengths, weaknesses and distinctive features. What I am arguing is that its current and historical weaknesses do not invite explanation in terms of profound socio-cultural exceptionalism. Britain’s economic performance in the longer term is simply not different enough from that of the other major ACC’s to invite explanation in such elaborately essentialist and extravagant cultural terms.
Although the British economy has succeeded in climbing back up some of the economic league tables since the early 1980s, confounding the cultural determinists, we are still left with the historical problem of explaining the relative decline of the nation that was the workshop of the world in the mid-Victorian era. Additionally, we need to test the City Hegemony thesis as an explanation of Britain’s lacklustre performance after WW2.

2. The End of Mid-Victorian Industrial Leadership

Up to a point, some sort of process of relative decline from Britain’s early industrial dominance was inevitable as simply a function of other countries catching up as they themselves industrialized. Unavoidably, Britain’s proportional share of industrial production fell as Germany, the US and the rest of Europe industrialized in the last third of the 19th century. So too did Europe’s in relation to the rest of the non-European world, but nobody talks of a ‘European disease’. But beyond the inevitable arithmetic of relative decline, Britain’s economic performance towards the end of the nineteenth century was unarguably sluggish. Britain was slow to modernize and participate in the second phase of the industrial revolution, when science, technology, technical education and industry became linked in far more systematic and complex ways than during the years of British industrial pioneerdom. A good example is provided by the case of the German chemical industry, whose development was enhanced considerably by these kinds of linkages, which, by comparison, were severely lacking in Britain.

The work of William Henry Perkin had pioneered the making in Britain of synthetic dyes from coal tar (1856), a process which eventually culminated in the emergence of the modern synthetics industry. The British dye industry, however, did not reap the benefit of Perkin’s work. German firms were able to draw upon a much greater depth of highly trained scientific expertise, more rationalised and focussed industrial investment and consequently much more modern and efficient production facilities (Lilley 1973:245). By the end of the 19th century, Germany dominated world production of synthetic dyes and had produced the crucial breakthrough of synthetic indigo (1897). The British market for synthetic dyes became dominated by German imports (90 per cent of the domestic market in 1913).

Britain’s relative failure to develop technical education is illustrated by comparison with the situation in Germany. By 1913, Germany was produc-

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84 See The Economist (2000). For example, British rates of GDP growth are now in the mid range of the G7 tables for the period 1989 –1998. For the entire period 1950-1979 Britain had been at the bottom of this table.
ing 7000 graduate engineers per year, Britain “only 350 graduates in all branches of science, technology and mathematics” (Hobsbawm 1969:182).

British productivity and industrial development fell behind in other areas. The Thomas- Gilchrist method of steel making (invented in Britain) benefited foreign more than British steel producers. In the area of electro-techniques, the pattern is similar. Despite pioneering British work by the likes of Faraday, Maxwell and Wheatstone, the British electrical industry, by 1913, paled by comparison with Germany and the United States. In 1916 a long list of inventions and innovations could be compiled, many originating in Britain, which were energetically exploited on the continent and the USA but only sluggishly adopted, if at all, in Great Britain (Gray and Turner 1916). In 1905, the London underground was electrified by American finance and capital (Hobsbawm 1969:181). In the early 1880s, telephones and electric lighting had been introduced into Britain by American owned companies (James 1994: 202). The Gatling and Nordenfelt machine guns used in the British imperialist campaigns in the 1870s and 1880s had been manufactured in the USA (James 1994:202). The overall picture by the outbreak of WW1 suggests that, in addition to the application of science to technology, Britain had fallen behind in several key areas crucial to maintaining industrial competitiveness. Fordist production methods were slow to take root in Great Britain, the development of Britain’s domestic market, despite rising worker incomes was slow to be exploited, and the process of industrial concentration was slow. The situation is summed up by Hobsbawm; “the most advanced industrial economy had became the most sluggish and conservative in the space of 30- 40 years” (Hobsbawm 1969:178).

One of the most widely canvassed explanations of this period of more-than-relative decline is that which highlights a disjunction between British industry and finance. The provision of international banking services and the City’s external bias is viewed as a factor contributing to the relative neglect of domestic industrial development. The external bias of the City is viewed as denying domestic industry the investment funds required for industrial renovation and modernization. The consequence was the failure of British industry to maintain its early technical lead.

From the 1880s when Britain faced earnest industrial competition from latecomer industrialisers, there was no sustained and concerted attempt to keep pace and maintain British dominance. But City hegemony theory and the cultural critique do not provide a coherent explanation of why this was the case.

Britain’s failure to keep pace with industrial rivals after the 1880s cannot be explained in terms of a disjunction between British industry and finance. The differences, which had emerged, between the British economy and
those of its industrial rivals are far more plausibly explained by the kind of molecular industrial structure that had been a natural consequence of industrial pioneerdom. British industrialisation had been spontaneously generated, the result of the actions of a very large number of small firms. It had not been the result of a powerful state-guided industrializing ideology as was the case in Germany, where the connections between finance and industry were always more centrally co-ordinated (Dillard 1967:399; Riesser 1911). In the United States, large investment banks encouraged industrial concentration and the emergence of oligopoly (Best and Humphries 1986:224). In early nineteenth century Britain, the typical sources of investment finance were family wealth and retained earnings (Cameron 1967:39; Heaton 1972:88-89; Michie 1987:101). The local domestic capital markets, which did emerge, were fragmentary in nature as they evolved in response to the financial requirements of particular firms on largely a regional rather than national basis. This was very largely a function of the smallness of most of Britain’s manufacturing firms (Cain and Hopkins 1993:14).

In the late nineteenth century it can be argued there was actually too much investment capital available. Best and Humphries observe that “by providing easy access to funds for new capacity, British stock markets facilitated entry into industry and exacerbated competitive pressures” (Best and Humphries 1986:225). In situations where there was a high degree of stability in bank-industry relations, and personal relations between the two sectors, as was the case with many of the country banks, short-term loans were often simply ‘rolled over’ in bad times (Best and Humphries 1986:227). This phenomenon undoubtedly contributed to the relative slowness of the industrial rationalization process in Britain, helping to preserve an internationally anachronistic, competitively oriented industrial structure.

The London stock market complemented rather than dominated the provision of finance up until the first war. Its major service was in providing a secondary market for securities and thereby ensuring market liquidity (Michie 1990:108). When the London Stock market boomed in the late nineteenth century as a consequence of the straining of local resources, the “floatation of joint-stock companies was not associated with the rationalisation of industry as had been the case in the US” (Best and Humphries 1986:226). Mergers and cartelisation were much slower to develop in Britain than on the continent and the USA. Why was this the case?

Britain’s early industrial structure of competitive capitalism bequeathed the ideology of laissez-faire, which had found its most famous early expression in the work of Adam Smith. It was the ideological background and investment decision making structure of competitive capitalism, rather than capital shortage or disdain for industry which made the prospect of centrally co-ordinated industrial renovation and modernization an unlikely prospect.
in late Victorian and Edwardian England. The industrial structure of competitive capitalism implied that any movement towards industrial modernization would necessarily be spontaneous – the result of a host of individual investment decisions, guided by the profit motive. But it has been shown that very satisfactory profits were able to be made employing existing techniques – and that for British industry to have modernized, present sacrifices for very uncertain future gains would have been required, something perhaps unfair to expect from rational profit seeking entrepreneurs (Richardson 1968: 275; Hobsbawm 1969: 188).

The gradual erosion of the openness of the 19th century world economy further complicated the situation. Germany, France, Russia and the USA came to rely fairly extensively on tariff barriers to assist their industrialization. Russia, France and Germany introduced protective tariffs in 1877, 1878 and 1879 respectively. By 1897 the general American tariff was 57 per cent (Gamble 1982:237). Even if Britain had modernized to a greater degree, it would have had great difficulty competing with more regulated and protected foreign markets. Rather, the British staple industries, (textiles, iron and steel) without the benefit of significant modernization continued to do very well up until the first war. The staple industries were assisted by the British economy undergoing what has been termed a ‘retreat into empire’. Profit levels and returns on capital could be maintained by exploiting the captive markets of empire – for example, providing industrial goods and building railways in the colonies, and providing investment finance for colonial development. This external orientation of finance and investment was not because of an anti-domestic or anti-industrial bias but simply because profit opportunities overseas were so numerous.

The extent of the external emphasis in British investment is indeed quite striking, and it is not surprising it should invite explanation in terms of a decisive rift between finance and industry. British capital exports dominated the capital exports of other industrial nations, and as a consequence domestic capital formation was correspondingly lower. In 1914, British overseas assets exceed the combined totals for the United States, Germany and France – Great Britain accounted for 44 per cent of the world total of foreign assets. (Pollard 1985:489). Great Britain’s overseas assets were four times those of Germany by 1913. The United States was still actually a net debtor by this date (Aldcroft and Richardson 1969:198) The domestic investment rates (as a proportion of GNP) of Germany and the United States were almost twice those of Great Britain (the British rate was approximately 7 per cent).

The retreat into empire is presented by City hegemony theorists such as Anderson as largely a function of the natural preference for investment in and commitment to formal empire by the City. The strong externalist em-
phasis of British investment is according to the City Hegemony thesis one of the key components of British capitalism’s exceptionalism. But the external orientation of the British economy was a vital component of the distinctive pattern of pioneer industrialization in Britain. Pioneer industrialization in Britain and early economic integration with the world economy went hand in hand. This doesn’t make the historical structure of British capitalism an exceptionalist abnormality. Rather, it indicates the global nature of the development of capitalism, a feature that was in evidence from the beginning of English capitalist development. The cotton industry was at the centre of Britain’s industrial revolution and it was pre-eminently an export industry, which also relied on overseas sources of raw materials. The concentration on exports had the advantage of avoiding reliance on the home market for growth. The capacity to produce export goods more cheaply than anywhere else provides a further and vital reason why Britain developed an abiding commitment to free trade and an open world economy in the nineteenth century.

Before 1820, Britain’s international economic prominence had been based on the rigorous commercial and strategic policies, which had made it the leading and most successful colonial nation. Britain’s emerging position as leader of the world economy from the 1820s, however, was based upon superior levels of productivity and hence the greater competitiveness of its leading industries. The repeal of the Corn Laws in 1846 was the culmination of a process, which had been on-going since the 1820s of opening British markets and reducing duties (Gamble 1982:55).

Great Britain was the first country to throw its lot in with the world economic system by abandoning agricultural self-sufficiency in favour of specialisation in the production of industrial goods in an international economy based upon free trade. The economic benefits wrought by the era of free trade allowed Britain’s population to grow far in excess of that, which could be domestically supported. But the benefits flowed in other directions as well since British imports of food and raw materials stimulated foreign incomes, which in turn enlarged, the size of Britain’s markets and contributed to the growth of the world economy. (Gamble 1982:56) The growth of the world economy inevitably provided attractive investment opportunities for British capital.

Britain’s early leadership in the world economy can be seen very much as a function of Britain’s industrial supremacy, which implied that commercial advantage, could be gained by inaugurating a liberalized and open world trading system. The spread of British industrial technology to other parts of the globe, which marked the beginning of industrialization in parts of Europe and the USA, created the world capitalist boom of the 1850s and the 1860s. The very processes, which enabled the first industrial nation to ex-
ploit its competitive advantages, were those, which precipitated its ultimate relative decline. By liberalising world trade, Britain greatly facilitated the industrialization of its ultimate competitors (Gamble 1982:56-57).

One further legacy of the golden years of international liberalism during the mid-Victorian era was the strengthening of the ideology of *laissez-faire*. As Kiernan states: “so far were *laissez-faire* attitudes pushed that they almost implied the withering away of the state like the one Marx preached from his different pulpit” (Kiernan 1990:81). This certainly had the effect of contributing to the development of an ideological and institutional climate unreceptive to the demands of modernization later in the century. When the newly industrializing countries began to compete with Britain from the 1880s there was no ‘wholesome guidance’ from the state in Britain, and Britain proved “unequal to the effort of modernizing its methods and holding on to its technological lead”. (Kiernan 1990:81)

The rise to dominance of the City of London as the financial and commercial nucleus of the emerging world capitalist system dates precisely from the period when British industrial capital was internationally dominant. This should be kept in mind when assessing theories of disjunction between the City and British industry. Although the City had certainly performed ‘pre-industrial’ commercial functions as a financial centre well before the industrial revolution, the central role which it came to play in the development of an interdependent world economy in the 19th and 20th centuries is inseparable from the early dominance and internationalisation of British industrial capital.

The era of ‘new’ imperialism in the last two decades of the 19th century has to be viewed within the context of rivalry between the world’s *industrial* nations. International tensions had been exacerbated during this period by the emergence of rival industrial powers (James 1994:202-203). From the early 1870s tariff protection had increased dramatically. The intention was to “shut out British goods, whilst denouncing free trade as hypocritical policy designed to promote British industry at the expense of the rest of the world” (Gamble 1982:57). As Gamble puts it, “trade rivalry and military rivalry became fused into one” (Gamble 1982:58). Geo-political considerations linked to substantial economic ones, lie at the heart of Britain’s commitment to imperialism and empire at the end of the nineteenth century. The process cannot simply be regarded as an abdication by industrial capital to a supposedly aristocratic/financial fraction of capital, especially in the light of the unbroken official commitment to free trade (which lasts until 1932 to be restored again after WWII) and the continuing failure of tariff reform.
3. The Inter-War Period

The case for a continuing disjunction between industrial and financial capital between the wars is even more tenuous. World economic growth fell away substantially during the inter-war years, as did growth in world trade. The war severely disrupted the international economy and correspondingly reduced international investment opportunities. The war itself had led to an intensification of protectionism because of the world-wide stimulus to import substitution during the war years (Kenwood and Lougheed 1971:185-186) In the 1930s, many nations responded to economic crisis by increasing tariffs. The financial disruption caused by the end of the Gold Standard in 1931 severely impaired the efficiency of the international payments system. International financial regulation and restriction was the order of the day.

After WW1, the City took a much greater interest in the domestic market with a resulting increase in the availability of funds for domestic investment (Cain and Hopkins 1993:14-20). The overwhelming problems confronting British industry during the inter-war years were not related to capital shortage, but those, which afflicted industry everywhere – economic depression, declining markets and decreasing profitability.

The return of the City to the domestic scene is associated with a mergers boom, which by the outbreak of WW2 saw the large corporation “well-established in Britain” (Cain and Hopkins 1993:17). The London Stock Exchange enabled much of this merger activity to occur. Domestic issues during the inter-war period were twice those of overseas issues. Immediately prior to WW1 only 30 per cent of new issues were for domestic concerns (Cain and Hopkins 1993:17) By the late 1920s the largest 100 British companies were producing 26 per cent of British output compared to 15 per cent in 1907 (Cain and Hopkins 1993:16). The Bank of England had played an important part in this process in its policy of encouraging the emergence of efficient big business. But industrial rationalization occurred later in Britain than elsewhere, and did not result in a comparable degree of coordination between finance and industry, as Cain and Hopkins emphasize.

In explanation of this, we have to consider the extent to which the process occurred from a low base - the pre-war legacy of a molecular industrial structure - and the prevailing ideological climate of not interfering with the market. The powerful ideology of laissez faire predominated and despite the merger boom, the city’s role was primarily that of financial intermediation, not financial and industrial supervision.

During the inter-war period the national clearing banks which had emerged in the decades before WWI as a consequence of expanding capital requirements and local bank failure, were disposed to rely upon “market coordination and competition to shape industrial development” (Best and
Humphries 1986:230). In other words, the stress was very much as it had been with the local banks on backing individual firms without considering the overall interests of industries. Why was the highly concentrated clearing bank system in Britain unable to provide co-ordinating guidance in the interests of the industrial sector as a whole?

One possible explanation for this failure was that the clearing banks had over-extended themselves during the euphoria of the post WW1 staple industry credit boom. The Chairman of Lloyd’s bank stated in testimony before the Committee on Finance and Industry, that during this period: “everybody thought that the trade of the world was at our feet” (Committee on Finance and Industry 1931: cited in Best and Humphries 1986:229). It was expected that the staple industries “would quickly extend and regain pre-war markets” (Best and Humphries 1986:230; Cain and Hopkins 1993:14-15). This did not happen and the banks were left in the position of being over-committed to a large number of distressed firms as the staple industries declined in the 1920s. While total advances to industry of the 10 largest London clearing banks dropped from £479.3 m. in 1929 to £352.9 m. in 1936, or 26 per cent, advances to heavy industry, iron and steel, engineering, and shipbuilding, dropped by 35 per cent, textiles by 51 per cent, and mining by 49 per cent” (Best and Humphries 1986:230). These figures suggest that during a period of increasing international competition, an important opportunity was lost for the establishment of a greater degree of involvement in industry by the banking sector. The conclusion which can be drawn from this is not that financial capital was extricating itself from industry because of a culturally derived disdain for it, or even in this case because of an over-commitment to ‘external’ development. Rather, the banks were actually making sound economically based decisions not to back declining, traditional staple industries, which were underperforming well before the 1929 slump. In the absence of co-ordinating policies from the state, the capacity of a concentrated financial sector to provide the centralized guidance required for industrial modernization was not exploited. And this, in turn, is more plausibly explained in terms of entrenched attitudes concerning the economic benefits of market competition, which have been so prevalent in the history of British capitalism.

The overvaluing of the Pound when the Gold Standard was restored in the 1920s has been viewed as a political triumph for the City lobby and confirmation of City hegemony. It is argued that the restoration of pre-war parities, which proved unfavourable for the international competitiveness of British industry, was seen as necessary to maintain the prestige of the City. But there is little evidence of any clear cut City-Industry divide on issues such as the restoration of the gold standard. Many industrialists were highly in favour of a return to the Gold Standard because they saw it as a guarantor
of international financial stability and hence to their benefit (Longstreth 1979:167-168). The chaotic international payments environment, which emerged after 1931, gives some credence to their views.

4. The Post-WW2 Period

According to the City hegemony thesis, the success of the financial sector assured its continuing political influence throughout the 20th century. This translated into a continuing bias in economic policymaking favouring the interests of financial over industrial capital. For example the stop-go economic policies adopted in Britain during the Bretton Woods era are viewed as favouring the City over industry. As in the 1920s a strong Pound was viewed as a necessary symbol of the continuing importance of the City. Although the Pound was substantially devalued in 1967 under a Labour government, it is stressed that its defence by means of stop-go over a long period impaired the international competitiveness of British industrial goods.

Stop-Go was not a policy setting unique to Britain. Balance of payments difficulties contributed to a series of ‘stops’ in Japan in the fifties and early sixties (Glyn and Harrison 1980:43), which did not impair Japan’s massive investment achievement during this period. The key factor underlying Britain’s relatively poor economic record up to the 1980s is the quality and direction of investment and research and development. The overall quantity of British research and development compares favourably with that of other countries. Between 1950 and 1960 US spending on R&D rose from 1 per cent of GNP to 2.8 per cent. The figure for Britain grew from 1.7 per cent in 1955 to 2.5 per cent in 1960 (Kenwood and Lougheed 1971:257). In 1967 Britain was ranked second in the OECD league table of total R&D spending (Dintenfass 1992:47). The evidence suggests a misallocation rather than a shortage of investment funds. Government sponsored R&D was higher than everywhere except the United States. Government investment tended to be narrowly focussed in low productivity areas such as defence, nuclear energy, space and civil aeronautics. Sectors of greater commercial importance such as machinery and chemicals were bypassed (Glyn and Harrison 1980:45) - the pattern of British investment was mismatched with the more lucrative areas of world trade. Even private sector R&D in Britain was similarly narrow in focus in comparison to the mix in Japan and Germany. (Dintenfass 1992:47)

What conclusions can be drawn from this data regarding the City hegemony thesis? Firstly, it must be noted that a misallocation of investment funding does not imply a capital shortage and disdain for industry by fi-
nance. It certainly doesn’t suggest industrial weakness. We should look with admiration at the productive history of a nation that was unable to design or manufacture its own machine guns in the 1870s, but by the 1970s was producing state-of-the-art nuclear submarines and supersonic passenger aircraft. The direction of investment is related to Britain’s geo-political circumstances after WW2. The economic impact of Britain’s unavoidable, political and military responsibilities abroad was magnified as the cost of military equipment and overseas deployment increased dramatically in the post-war years. These imposts had little to do with the capacity of the patricianate for imperial delusion, an argument often put by City/Aristocracy hegemony theory. Britain’s world role was simply a geopolitical reality of the post-war international settlement, a phenomenon that occurred independently of the social composition of its ruling class.

Britain’s world role in the post-war period had the consequence of creating a government led bias in investment spending towards areas of low commercial returns. There is evidence of a significant crowding out effect because of the high levels of government expenditure required by Britain’s defence commitments. Excessively high levels of taxation were required, which in turn stifled further innovation and productive development. Clearly, the opportunity cost of the direction of investment was high. By comparison, government policy in Germany and Japan during this period was focussed on generating and encouraging export-led private sector industrialization and modernization. Investment was officially encouraged, assisted and fostered in the most commercially viable areas of production.

Britain’s balance of payments crises during the 1950s and 60s are largely explicable in terms of the enlargement and increased expenses of, the role of British government abroad. The British visible trade deficits of the 1950s and 1960s were nothing new; in fact they were proportionally smaller than the deficits of the nineteenth century. What was new in the 1950s and 60s was a dramatic increase in the size of government expenditure abroad, without which, as Manser demonstrates, there would have been no British balance of payments crisis and no lambasting of supposedly lazy and ineffi-

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85 Visible trade deficits have been a characteristic of the British economy throughout the nineteenth and twentieth centuries – even during the mid-Victorian period of industrial supremacy Britain was running them. The explanation is straightforward. British industrialization implied a massive increase in imports of raw materials (of which a small island nation was not richly endowed) and as population grew, a massive increase in food imports was also required. As a consequence of industrialization, export growth was more than matched by increases in visible imports. Britain’s overall balance of payments were kept in surplus because of invisible earnings, returns from shipping, insurance and banking services, and income from overseas investments (Manser 1973:37-50). In balance of payments terms, the City was always an integral rather than a dissociated part of British industrialization.
cient British exporters. From 1952 to 1969 Britain only experienced one current account deficit, a small one of £17m in 1955. Apart from that year, long-term capital exports were more than covered by a succession of current account surpluses. The overall balance was drawn into deficit in 10 of these 18 years by government deficits on the capital account. For example in 1967, the year of Britain’s famous devaluation, Britain enjoyed a current account balance of +£414m, a long-term net capital exports balance of –£82m, and a government balance of –£793m. The overall deficit (Government and private balance) was –£461m. (Figures cited in Manser 1973:Table 6, Appendix 11). These were not untypical balance of payments figures for Britain in the 1960s.

5. Conclusion

The development of the British economy, largely because of the legacy of pioneer industrialization, has undoubtedly been different in important respects from the growth experiences of other countries. Only an unacceptably unilinear theory of industrial capitalist development would find this problematic. The relationship between finance and industry has been distinctive, but there is little evidence for the kind of rift between industry and finance argued for by City hegemony theory. Externally oriented British financial capital was an integral part of the kind of export-oriented industrial capitalism, which developed in Britain. For a small island nation, high levels of industrial exports implied even higher levels of imports, and what propelled the overall balance of payments into surplus were the invisible earnings of the financial sector and the role it played in enabling overseas investment. The massive increase in British industrial exports during the mid-Victorian era would not have been possible without this indirect symbiosis between finance and industry.

Shortages of investment capital have not been a problem for British industry. What has been lacking is the capacity for industrial co-ordination and supervision, but this is more readily explained by the legacy of free-market capitalism and the ideology of laissez-faire than by systematic cultural disdain for industry.

Certainly British growth rates look unimpressive compared to the Japanese and German post-WW2 economic miracles, but these were exceptional economic events caused by unique circumstances. British failure to emulate these economic miracles does not require elaborate explanation such as the arguments for City hegemony and cultural exceptionalism. Government was freer in Germany and Japan to foster export led industrial growth, unburdened, unlike Britain, by international military and financial responsibilities.
The problem for the cultural critiques offered by Anderson and Wiener is that although the pathway of modern British capitalism has been qualitatively unique in many respects and overshadowed from time to time by the economic growth performances of other countries, none of these features is adequately explained predominantly at the cultural level. This paper has considered a number of essentially non-cultural determinants as more plausible explanations of relative industrial decline during the late nineteenth century and slower growth during the long boom after WW2. These have included the legacy of pioneer export-oriented industrial capitalism, the inheritance of a ‘molecular’ industrial structure (and *laissez-faire* ideology), the profit-seeking rationality involved in the exploitation of the economic potential of empire, and the economic impact of Britain’s geopolitical circumstances after WW2.

There is no doubt that some of the kinds of cultural processes analysed by Anderson et al. have been in evidence in the British case – to a degree. Like several countries, Great Britain produced a dynamic and negative cultural response to the onset of industrialism. But the extent and symptomatic importance of this response has been overstated in the cultural explanations. To posit a crippling and enduring anti-industrial ethos as the definitive and formative ideological feature of modern Britain, does not really make sense when we consider the current economic status of Britain as one of the largest and most successful industrial capitalist economies. If this argument is accepted then it is clear we must reject the supposed anti-industrial orientation of British finance posited by the cultural critiques. The relationship between finance and industry in Great Britain has been distinctive only because Britain’s pathway to industrial capitalism has been unique in so many ways, but this does not imply the kind of cultural exceptionalism argued for by Anderson and Wiener.

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The internationalisation of banking: portfolio or foreign direct investment? Some implications from the recent merger boom

1. Introduction

By almost any measure, the current merger and acquisition (M&A) boom has been historically significant. Quantitatively, both the number of mergers and the prices paid for individual mergers has been exceptional. As financial journalists and especially merger monitors have scrambled for superlatives to describe successive record years for mergers, the ownership structure of industry and commerce in most countries is undergoing rapid change (UNCTAD 1999).

But international M&A activity has not simply increased FDI flows, the form of many M&A transactions resists ready comprehension in national balance of payments accounts. Within FDI statistics, for instance, the current international merger wave has helped to highlight two issues. Firstly, financial institutions, generally defined, have not only been important in providing the finance for much international M&A activity, they have themselves become amongst the most active M&A players. For instance, two of the top ten industries internationally for M&A’s in 1998 were finance related (banking at rank 3 and Insurance at 7) (Miyake et al., 1999). This has undermined the earlier institutional association of FDI with international investment by non-financial corporations and Portfolio Investment with international investment by banks and financial institutions. Further, many large individual M&A deals involve related transactions (reciprocal ownership transactions, such as share swaps), which means that in Balance of Payments accounting a single M&A is often recorded as both an FDI inflow and outflow. The resulting cross-flows can significantly affect the interpretation of both inward and outward aggregates. For instance, in the US in

86 The author would like to thank Dick Bryan and Michael Lönnborg for helpful discussions on the subject and for comments on the current paper. Wilco Burghout provided expertise with the charts and tables. Financial assistance from the Foundation for Baltic and East European Studies is gratefully acknowledged.
1998, the BP-Amoco merger and the Daimler-Chrysler merger were the two largest single FDI transactions for that year and both exceeded the size of any previous single foreign direct investment transaction. Both were accomplished partly by way of equity exchanges, which significantly affected not only the sectoral positions in petroleum and manufacturing, but also aggregate inward and outward FDI statistics (Bargas and Troia 1999).87 Similarly, but larger transactions occurred in 1999.

However, there is also increasingly the fundamental issue of whether or not the very process of attributing a national characteristic to investment a priori, has not itself become one of the limitations of standard economic analysis. The question here is not only whether the forms of investment are beyond comprehension in national terms, but also whether the mobility of capital increasingly makes the adoption of a national taxonomy of capital a contrivance. It can be argued that national accounts is presenting both a distorted and a limited perspective on international investment and finance: distorted because flows which are global in nature have to be squeezed into national categories for policy consumption; and limited because a vast range of financial transactions are simply not recorded in national accounts, but have a direct connection to economic activity occurring in a country88.

One way of addressing these issues is to examine the changing relationship between direct and portfolio investment that has accompanied the merger boom. Perhaps surprisingly, this aspect of recent capital flows (the role of internationalised finance in facilitating international merger activity) has been less well documented and discussed. In particular, the international merger boom has required long and flexible lines of credit to be established, and this credit is also highly internationalised. Furthermore, banks and other financial institutions have been at the forefront of recent FDI activity. In this way, banks which were traditionally thought to be the institutional proxy for portfolio investment have also become much more closely associated with FDI. Through these two aspects of international M&A activity, therefore, international portfolio investment is being ‘recycled’ into FDI, and this suggests not only that the relationship between Portfolio and Direct Investment has been changing, but also that the differences that permitted and sustained their statistical separation in balance of payments accounting in the mid twentieth century are diminishing.

87 For parallel observations on this development for Sweden, see Östberg (1994), and for Australia, see Bryan and Rafferty (1999).
88 Garber (1998), for instance, has shown that the development of ‘off-balance sheet’ transactions (such as financial derivatives) has undermined the analytical coherence of balance of payments accounts in several important ways (see also Kester 1995 and Heath 1998).
Before developing the changing relationship between forms of international investment, the paper reviews some of the relevant debates within FDI research. The paper then presents evidence on outward FDI from Australia suggesting that the portfolio-direct distinction is far less secure than is now generally accepted. Indeed, historical reflection suggests that the categories have been much less stable over time than is usually claimed for the traditional distinction.

It needs to be stressed at the outset, that in many ways none of the developments discussed in the paper are ‘new’. The recent period has rather seen an intensification of the presence of international mergers and acquisitions in FDI, not the invention of them, and a further elaboration in the funding options, not the sudden invention of entirely new sources. After all, Edith Penrose’s (1959) pioneering study of the expansion of General Motors after the Second World War was a case study of a takeover of an extant car company. And the diverse funding of that expansion (including local capital markets) was also noted in her study. Rather, it is that these forms were generally expected to be more of an exception to general patterns of FDI. And for a while they actually were. It is to the question of what happens when they have to be incorporated into the centre of FDI analysis that this paper is addressing, not the suggestion that we are in a ‘new’ era of FDI.

These developments in turn create the second duality of the paper. It is possible to see that recent patterns of international capital flows are having implications at the level of both statistical concepts and theoretical debate. There are some signs of convergence in these debates and this paper is an attempt to encourage that convergence on the basis that the two debates share some common analytical dilemmas⁸⁹.

The paper is organised as follows. It begins providing some background on the evolving definition of FDI within Balance of Payments accounting. In an important sense, FDI is a creation of Balance of Payments accounting, and economists have periodically wondered about the economic content of the FDI category. Developments in international capital over the last fifteen years has meant that the question has never really been off the agenda. The paper then presents some stylised facts on recent FDI and the role of international M&A activity within it. The paper then sets up a few hypothetical cases of how various funding arrangements can affect the way M&A activity is recorded in Balance of Payments. The paper concludes with some suggestions about the interpretation of M&A’s in the context of internationalised finance, and reflects of the challenges remaining for the definition of FDI.

⁸⁹ Some aspects of this are also explored in Bryan and Rafferty (1999;2000). See also for instance Julius (1991) and Kester (1995).
2. Background - the Evolving Concept of FDI

Charles Jones (1987) reminds us that the criteria used to distinguish between direct and portfolio investment has undergone several redefinitions in the post-war period. The original criteria had two basic components. Direct investments were those investments that involved managerial control and did not employ the medium of the stock exchange. The distinction was, as Jones points out, devised by economists in the middle of the century, employing the paradigm of FDI as the international expansion by corporations like General Motors or Coca Cola, establishing wholly owned subsidiaries abroad. Indeed, the categories worked fairly well for the middle years of the twentieth century, when it broadly corresponded with the particular organisational form of corporate expansion then occurring. “The practical effect of employing this criterion,” as Jones adds, “based as it was on twentieth century practices and organisational forms, was to yield statistics which showed direct foreign investment to have grown rapidly since the turn of the century from a low base, to be a tactic more often employed in the past by banks or commercial corporations” (1987, p. 17).

It also needs to be noted here that behavioural assumptions were involved in distinctions between international capital flows. The distinction between FDI and other forms of international capital flow was made, as Dooley and Walsh (1999) suggest, partly on the assumption that “…the motivation for a capital flow was related to the type of transactor and the type of financial instrument traded”. Control over capital flows was an important tenet of the Bretton Woods agreement, and there was special attention paid to controlling capital flows that were seen as destabilising. Thus capital and current account categories were in part modified to identify ‘abnormal’ and ‘speculative’ flows, especially those short-term flows thought to be responding more to interest rate differentials than to long-term influences such as facilitating trade, or production. Clearly, such a regime required a statistical counterpart that contrived a separation between forms of capital flow as either productive or speculative, short-term or long-term, equilibrating or dis-equilibrating. Thus direct investors were assumed to be motivated by a different interest than portfolio investors (the profits arising from long-term control rather than more short-term profits from cross national interest rate differentials). The forms that direct investment took (and

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90 As has been increasingly appreciated thanks to work of economic historians, the newness was in part a conceptual and in part a statistical construction (see for instance Wilkins 1979).
91 Jacob Viner was critical of the Bretton Woods proposals for capital controls, on the basis that it would be difficult to distinguish in practice even between capital account and current account transactions, except by postal censorship (for a discussion of the debate over capital controls in the Bretton Woods process, see Helleiner 1994 and James 1996).
its behaviour over time) were also thought to be different from portfolio investment. While there are differences in forms of international capital flow, today they appear more as differences within a unity, rather than distinct categories, requiring category-specific analytical approaches.\textsuperscript{92} Dooley and Walsh report Claessens et al. (1995) study, which showed that balance of payments labels did not help predict the time series behaviour or the predictability of different types of capital flows.\textsuperscript{93} This is not a universal conclusion of such studies, but in a period of rapid financial innovation, any particularities, such as they are, are likely to be unstable over time.

And it should perhaps be no surprise then that as the second half of the twentieth century unfolded, the international capital categories have themselves been modified in response to two related developments. Jones notes that the first challenge to the categories came from economic and international business historians attempting to retrospectively apply the categories to international capital flows and business in the nineteenth century. They were forced to confront the fact that the economic content of the distinction required recognition that the internationalisation of business in the nineteenth century occurred in a different legal and organisational environment (especially through the use of unincorporated partnerships and free-standing firms, and the importance of family and social networks for managerial control).

The second and perhaps more significant development has been the ongoing evolution in the organisational forms of capital since the 1960’s. In the last twenty-five years in particular, the range of organisational forms of international expansion has become more and more diverse, and now includes joint ventures, franchising and so-called strategic alliances. Partly in response, the requirement that FDI not employ the stock market has been dropped, and the equity threshold used to distinguish FDI from portfolio investment has fallen in a stepwise manner. But throughout this period of re-definition, the economic content of the distinction remained, and the distinguishing feature of FDI was that the investment was made with the intention of controlling the operations it was funding. This then was the core of the FDI definition.

\textsuperscript{92} In an era of intensified financial innovation as we have been experiencing, it is possible to see that the forms (financial instruments) of international investment have been growing, thus making the distinctions between direct portfolio and other investment even more ‘behavioural’. As discussed below, for instance, the Balance of Payments distinction between debt and equity now depends more on \textit{where} a company borrows than whether it borrows.

\textsuperscript{93} This, as Lipsey (1999), suggests is partly related to the fact that in a world of highly liquid capital markets and with the ability to transform maturity structures through derivatives, original maturity is now of little importance. See also especially Garber (1998).
Lipsey (1999) points out that even the remaining basis of the FDI definition has fallen out of the new Balance of Payments manual (BPM 5). The criterion of control has abandoned from the new FDI definition altogether. Perhaps recognising the incredible diversity in organisational forms of international business, and the difficulty of establishing an operational definition of control at an aggregate level, the current definition of FDI has instead embodied what Lipsey correctly describes as the much more vague concept of ‘lasting interest’. This new criterion simply requires that the investor is or has established a “long-term relationship…and a significant degree of influence on the management of the enterprise” (OECD cited in Lipsey 1999). In practice, the new BPM definition recommends that a lasting interest be determined when a foreign investor has secured ownership of 10 per cent or more of the ordinary voting shares of an incorporated or unincorporated enterprise. The problem of determining at an aggregate level when ‘control’ was or was not being exercised by an overseas investor had, it seems, become too unstable to sustain the definitional weight it was carrying. But what the new concept of ‘lasting interest’ offers in flexibility and avoidance of arbitrary aggregation, it surely loses in clarity. The definition of lasting interest imparts a larger concept onto FDI than only the notion of control⁹⁴. But ‘lasting interest’ is about ‘potential’ influence as well as actual control and in practice this requires perhaps even more discretion on the part of statistical users and compilers. Doubt must therefore exist as to whether the lasting interest criterion will perhaps be any more stable than the concept of control⁹₅. Little wonder then that one FDI statistician recently suggested that “For Canada, the determination of direct investment is a subjective judgement, and the 10 per cent ownership threshold is used a

⁹⁴ Thus, the lasting interest criterion brings together financial transactions involving wholly-owned branch offices, and majority-owned subsidiaries, as well those involving minority interests in associated companies (OECD 1999).

⁹⁵ Indeed, the lasting interest criterion, with its 10 per cent equity ownership threshold is being challenged directly by calls for a ‘supplemental framework’ focussing more specifically on ownership (with a much higher, perhaps 50 per cent threshold). For those interested trade effects of FDI, such as Julius for instance, nationality of owners may be a more informative basis for national accounting than geographic location of production. Julius has suggested the criterion for determining a foreign company should return to the 50 per cent foreign ownership level (reflecting the emphasis on control). The same theme has been taken up by the US National Academy of Science’s Panel on Foreign Trade Statistics, Chaired by Robert Baldwin, formed to address the analytical and statistical challenges which have arisen with globally integrated accumulation (Kester 1992 and 1995), and subsequently by work undertaken by the BEA (Whichard and Lowe 1995). For a review of the geography versus ownership debate, see also Bryan and Rafferty 1999.
The internationalisation of banking: portfolio or foreign direct investment?

guideline to bring transactions to the attention of the balance of payments compilers for analysis” (Chow 1999).6

This brief review has highlighted that the category of FDI (and thus the portfolio-direct distinction) has been one of the most unstable categories in Balance of Payments accounting. FDI has been marked by ongoing redefinition, partly in response to our changing understanding, and partly in response to changing organisational forms of international capital, and the way these are expressed in forms of international capital flow. But the ongoing definitional changes are also partly a political-cultural phenomenon too. Jones has even contended that “successive interpretations of the direct-portfolio distinction, and even the basic concepts in terms of which any such distinction must be couched are culturally derived and, as such, are unstable in the long run.” (1987, p. 20). He has suggested that economists have been unwilling to realise and exploit this fact, and that economic historians were perhaps better placed to avoid the problem.

How legitimate are these charges? Since Jones made them in the late-1980s, research on the changing nature of FDI, in both theoretical and statistical fields, has flourished. Was Jones simply anticipating this development, or do his charges remain valid? In order to develop an adequate response to these charges, we would need to survey this burgeoning field in a more comprehensive way than is possible here. Instead, this paper considers the contemporary basis of the definition of FDI through one particular development - the recent international M&A boom. After describing the nature of the boom in broad terms, the paper presents a series of stylised

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6 Chow (1999) also suggested that even in the earlier era when control was the criterion statisticians had to make many adjustments to the source data to make meaningful ‘economic’ sense of them. FDI statistics were then even ‘more a craft than a science’. In the current period of computerised compilation, fewer adjustments are being made and Chow reports that the ‘trend is to go with the form of the transaction’. Given the growth in forms of international finance, and their use for many different functions, transaction-based classification is surely also problematic.

7 In the light of the ongoing nature of changes to the FDI definition, it has become even more apparent the extent to which portfolio investment is a residual category in Balance of Payments.

8 Jones also made the claim that even distinguishing between domestic and foreign investment is problematic, requiring an unambiguous definition of the nationality of investors. In periods when nationality itself and the importance attaching to it are in a state of flux (in Jones’ case the mid-to-late nineteenth), such a distinction has to be more legalistic than an economic one. It is perhaps no surprise that the issue of corporate nationality has re-emerged again in the last ten years, in a period of rapid change in the organisational forms of international capital, and in the context in which that change is occurring (see for instance, Akyuz 1995, Bairoch and Kozul-Wright 1996).

9 For a review of FDI theory, see Rafferty 1998.
facts on how different ways of funding this type of FDI is being recorded in Balance of Payments accounting.

3. Recent Developments in International M&A activity

The 1980s merger boom, which had up until then been the largest in history (Ravenscraft 1991), became variously known under titles like the ‘deal decade’. It was often thought that a number of conjunctural factors combined in the 1980s to produce a one-off jump in mergers. But the 1990s merger boom dwarfed all of the 1980’s records. For instance, at the peak of the 1980s M&A wave in the US, there were over 3,000 merger announcements (1986) and a peak value of activity of around $300 billion (1988). In the 1990’s, every year since 1995 has seen both these 1980s records surpassed. For instance, at the peak of the 1980’s M&A wave in the US, there were over 3,000 merger announcements (1986) and a peak value of activity priced at around $300 billion (1988). The 1990s merger boom, which began in the mid-1990s saw these 1980s records surpassed several times. Indeed, every year since 1995 has seen the earlier records tumble and in 1999 there were 9,278 mergers valued at $1,425 billion (Mergerstat 2000). And this merger boom was not solely a US phenomenon. In the last three years, M&A activity in Europe has been growing at around 50 per cent per year and according to ECB estimates reached a total of 1,187.1 billion Euros in 1999 (OECD 2000).

The current merger wave has also been noteworthy for its strong international orientation, and in recent years M&A activity has been dominating FDI transactions. It has been estimated that cross-border M&A’s have been accounting for more than 60 per cent of reported FDI in the advanced countries in late-1990s (UNCTAD 1998). In some countries, such as the US and Australia, the domination of FDI transactions by international M&A activity is reported to have been much higher still100. It is in this context that Miyake et al. (1999) recently suggested that, “understanding trends in international M&A’s has become increasingly important as a means of understanding FDI trends”.

International M&A’s are not seeing a new era where the organisation of economic activity is completely transcending national spaces and thereby eradicating the significance of nationality in economic processes (Bryan and Rafferty 1999). On the contrary, nationality remains important: it is how nationality matters that needs deeper consideration. And in addressing this

100 US estimates have suggested that it may have accounted for about 80 per cent of transactions, and estimates for Australia placed it even higher at 85 per cent (Miyake et al., 1999).
question of how nationality matters, we need to pay more attention to how FDI is being funded. Before turning to that question, it is worth providing a background to recent funding of M&A’s.

3.1 Background to the Changing Funding of FDI – Leveraged Buyouts in the 1980s

The last big merger boom in the 1980s also occurred during a period of change in the relationship between forms of finance, associated particularly with rapid financial innovation. The financial innovations were wide ranging but included the development of so-called junk bonds (or below investment grade bonds) that allowed un-rated borrowers to become active in the takeover market, and the growth of institutional investors, which not only became a dominating presence in equity markets, but also came to control large pools of mobile capital (Jarrell 1987). Indeed financial innovation was widely seen as a critical factor in the scale and nature of that merger boom. These innovations combined to produce a merger wave that was best characterised by the ‘leveraged buyout’ - where highly liquid pools of credit were assembled to facilitate largely debt funded takeover activity, notably by small groups of highly acquisitive firms (variously known as ‘entrepreneurial’, ‘asset strippers’, and so on). The link between increasing leverage, and acquisitive entrepreneurial companies helped to give the 1980s its widely held association as one of speculation.

Analytically, the combination of credit innovation and its association merger-related activity helped to revive interest in the nature of distinctions between debt and equity, and of relationships between forms of finance (Bulow et al., 1990). While finance researchers have retained most of the earlier distinctions between debt and equity, the reconsideration did help to produce a recognition that changing financial practice had begun to erode the “traditional financial and legal distinctions between debt and equity” (Kopcke and Rosengren 1989). Some scholars went even further to suggest that in retrospect perhaps the basis of the distinctions had always been largely descriptive and therefore historically unstable (Ginsberg 1990). Subsequent developments suggest that the analytic instability introduced by the ongoing nature of financial innovation has continued to be a feature of contemporary finance101. In the 1990s, however, we can see that the more explicitly global nature of these developments has shifted analytic instability to the international level also. It is to this issue that the paper now turns.

101 The junk bond market and the liquidity that mutual funds have provided to it have been critical to the current merger wave (for recent discussion of the role of leveraged finance in M&A activity, see Luce 1999 and Catan 1999).
3.2 The Changing Funding of FDI

There has been a continual evolution in the way that firms have funded their operations, and this applies especially to international firms. In Balance of Payments statistics, this is partly reflected in the changing composition in the way FDI transactions have been funded. We have already noted the increased role of credit in funding the current international M&A wave. This section considers some stylised facts about four ways that FDI is being financed: retained earnings, borrowing from the parent company, share exchanges, and national and international capital markets.

1. Retained Earnings

Retained earnings correspond to the undistributed profits of earlier investment accruing to a direct investor. The importance of retained earnings for financing FDI flows, especially for the older FDI source countries is undisputed. Lipsey (1999) notes that this has been especially the case for the US, where retained earnings typically represent the largest source of FDI outflows. But the inclusion of retained earnings within national FDI measures is not universal. Some countries include it, while others do not and this issue has been one of the unresolved issues within Balance of Payments accounting. Table 1 shows the way retained earnings are represented in Balance of Payments.

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Inflow</th>
<th>Outflow</th>
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<tr>
<td>Capital flow in the capital account</td>
<td>Income flow in the current account</td>
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When reinvested earnings are recorded in the Balance of Payments, there are actually two transactions reported simultaneously. The first is a current account transaction, as direct investment income (the repatriation of profits). The second, a capital account transaction, is an increase in FDI (new investment). Yet both are notional capital flows. As one OECD (1999) report on the recent introduction of reinvested earnings in French direct investment flows noted, retained earnings (and the associated repatriation of earnings) appear ‘by construction’ in balance of payments statistics. One problem that the OECD report noted was that of disinvestment from negative retained earnings. Retained earnings are the sum of two groups – income from those investments that made profits, and those incurring losses. When the weight of the latter outweighs the former, then retained earnings will actually re-
duce recorded FDI flows. This is also highlighted in the case of outward FDI from Australia in the late 1980s and early 1990s. In the wake of the 1987 share market crash, the investment strategies of several outward investors that had dominated outward FDI data, became unviable, and in some cases resulting in several years of negative outward FDI flows (Bryan and Rafferty 1999).

One of the important issues that the variable treatment of retained earnings highlights is the difference between FDI as a measure of actual capital flow and as a measure of foreign control of resources. For instance, Mailett (cited in Wilkins 1979) noted that except for the period 1950-1962, the total financing of US companies in Europe through funds from the US never exceeded 25 per cent. Amortisation, and reinvested profits provided around 40 per cent of funds in FDI, while capital obtained outside of the US more generally (such as from funds raised in Europe), accounted for a similar amount102.

It is surely also somewhat ironic then that FDI has been found to be one of the most stable forms of international capital flow, and that this may be due in no small measure to a component of FDI, that is not really a capital flow at all except by construction of Balance of Payments.

*Chart 1. Retained earnings – a two-period representation of an expanding foreign subsidiary*

**2. Corporate Borrowing by Subsidiary**

The importance of credit in funding FDI was noted earlier in the paper and is discussed in more detail elsewhere (Bryan and Rafferty 1999, 2000a). Of importance here is that as one form of funding FDI, it has implications for

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102 Mailett also showed that, if amortisation is excluded, net new investments by US firms in Europe during the 1950’s were financed as follows:

- reinvested earnings 20 to 25 per cent
- funds from the USA 25 to 30 per cent
- funds from outside the US more than 50 per cent (cited in Wilkins 1979)
both balance of payments, and FDI theory. In particular, the growth of debt-funded investment has blurred the meaning of foreign direct investment in three important ways:

First, with the increasing use of international credit, the distinction between debt and equity now seems to depend more on where a company borrows than whether it borrows. A subsidiary borrowing directly from the parent company, which itself has raised the credit, is usually classified as direct investment by the parent company, while the subsidiary borrowing from other sources is usually not, even if the debt is guaranteed by the parent company.\(^{103}\)

Second, direct investment need not involve an actual cross-national borrowing from other sources, when the investor borrows in the country in which it is investing.\(^{104}\) This aspect has been accentuated in the recent M&A wave where equity issues as well as other domestic capital raising have helped to finance many large M&A transactions. Partly for this reason, the figures published in the press on the market value of M&A transactions often differ markedly from the direct investment recorded in the balance of payments (Grosch 1999 and UNCTAD 1999).

Third, the distinction between direct and portfolio investment has been blurred by the new forms of credit that are a mix of characteristics that were traditionally identified with being either a portfolio or a direct investment transaction. Financial innovation produced many new funding instruments that were neither clearly debt not equity, but contained characteristics of both - such as convertible bonds where the debt holder and/or borrower has the right to convert the debt into equity.\(^{105}\) The status of these securities must be determined on a case-by-case basis, and are not readily subject to statistical aggregation. Indeed, as we have noted, the basis of distinctions between categories of international capital flow has been continually evolving over the post-war period, so that the recent modifications only emphasise the continuity of that change.

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\(^{103}\) These intercompany debt flows, associated with direct investment companies, are not a minor affair. In the US and Australia for example, intercompany debt flows have been accounting for up to one quarter of 'direct investment'-related activity (for the US, see for instance, Bargas and Troia 1999; for Australia, see Bryan and Rafferty 2000b).

\(^{104}\) Once again, there is no claim here for 'newness' here. Rather, continuity seems more evident. Jones (1987) has for instance, pointed out that there is a long history to the domestic financing of the international operations of firms. Indeed in the nineteenth century it was often easier to raise funds in the host market than transferring capital from the source country. One effect of this type of financing was to obscure from view the development of international firms in the late-nineteenth century.

\(^{105}\) Burgess and Lean (1991) cited a study by Arthur Anderson and Co., which identified over 600 new financial products introduced between 1986 and 1990 alone.
Table 2. Capital Flow Implications of Borrowing by Subsidiary in the Balance of Payments

<table>
<thead>
<tr>
<th>Borrowing by Subsidiary from Parent</th>
<th>Inflow</th>
<th>Outflow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital flow in the capital account – Increase in inward FDI or Net Foreign Debt</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The issue of short-term claims versus longer-term credit provided by home country firms to their subsidiaries is another issue here. In the case of Sweden, for instance, if one were to include short-term claims of home country firms (net of liabilities) then the recorded value of Swedish-owned assets abroad in 1997 would increase by SEK 60 billion ($US7.2 billion), increasing total assets of Swedish firms abroad by around 10 per cent (Falk et al., 1998). The problem here is that some countries count all claims, while others count only longer-term claims.\(^{106}\)

In an era when taxation arrangements are a driving force in the structure of international transactions, the forms in which credit and even equity are advanced by firms to their subsidiaries seem to be quite sensitive to taxation structures.\(^{107}\) The implication is that financial forms may have as much to do with minimising tax, as signalling different functions the finance may play (cf. Chowdhry and Coval 1998).

Chart 2. Schematic Representation of Direct Borrowing by Subsidiary in Host Market

\(^{106}\) As Garber (1998) has shown, derivatives can change the effective term structure of finance anyway, thus rendering the temporal dichotomy more difficult still.

\(^{107}\) Bargas and Troia report that for the U.S. reported intra-company debt inflows in 1998 reached $24.3 billion, of which more than half were related to transactions from parents in Luxembourg. Interestingly, they report that the credit was partly related to M&A activity.
3. Exchange of Shares

Many large individual M&A deals now involve reciprocal ownership transactions, such as share exchanges, which means that in Balance of Payments accounting a single M&A is often recorded simultaneously as both a FDI inflow and outflow. And what makes the share swap issue interesting is that the larger the merger value (and larger the P/E ratio of the ‘acquiring’ firm), the more likely it is that the transaction will be wholly or partly funded by an exchange of shares (Caballero and Hammour 2000). The resulting cross-flows can significantly affect the interpretation of both inward and outward FDI aggregates. For instance, in the US in 1998, the BP-Amoco merger and the Daimler-Chrysler merger were the two largest single FDI transactions for that year and both exceeded the size of any previous single FDI transaction. Both were also accomplished by way of equity exchanges, which resulted in the simultaneous inflow and outflow significantly affected the aggregate statistics, with even more dramatic impacts on the sectoral positions in petroleum and manufacturing (Bargas and Troia 1999). Similar, but larger transactions have occurred since then. If large transactions like this can significantly affect U.S statistics, it will be of no surprise to learn that even larger impacts can occur in smaller FDI countries, such as Australia (Bryan and Rafferty 1999), and Sweden (Östberg 1998). There is an obvious case here for a more disaggregated approach in understanding international capital flow data when share exchange-type M&A’s are occurring.

At a deeper level, there is an issue here about the ‘flow’ aspects of international capital transactions. With share exchanges, it is clear that legal titles of quite important magnitudes are being traded across national borders, but the capital flow implications of these transactions, both immediately and in the future are not clear. Currently, Balance of Payments accounting measures these as capital flows, but whether this is the best way of under-
standing what is actually happening surely depends on what sort of questions we are asking. Once again, we are confronted with the question of whether FDI statistics are measures of capital flow, or measures of foreign control.

Table 3. Capital Flow Implications of M&A by Share Exchange in the Balance of Payments

<table>
<thead>
<tr>
<th>Share Exchange to Fund M&amp;A related FDI</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflow</td>
<td></td>
</tr>
<tr>
<td>Capital flow in the capital account – Increase in inward FDI</td>
<td></td>
</tr>
<tr>
<td>Outflow</td>
<td></td>
</tr>
<tr>
<td>Capital flow in the capital account – Increase in outward FDI</td>
<td></td>
</tr>
</tbody>
</table>

Chart 4. Schematic Representation of Merger by Share Exchange

4. International Credit Markets

It has already been mentioned that internationalised capital markets have been important in providing the funds for the current global merger boom. This development is itself part of a longer-term trend. Indeed, a key to the rapid growth of outward FDI from Australia and other countries in the 1980s was the role of internationalised credit (Bryan and Rafferty 1999). To recapitulate the Australian story briefly, this development had at least two dimensions. First, international credit enabled a small number of ambitious entrepreneurs based in Australia to gain access to funds for domestic and international takeovers. In effect, internationalised credit was being recycled by these firms into FDI by means of international takeovers. For several of these firms, the 1987 stock market crash rendered this accumulation project unviable, and interestingly also the liquidation of their assets (especially the purchase of the international purchase of their assets) created both negative outward FDI and significant inward FDI. Subsequently, it has been domestic financial institutions that have been the most active borrowers in international credit markets, and again these funds have been used in part at
least for international expansion by M&A activity. In both cases (the entre-
preneurs and the banks expanding abroad), the net effect of such transac-
tions on balance of payments in Australia was to increase both net foreign
debt, and outward FDI. In the current M&A boom, we can see that this
funding regime (and the role of financial institutions in international
M&A) has again been crucial, suggesting that we have been seeing
something of a long-term change in relations between forms of international
capital. Once again also, the particular funding of FDI is seeing Balance
of Payments accounting capturing both inward and outward capital flows
for the same transaction (this time a typical effect would be an inward flow
of foreign debt and outward flow of FDI). The relevant question however, is
to what extent either the ‘inflow’ or the related ‘outflow’ have been associ-
ated with the home country?

Table 4. Capital Flow Implications of International Borrowing to Fund FDI
in the Balance of Payments

<table>
<thead>
<tr>
<th>Borrowing to fund FDI</th>
<th>Inflow</th>
<th>Outflow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital flow in the capital account – Increase in Foreign (Debt)</td>
<td>Capital flow in the capital account – increase in outward FDI</td>
<td></td>
</tr>
</tbody>
</table>

108 The Reserve Bank of Australia estimated for instance that until 1990, this way of funding
outward FDI had increased net foreign debt in Australia by around $A40 billion (Bryan and
Rafferty 1999).

109 Financial institutions, generally defined, have not only been important in providing the
finance for much of the current international M&A activity, but have themselves become
amongst the most active M&A players. For instance, of the top ten industries internationally
for M&A’s in 1998, two were finance-related (banking at rank 3 and Insurance at 7 (Miyake
et al., 1999).

110 Thus while the particular project of these entrepreneurs proved to be illusory, perhaps
their historical role will be best seen in helping to pioneer the closer link between
international credit and FDI.
4. Conclusion

International integration of capital markets and the generalisation of TNCs as a form of corporate organisation, have both confronted standard notions of what constitutes a cross border capital ‘flow’. As well, financial innovation has challenged widely held distinctions both between and within forms of international capital transaction.

The domination of merger and take-over activity in recent FDI transactions has also been a factor in stimulating a parallel statistical debate about the interpretation of balance of payments data in the context of increasingly
integrated international resource movements (IMF 1999). These problems have generally addressed technical problems, such as the growing omissions and mis-categorisation of transactions. Behind these ‘technical’ problems (Garber 1998), however, lays the wider conceptual problem of the analytical status of the categories used in the national accounting process, and how these are to be used in economic analysis. Moreover, the form of data classification has created something of a confusion between actual cross national capital flows and changes in the national ownership of capital. The implication is that national data need to be understood as much as conceptual constructions as objective measures of ‘real’ processes.

There are however, a number of places where it is possible to see this issue coming through in theoretical discussions. In the United States, for instance, it is increasingly recognised that a distinction can be drawn between the competitiveness of the US as a location (for export production) and of US MNE’s that export from both the US and from foreign locations. It has been observed that while industry located in the United States may have been losing its competitive edge (manifesting as a trade deficit), US companies producing outside the US seemed to be performing quite well. Lipsey and Kravis (1987), for instance, found that the shares of the US as a nation in international exports and of transnational corporations of US origin in global manufactured exports were behaving in different ways. While exports from the United States make up a shrinking proportion of world exports, US TNCs were maintaining their share of world exports.

This sort of concern is also manifesting in a parallel ‘statistical’ debate about the construction and interpretation of balance of payments data in the context of increasingly internationally integrated accumulation. There has been general recognition that the role being played by international corporations in cross border transactions requires statistical focus to shift to the role of such companies in “the global business of a country” (Landfield et al., 1993). Should the ‘United States economy’ include the off-shore activities of United States companies; should it include US-located activities of ‘foreign’ companies; and how can such categories be clearly delineated? The answer, of course, is that it depends on the question being asked, but the fact that these questions have been re-opened is both historically and analytically significant.

These debates have been most conspicuous in the US, but it should be recognised that there are some important conceptual principles at issue here also, principles which transcend the US situation. It is increasingly unclear for instance, in the context of internationally integrated accumulation, as to how national aggregation is to be used in economic analysis. A problem for examining the issue of national aggregation is that the US case alone does not help to clarify the scope and nature of the issue. As the ‘home’ of some
of the largest and oldest TNCs, the US may not reflect well the contemporary issues of understanding new international investors and their links to their nation of origin. Thus, although the debate may have been precipitated by incongruous movements in the United States balance of payments since the mid-1980s, the conceptual issues extend beyond that country and perhaps also beyond those historical circumstances.

The ownership-geography debate has been important both at an analytical and a statistical level. In some ways, however, the debate has actually served to paper-over the analytical dilemma posed by recent international capital flows that this paper has been addressing: namely the changing relationship between forms of international capital. For instance, in one of the most important contributions to the ownership-geography debate, Landfield et al. (1993) have reiterated the verity of the traditional portfolio direct distinction, suggesting that: “direct investment income differs fundamentally from income on portfolio investments. It represents U.S. companies’ returns on sales to foreigners that - for reasons such as efficiency, lower transport costs, or avoidance of trade barriers - are made from foreign, instead of U.S. locations, whereas portfolio investment merely represents returns to passive investments in foreign stocks and bonds” (1993, p60).

This paper has drawn together the issues of international M&A and FDI. The way these issues are tied together was through a consideration of the changing funding of FDI transactions. Developments in funding have permitted the current merger boom, and this is being picked up in record global FDI flows. From the analysis the paper has developed on the funding of FDI, it can be concluded that we need to be much more circumspect about the economic significance of distinctions between forms of international capital flow occurring in Balance of Payments accounting than is generally acknowledged. This conclusion may be confronting and indeed the paper has developed its arguments largely at a conceptual level. Clearly, the conclusions should be considered tentative but suggestive. Much more empirical work needs to be done on the issue. But to return to the other motivation for the paper, there are other problems about the role of contemporary finance that may yet prove to be even more daunting for FDI scholars. From a different perspective, Garber (1998) has been showing that FDI-type transactions can be occurring almost entirely outside of the view of Balance of Payments accounting altogether.

The issues of whether international investment produces effects on national income and welfare, as well as the trade and employment implications of internationalising firms are just as important today as in the 1960s when this issue first emerged, and perhaps it is more urgent today. After all, more and more companies are investing, trading and borrowing internationally than ever before. But one of the implications of this paper is that a satis-
factory answer to questions like these cannot surely be found in simply adding up the diverse trade and investment patterns of international investing companies, which happen to be registered in one country, and attributing a national characteristic to that aggregation. The case of the changing funding of FDI suggests one dimension of this problem, namely that patterns of investment and finance are increasingly globally integrated. This is not a proposition, pace Ohmae and others, about globalisation eradicating any national dimension to economic activity. We can see national patterns continuing (and being reproduced) in the very process of global integration, and there are, in any case, strong analytical grounds for questioning the assumed mutually exclusive dichotomy between the global and national. Rather, it is that in understanding the national dimensions of these international patterns researchers will also have to rediscover the analytical space that these changing patterns of international resource flows seem to have been closing down. To borrow from a soccer analogy, and paraphrase Rodrik (1998), this may be one occasion when in order to go forward, we will first have to go backwards.

References


Wilkins, M. (1979), The Emergence of Multinational Enterprise, Cambridge (MA).
Pensions Funds and the internationalisation of insurance companies: An Australian example

1. Introduction

This paper outlines the development of the pension industry in Australia and then examines the implications of the new system for one company that has come to dominate both the insurance and pension fund industries in Australia. AMP, formerly called Australian Mutual Provident Society, has since its demutualisation taken full advantage of the new pension system. Importantly, having acquired ten years experience in the second and third pillar pension markets of Australia and having purchased the British company Henderson Global Investments, it is now well set up to expand further into Europe.

Australia first introduced its mandatory employee and employer funded retirement pension system in 1992, now more than ten years ago. While the structure of the Australian pension system is considered an anglicised model, closely resembling the US and the UK, it may hold some lessons for Scandinavian and Central European economies, who have recently reformed or are currently reforming their pension systems along the line of the World Bank Three Pillar Model. The most notable changes that have occurred as a result of the introduction of the system have been a dramatic increase in pension fund assets, as well as a diversification of pension funds’ portfolio investment – most notably an increase in international assets held by pension funds.

However, another fundamental change has involved the reshaping of both the pension and insurance industries. What has emerged is that the larger pension funds, like AMP, who followed a policy of generally diversifying their operations into pension industry from the insurance industry have not only come to dominate the pension sector, but also have begun to expand their pension operations internationally. Most importantly it has been the experience gained from managing pension funds and other pension fund’s externally contracted business that has allowed them to expand their operations internationally, rather than through their more traditional insurance activities.
2. An Overview of Australia’s Pension System

It is useful to provide an overview of Australia’s pension system, as this evidences how much AMP’s profitable superannuation business has allowed it to develop its international operations. We begin by looking at why the pension system was implemented then turn to examine the impact that the policy change has had on superannuation in Australia.

2.1 The Implementation of the Superannuation Guarantee

In June 1992 the then Labour government introduced a pension reform called the superannuation guarantee policy (Dawkins, 1992). This was a policy of mandatory employee and employer contributions to superannuation (pension) funds, with selected tax breaks. Employee contributions have since reached 7 per cent of salary (it seems unlikely that the scheduled mandatory contribution of 15 per cent of employees salary that was due to be implemented by 2002 will be met). The system was also designed so that future national wage increases would also partly be channelled through this superannuation system, in the form of increased employer contributions that would be negotiated via industrial agreements. The pension system differs from the Swedish pension reforms in that the mandatory second pillar (to use the World Bank’s three pillar categorisation of pension systems, 1994) was turned over to private pension funds from the scheme’s inception as the second pillar was created by the formation of private industry based pension funds. The private funds are closed funds attached to the industry or workplace that the employee is employed in. This means that the employee does not have a choice of fund, though this may change after the Australian elections in November 2001.

The reasons for implementing the superannuation guarantee were essentially twofold; the first was macroeconomic while the second is demographic. Turning to the first, Australia’s economic history has been marked by rising foreign debt and current account deficits particularly since the 1980s. Popular perception had it that the external imbalance was getting out of control. Domestic savings, particularly household savings, had been declining relative to domestic investment and this resulted in a call on foreign savings (see Figure 1 showing the decline in Australia’s household saving ratio).
The aim of mandatory retirement savings accounts, in the form of the superannuation guarantee measure, was to increase private household saving and reduce government expenditure thereby also increasing government savings. Figure 2 shows the Australian Treasuries estimations of the impact of the superannuation guarantee on private, government and national savings, with a predicted net positive impact of 1 per cent of GDP by 2006/07 (though these estimates are now considered optimistic). The spectre of Australia’s aging population, like its European counterparts, was the other crucial justification for development of the new pension system. Indeed, as early as 1985 the potential future fiscal crisis in the form of increased public pension pay-outs, was already starting to be discussed with significant alarm.
2.2 The Impact of Pension Reforms on Superannuation Business

Turning now to the impact the new pension system has had on the Australian financial system, we can summarize the impact as roughly threefold: (1) it has increased the number of assets held by pension funds; (2) it has changed the structure of existing pension funds investment; and, (3) it has altered the structure of the financial system.

The growth of pension fund assets since 1992 has been startling. Indeed, their growth is the second fastest in the OECD. In 1990, Australian institutional investors did not rate a mention in OECD surveys of institutional investors by country rank, having only $3.4 billion in assets or 49.3 per cent of GDP. However, by 1997 Australian pension funds had reached the top ten with assets worth more than 83.8 per cent of GDP (OECD, 1998:35). As shown in Figure 3, in September 1999 total superannuation assets reached $415.1 Aus billion. It is projected that superannuation assets will be $931 Aus billion by 2010 (Hockey, 1999). Most importantly, a key feature of this growth also involves the quantitative increase in superannuation assets being invested offshore.

The investment spread of Australian pension funds has, throughout the 1990s, remained in similar proportions, albeit with some change. In 1990, 37 per cent of funds investment was in bonds but this has decreased to 31 per cent in 1997. Shares on the other hand have increased from 39 per cent to 55 per cent, with the remaining investment being in loans and ‘other’ predominantly securities (OECD, 1998) (APRA, 1999) and as figure 3
shows the other key feature has involved diversification of the portfolios particularly into international assets. In 1994/95 this was 15 per cent of all superannuation assets and by 1999/2000 this had increased to 18 per cent. We shall see later in the paper, that this international diversification has been driven by the larger superannuation companies such as AMP who have the economies of scale to be able to invest in international markets.

**Figure 3. Total Superannuation Assets ‘In’ and ‘Outside’ Australia**

![Graph showing total superannuation assets in and outside Australia](image)

*Source: APRA, 1999*

*Notes: Figures are for June with the exception of 1999/2000 (September). Components of Superannuation include funds held with life office statutory funds traditionally excluded from ABS cat. 5655.0.*

We can now turn and examine the implications of the new pension system for the financial system. Six years after the introduction of the new pension system there were approximately 186,000 superannuation entities operating in Australia and 185,000 funds and 1,300 approved deposits. Superannuation coverage of the Australian workforce is higher than eighty nine per cent and coverage of full-time employees is greater than 98 per cent (APRA, 1999; ISC, 1996/98:78). While there are a large number of superannuation funds in Australia, there is also a high degree of industry concentration. In the words of the superannuation regulator:

The industry is concentrated around a small number of large funds, which hold approximately 85% of assets, only 4% of funds have assets in excess of $1 million, and 77% of funds hold less than $250,000 (ISC, 1995/96:75).
In Australia there are many versions of superannuation funds and accounts. These are: corporate ($69 billion assets); industry ($30 billion); public sector ($96 billion); retail ($119 billion); and excluded funds\textsuperscript{111} ($55 billion) (APRA, 1999; ISC, 1997/98:69). Broadly these categories can be divided into (1) industry funds/public sector funds and (2) market pooled superannuation funds, including corporate, retail and excluded. But these categories are far from exclusive with a number of funds, of which AMP is included, that operate in both. Using Gordon Clark’s (2000:85-93) categorisation of the structure of OECD pension industries we can probably summarise the Australian structure as a combination of Model A (where there are a large number of small pension funds whose size is unrelated to assets) and Model B (where there are a few key large funds that do internal funds management).\textsuperscript{112}

Within this industry structure AMP is largely a market pooled superannuation fund. AMP is the largest provider of corporate superannuation in Australia and AMP Asset Management claims to be the largest fund’s manager in Australia and New Zealand, controlling 12.12 per cent of all retirement savings (Mace, 1999). AMP globally manages $185 billion in superannuation assets (AMP, 2000 Annual Report). Figure 5 shows some of the superannuation funds AMP operates in Australia, NZ and the UK.

Accordingly, AMP’s dominance extends beyond providing pooled superannuation products. The level of contracting out being undertaken by the industrial and public sector funds combined with AMP’s economies of scale means that AMP provides a significant range of services to these smaller funds. For instance, it is an insurer of superannuation funds, a trustee, an investment adviser and a fund manager.

\textsuperscript{111} Excluded funds have five or less members and typically service self-employed and partnerships.

\textsuperscript{112} The additional categories are: Model C, large funds with extensive fund and service delegation; and Model D, large funds with intensive delegation.
Table 1. AMP Superannuation Funds

<table>
<thead>
<tr>
<th>Fund/Plan</th>
<th>Accured Benefits ($ m)</th>
<th>Plan Assets ($ m)</th>
<th>Vested Benefits ($ m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMP Provident Fund</td>
<td>482</td>
<td>551</td>
<td>437</td>
</tr>
<tr>
<td>AMP Agent's Retirements Benefits (Aus)</td>
<td>40</td>
<td>39</td>
<td>34</td>
</tr>
<tr>
<td>AMP (NZ) Staff Plan</td>
<td>46</td>
<td>81</td>
<td>38</td>
</tr>
<tr>
<td>AMP Agent's Retirements Benefits (NZ)</td>
<td>49</td>
<td>36</td>
<td>45</td>
</tr>
<tr>
<td>London Life Superannuation</td>
<td>90</td>
<td>98</td>
<td>n/a</td>
</tr>
<tr>
<td>Pearl Assurance Company</td>
<td>1921</td>
<td>2444</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: AMP, 1997

3. The Growth of AMP’s Pension Fund Business and its internationalisation

Readers are directed to the official corporate history of AMP if they wish to discover more about the first 150 years of AMP and its operations (see Blainey, 1999). However, it is important to realise that pension investments were not a large part of AMP’s business until after 1992. Prior to then AMP’s core business had been life insurance. AMP came into being as a mutual in 1848, when it was felt that the Australian colonies needed their own life insurance companies, in part due to the reluctance of British insurance companies to provide policies covering people and business in the Australian colonies (Blainey, 1999).

One hundred years since becoming the first Australian insurance company, AMP naturally dominated the life insurance market. In 1945, AMP possessed 42.3 per cent of total life insurance; nearly four times that of its next competitor (Blainey, 1999:244). AMP did offer its first superannuation scheme in 1954 when it managed such a fund for Qantas employees, and later similar schemes for Caltex, Mt Isa Mines, Woolworths and Ansett (Blainey, 1999:264).

Nevertheless, it is not until the introduction of the superannuation provisions in 1992 that AMP starts to focus on pension fund business more closely. This was both in the form of more corporate superannuation schemes, but also in terms of asset management for the newly established compulsory industry based pension funds that lacked experience in asset management. AMP quickly positioned itself to provide most of the outsourced services these small pension funds were looking for: management advice, funds management, trustee consultation and, of course, insurance.
The other key development in both AMP’s internationalisation and its move into pension funds came with its somewhat controversial demutualisation in 1997. AMP shares were floated on the stock market following a policyholder vote (AMP, 1997). Part of the reason for the demutualisation of AMP was so that it could better access international capital and equity markets and maintain cost competitiveness against other globalising ‘Australian’ financial institutions such as Westpac and the National Australia Bank (Brenchley, 1997, AMP 1997:28).

These other banking institutions were raising capital throughout the 1980s on international capital markets to fund overseas investments. The mutual structure, with its historical roots in economic nationalism, meant that there were legal restrictions on these activities. Since demutualisation AMP has undertaken a hostile merger with a smaller insurance company, GIO (see Rogers and O’Riordan, 1999) and examined the possibility for merging with a major bank in the Australian economy, the NAB (see Aylmer and Lekakis, 2000). One of the central reasons for such activity has been to try to generate significant enough economies of scale to allow it to compete with other global financial institutions (ABC TV, 2000). Better access to international capital markets will no doubt assist AMP in extending its operations further into pension funds.

Since 1997 AMP has concentrated on its pension business and funds management. It has been the relative success of this segment of its operations that has led the CEO of AMP to estimate that within five years to ten years 70-80 per cent of AMP revenues will be generated overseas (Brenchley, 1997:13). Elsewhere, the then CEO George Turnbull has stated that “in reality AMP is now a multi-national company with the majority of its revenue and assets outside Australia” (AMP, Press Release, 9 Feb 1999). While that is not strictly the case the trend is certainly true. Figures 4 and 5 show AMP’s assets and profit by geographical segment have generally expanded overseas since demutualisation. Segmentation data is notoriously inaccurate as it generalises the degree of international assets and international revenue into the category of other than domestic, but still it tells a story.

Figure 4 shows AMP’s overseas assets expanding dramatically in the last four years. In 1998 overseas assets were 42 per cent of total assets, by 2000 this had expanded to 61 per cent. Figure 5, showing international profits, is

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113 In the words of the then AMP chairman, George Turnbull, ‘Once we have demutualised we will have the stock to use as currency so we don’t have to put in all cash’ (Brenchley, 1997:13).
114 The distinction between domestic and international investment or between domestic and international revenue can be arbitrary for all the same reasons as Bryan’s (1995) criticism of national accounting.
something of an exception. International profits, which began to expand in 1999 reached 55 per cent of all profits but then contracted, in 2000 back to about 35 per cent, just as international assets were expanding. The inverse trend may be principally due to the underperformance of new overseas investments.

**Figure 4. Geographical Segmentation of AMP’s Assets for 1997 to 2000**

Source: AMP Annual Reports

In terms of AMP’s overseas assets, it now has operations in 16 different countries, these are: UK, Australia, New Zealand, USA, Netherlands, Luxembourg, Germany, Italy, Canada, Japan, Ireland, India, Chile, Hong Kong and China. Importantly, all of these countries are in the process of privatisation or have recently privatised their pension systems and moved toward compulsory privately managed pension fund schemes (second tier pension systems to use the World Bank’s classification system – World Bank, 1994). Europe and China are the main target pension markets. As Europe in particular follows other countries such as Australia, US, Chile and Singapore down the compulsory pension direction, AMP is hoping its experience in the Australian market will position it to become a major investor and funds manager of pension savings (Deans, 2001). In AMP’s words “capitalising on the deregulation in Europe and rapidly growing European pension funds market” is a major goal (AMP Annual Report 2000:19).

115 A number of the smaller overseas operations involve joint ventures. These include joint agreement with Unit Trust of India to invest funds in India and plans to later offer pension products (AMP, *Press Releases*, 9 March 1999; Durie, 1999), AMP has also set up the Samar Group which provides life insurance and AMP has the maximum share of 26 per cent to which it is legally allowed. They have also set up a property investment fund in Singapore with partner Keppel Land (AMP, *Press Releases*, 5 May 1999). Other East Asian activities include AMP Panin Life, which provides life insurance in Indonesia (1998:75). In Japan AMP has joint venture with NEC and MJS. The MJS partnership is focusing on pension funds and managed funds (AMP Investors Report 2001:22).
AMP Henderson’s investment arm is the key to this international expansion. Henderson was originally a London based company purchased by AMP, which in the last 12 months has been wound up into AMP’s new asset management arm, called Henderson Global Investors. This means, together with AMP’s Pearl life insurance, and AMP financial services, and the joint venture with Virgin (the later two offering a range of banking and financial services), that the vast bulk of AMP’s operations are now run out of London – see figure 6 for a list of geographical operations by market type.

In the 2001 AMP Investor Report it states that Henderson will “continue to build a credible presence in the European savings market through a network of 129 distribution and trail outlets … with local infrastructure in the core markets of Germany, Italy and the Netherlands” (AMP 2001:21). For North America AMP is launching a Henderson branded international mutual fund in September, while in the Asia Pacific the Hong Kong, Singapore and Japanese operations are being increased. In total AMP, through its Henderson investments arm, has $291 billion in pension funds assets under management. By geographic location more than 70 per cent of these funds are under management in the UK and Europe, with 26 per cent in Australia and New Zealand (the remaining 4 per cent being in the US) (AMP, 2000 Annual Report:19).

Figure 5. Geographical Segmentation of AMP’s Profits for 1997 to 2000

It has been AMP’s experience in the pension industry that has given it this ability to internationalise. Whether its optimistic forecasts of 70 to 80 per cent of revenue, in the future, coming from overseas expansion are achievable remains to be seen. Certainly AMP’s expansion has had some setbacks. For instance, the take over of GIO (a smaller Australian share company) sent AMP shares plummeting when it took on the troubled insurance company at too high a price. And the current down turn in global equi-
ties markets has seen a significant loss from AMP’s UK Financial Services Business, which also included some accounting irregularities. These also caused a substantial fall in AMP’s share price to between $8 and $9 Aus and eventually cost the AMP’s CEO his job. The new CEO Andrew Mohl committed to maintaining their international operations, but conceded their heavy reliance on using their UK operations as a foothold in Europe had cost them in a prolonged bear market. In his words: we are “focused on improving profitability and returns … to fixing the problems, not looking for an exit” from the UK Financial Services Business (Press Release, 3 October 2002).

The point though, is that AMP’s opportunities for expansion internationally have developed out of its strength in the pension fund markets. And, as Australia’s pension reforms preceded much of continental Europe by a few years, AMP believes it has as a competitive advantage when trying to get a foothold into Europe. On the other hand acquisition of Henderson Investments only gives AMP a foothold in Europe. Whether AMP can expand fully into the European markets is a question yet to be answered.

**Figure 6. Geographical location of AMP’s operations including core markets, from 1998 Annual Report**

<table>
<thead>
<tr>
<th>AMP</th>
<th>Locations</th>
<th>Products/Services</th>
<th>Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets = $(mill)49777</td>
<td>Australia</td>
<td>Life &amp; risk Insurance</td>
<td>Individuals</td>
</tr>
<tr>
<td>44% of Total Assets AMP</td>
<td>New Zealand</td>
<td>Savings &amp; investments</td>
<td>Small business</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Superannuation</td>
<td>Corporate and Industry</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Annuities</td>
<td>Financial Planning</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Superannuation funds</td>
</tr>
<tr>
<td><strong>UK Financial Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets = $ (Aus mill) 51189</td>
<td>UK</td>
<td>Life &amp; risk Insurance</td>
<td>Individuals</td>
</tr>
<tr>
<td>48.3% of Total Assets</td>
<td></td>
<td>Personal equity plans</td>
<td>Small business</td>
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<tr>
<td>Pearl</td>
<td></td>
<td>Pensions</td>
<td>Corporate pensions</td>
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<tr>
<td></td>
<td></td>
<td>Unit Trusts</td>
<td>Funds</td>
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<td></td>
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<td>Some banking services</td>
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<tr>
<td><strong>General Insurance</strong></td>
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<td>Assets = $(Aus mill) 2675</td>
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<tr>
<td>2.3% of Total Assets</td>
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<td>Indemnity</td>
<td>Companies</td>
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<td>AMP</td>
<td>UK</td>
<td>Lenders’ mortgage insurance</td>
<td>Small business</td>
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<tr>
<td><strong>Asset Management</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets = $(Aus mill) 584</td>
<td>Australia</td>
<td>Asset Management</td>
<td>Corporate, gov. and industry</td>
</tr>
<tr>
<td>0.5% of Total Assets</td>
<td>New Zealand</td>
<td>Property Services</td>
<td>Pension funds</td>
</tr>
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<td>AMP</td>
<td>UK</td>
<td>Private capital</td>
<td>Companies</td>
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<td>Infrastructure</td>
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<td></td>
<td></td>
<td>Custody services</td>
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<tr>
<td><strong>Total 1998 (Aus mn/per cent)</strong></td>
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<td></td>
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<tr>
<td>Geographical segment</td>
<td>Revenue (mn)</td>
<td>Total assets (mn)</td>
<td>Per cent</td>
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<td>52985</td>
<td>46.9</td>
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<tr>
<td>UK</td>
<td>26074</td>
<td>112887</td>
<td></td>
</tr>
<tr>
<td>Total (after eliminations)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: AMP 1998a:14 & 43; 1998b*

*Notes: Figures are for 1998 financial year. Industry Segments exclude ‘Corporate Office’.*
4. AMP’s International Diversification of Pension Fund Assets

There is also another interesting consequence of AMP’s internationalisation. As its experience of international capital markets grows AMP is increasingly becoming a market leader in diversifying pension fund investments internationally. AMP is a key pension fund assisting the drive to invest pension portfolios into international assets, which we saw earlier. For AMP’s standard institutional funds, between 17 and 21 per cent is invested in overseas equities. However, AMP offers institutional investment funds geared to just investing overseas, providing the service for smaller superannuation funds who want to out-source the international equities investment function to another organisation. The Global Share Fund is an AMP institutional fund that invests entirely in overseas assets. The majority of its customers are ‘Australian’ pension funds. Figure 7 shows the asset spread on a geographical basis.

*Figure 7. Asset Spread of AMP’s MultiManager Global Share Fund*

This diversification into international investment is part of modern risk management. AMP would be neglectful to its shareholders, policyholders and pension fund customers if it did not try to spread some risk into international assets. International investments are crucial to company strategy. An article published in AMP’s *SuperTrends* publication states that:

Funds should do what is best for their members. That typically means investing some proportion of funds overseas. Doing so smoothes returns to members (and, given high returns gained on overseas equities, it potentially improves returns as well). In fact, investing overseas allows access to smoother returns in general, simply because
the rest of the world is so much larger than Australia, and so it is a less ‘volatile market’ (AMP, 1996:3).

And to those who saw this international investment as a loss to Australian companies, Roger Yates, CEO of AMP’s Henderson Global Investments arm has argued in the financial press that it is essential AMP invest across national boarders to get the best returns. He states:

> When you buy shares in Nokia it is not because its Scandinavian … it’s because it is an outstanding company. When Australian investors look at an opportunity available to them, it’s no surprise that they are starting to seek out the best opportunity available to them … I just think the trend is going to deepen and move faster and faster (Hyland, 2001:6).

As AMP further expands its operations internationally the company appears to increasingly prefer a strategy of international investment of pension assets, particularly as experience in international capital markets and conditions grows. It could be said that structural internationalisation and the international diversification of pension fund assets are mutually self-reinforcing.

However, modern portfolio theory did not suddenly just come along and inform this diversification. AMP learnt the hard way, through its investments in the Australian economy, that to avoid future potential problems it needed to diversify its investments internationally. By 1946 nearly all of AMP investments went on loans to government instrumentalities and in mortgages on property. After 1946, and with a change in NSW legislation, it began investing in equities. At the time risk management was fledging in character and 5 per cent ceilings on the maximum level invested in one company were used to avoid collapses. By 1965 about 12 per cent of AMP’s funds were in shares. By 1972 it held 14 per cent of its funds in shares, 17 per cent in property, and 22 per cent in Government bonds (Blainey, 1999:260).

According to Blainey “never before had one firm held such a stake in the stock market of Australia” (1999:264). It had major stakes in all the blue chip companies in mining, manufacturing, banking and retail services. As such a dominant life insurance company AMP was also a central investor in the Australian economy, but this was not without its problems. A major concern developed that there was nowhere left to invest that brought in similar returns. And, many were suspicious that AMP was exercising influence on the boards of these companies to which it was an investor, leading to muted claims of insider trading. By 1978, AMP held such a volume of
Australian equities that its fund managers were complaining that the portfolio was too weighted to domestic equities.

By the 1980s, the AMP board started to consider a conflict of interest between its responsibility as a key funds manager and the national interest test that it applied to its investments policies. The debate mirrored the same arguments taking place in policy and academic forums concerning national economic sovereignty, foreign ownership, and, of course, that of speculation. A critical question emerged over whether AMP had a responsibility to exit poor share investments quickly or whether it should hold out its investment so that longer term gains could be achieved. In general Blainey argues that during this early 1980s period AMP focused on investing in companies that should provide long-term capital in Australia.

In Blainey’s own words, AMP “believed that to finance (say) major mining ventures was in the national interest: a new source of national wealth, a new source of export income” (1999:287-8). However, when it came time to defending the ‘national interest’ during foreign ownership battles AMP’s nationalism was not as clear-cut reflecting its position as an investor of other peoples’ savings. As AMP owned shares in the majority of major Australian corporations, when those companies came under potential acquisition threat as part of the 1980s FDI mergers wave, pressure was placed on AMP to support the local board directors as opposed to those of the ‘foreign company’. Increasingly AMP tended to side with the decision that was in the best interests of its own shareholders and this lead to its policy of maximising shareholder value on the funds it was investing (Blainey, 1999:288). Diversification also had its roots in the political problems associated with being a key investor in a relatively small economy.

5. Conclusion

We have examined then the development of mandatory pension savings in Australia and looked at how this policy development assisted in the internationalisation of one company, AMP. The fact that international diversification of pension fund investments occurs at the same time the institution is expanding its operations internationally should not be surprising. But these developments also show how naive the original 1992 policy justification for introducing mandatory pension savings really was. As national savings had been declining, mandatory pension savings was seen as increasing the national pool of savings (potentially) available for domestic investment. This was certainly naive in an internationalising financial system. And as the AMP example shows, the business from this savings policy facilitated both the global expansion of the institution and its investment of these pension
savings – the so-called national savings. Finally, while this story about AMP and the Australian pension system may seem removed from Scandinavian insurance issues it provides some interesting examples for current business decisions from a pension system that is only a couple of years further down the track.

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The International Expansion of Australian Banks

1. Introduction

Banks have been expanding their operations internationally for many years. The New Zealand market provides a striking illustration of this, with only one bank operating in New Zealand being owned domestically, and with that institution having a market share of 0.79 per cent of the total assets of the New Zealand banking system as at 30 September 2000. The other banks operating in New Zealand have parents domiciled in a range of countries, including the Netherlands, Korea, the United States, the United Kingdom, and Australia. The Australian banks are of particular interest because of their dominance of the New Zealand market, with a combined market share of 69 per cent as at 30 September 2000. The international operations are not only of significance to the New Zealand market. All the major Australian banks have significant international business, and the different scope and nature of their international business tends to distinguish these four banks from their domestic competitors (generally referred to as the regional banks). The recent round of insurance company acquisitions appears as only a temporary refocusing in this process.

Because of the varying pattern of the international expansion undertaken by the four major Australian banks, it is to be expected that their reasons for expansion and their resultant experiences also vary. This study of why these banks have chosen to operate internationally begins by briefly reviewing some of the theories proposed to explain the international expansion of banks. To date none of these theories has been established as a clear favourite, with each having valid arguments both for and against it. This is followed by a look at the international operations of the Australian banks and at how these can be related to the theories. Finally, we examine the fi-

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116 ANZ, Commonwealth Bank, National Australia Bank and Westpac. AMP Bank also has business in New Zealand, but this is of relatively less significance, with AMP Bank’s market share being only 1.58 per cent of total New Zealand bank assets as at 30 September 2000.
nancial outcomes of the banks’ international operations, and consider the returns gained by the banks as a result.

2. Theories of International Expansion of Banks

The essential reason that banks choose to expand internationally is profitability; i.e. revenues generated as a result of the international expansion will exceed the costs of expanding. However, there are a variety of ways in which international expansion can be argued as enhancing bank profitability, including regulations, competition and customer behaviour. Moreover, as Zimmer and McCauley (1991) have highlighted, banks from different countries have different perceptions of the adequacy of profitability, which will have an impact on their international expansion behaviour.

A number of theories have been suggested in an attempt to link this pursuit of profitability to banks’ actual international expansion behaviour, and these can be differentiated as follows:

- Industrial Organisation theory
- Comparative Advantage theory
- International Investment theory
- Portfolio theory
- Internalisation theory
- Eclectic theory

The Industrial Organization (IO) theory has four primary strands. The first suggests that international expansion is a defensive measure to protect banking relationships with existing customers, and entails ‘following’ customers into foreign markets.\(^{117}\) This is to ensure that customers are serviced adequately, and to limit development of a relationship between the customer (or its subsidiaries) and a domestic bank, which might undermine the home market relationship with that customer. Aliber (1984) suggests claims that host country banks were ill equipped to serve the foreign operations of home country firms would explain the international expansion of colonial banks in the 19th century, while Kindleberger (1983) sees this argument as being the basis for the proliferation of multinational banking activity in the 1970s.

Coulbeck (1984) sounds a note of caution with respect to expansion under this theory. He suggests that “the attempt to provide services beyond its capabilities may lead a bank into unprofitable operations where it never achieves the volume and quality of business necessary to break even” (p. 19).

\(^{117}\) This is sometimes known as the gravitational pull effect.
The second strand to IO theory argues that expansion results from a high concentration ratio in the home market, leading to greater profitability which makes more capital available for expansion. The main criticism of this argument is that banks frequently appear to use international expansion to improve their competitive position at home. A third strand claims that the importance and strength of the home currency causes banks to expand internationally. This is supported by the history of UK banks expanding in the 19th century when the pound sterling was the dominant world currency, United States banks during the 20th century when the US dollar was important, and Japanese banks in the 1980s as the Yen became prominent. However, it can be argued that these expansions simply reflect the flows of foreign investment occurring at those times, and that this strand of the theory is just a variation of the first strand’s ‘following the customer’ proposition. The final strand of IO theory argues that expansion occurs in order to secure deposits in the host currency directly, to reduce dependence on interbank currency markets. This could be argued strongly for expansion into the US market, but it could also be argued that this is simply an internalisation benefit (as discussed below).

Comparative Advantage theory is based on the idea that banks expand from countries with a comparative advantage in the supply of banking services. The comparative advantage can be seen in terms of the loan-deposit spread, which varies between countries. Aliber argues this spread is caused by ‘barriers to trade’ in money which result from regulations (1976, cited in Cho, 1985). However, Cho (1985) claims that this theory explains who should produce a specific product for which market but not how or where it should be produced. Williams (1997) notes that the difference in spreads between loans and deposits between countries is likely to arise from issues relating to differences in perceived risk, and may not be a reflection of any comparative advantage at all (pp. 85-86).

Grubel suggests that “the ability to draw on the information and personal contacts between the bank’s and manufacturing firm’s parents ... at a very low marginal cost represents the main source of comparative advantage” for the bank’s foreign branch (1977, p. 353). Accordingly, there is a link between this theory and the IO theory. Smith and Walter (1997) identify a number of firm-specific attributes, which also offer a comparative advantage, including “the adequacy of the institution’s capital base and its institu-
tional risk base, its access to human resources, its access to information and markets, its technology base and managerial culture, and the entrepreneurial qualities of its people” (p. 419). Interestingly, these forms of comparative advantage would appear to be examples more attributable to internalisation theory, discussed below. This is because comparative advantage (at least in a Ricardian sense) should exist for all banks from the one home country, and would thus be reflected in similar patterns of international expansion.

Another form of comparative advantage can be a bank’s national origin, which provides an uncopiable advantage. The “bank’s national origin may carry some cachet” according to Tschoegl (1987, p. 77), and he uses Swiss banks as an example. He goes on to suggest that a bank’s nationality may also signal an implicit assurance of support and/or supervision from the parent’s central bank. Finally, he points out that “one cannot ignore simple nationalism” (p. 78). While this advantage cannot be copied by another bank, it is not unique to a particular bank, applying equally to all banks from a particular home market.

This brings us to the International Investment theory. Cho (1985) explains that banks are expected to expand internationally in order to avoid or exploit market externalities. In essence, the theory claims that international expansion occurs in order to take advantage of externalities in the host market or to minimise the impact of externalities at home. A major cause of market externalities is government-imposed distortions in the form of regulations. This theory is related to the comparative advantage theory, where the comparative advantage is in relation to market regulations. The expansion of United States banks in the 1960s into Europe to avoid government restrictions on capital outflows can be used to support this theory. However, Cho (1985) points out that the removal of the restrictions in 1974 should have caused a slowing of international expansion by United States banks, whereas it continued at an increasing rate. This theory may also help explain the rapid entry of international banks into New Zealand following deregulation of the banking industry. Location-related advantages can certainly be created by market imperfections, and this theory can help to explain the locations selected by expanding banks.

Related to this is Portfolio theory, which argues that international expansion is a risk diversification decision. It relies on the assumption that business cycles vary between geographical regions, allowing volatility to be reduced through the business cycles being negatively correlated, allowing greater stability of earnings. Grosse and Goldberg (1991) found that banks from countries considered risky were more likely to have a foreign office.

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120 Walter and Gray (1983) suggest that the United States, the United Kingdom and Switzerland enjoyed a comparative advantage in banking (p. 605).
which supports the theory. However, a bank’s loan portfolio can be diversified geographically without foreign offices (although a bank’s lending would then be limited to low-margin, wholesale business).

Internalisation theory recognises the market imperfections which prevent the efficient operation of international banking and suggests that a bank expands internationally in order to overcome externalities, including those resulting from government induced regulations and controls (Rugman, 1981). Originally proposed to explain multinational enterprises, this theory can equally apply to multinational banks. Rugman explains the “process of internalization is complementary to that of international diversification” (1981, p. 90). He argues that multinational banks can overcome the usual imperfections in the financial information market and generate an internal advantage specific to the firm from doing so. Other externalities that could be internalised include economies of scale, the bank’s reputation and technology and product advantages. In essence, Internalisation theory argues that the bank is able to retain firm-specific advantages for its own benefit. According to Williams (1997), these advantages include bank-client relationships, which makes the Internalisation theory equivalent to the first strand of IO theory, discussed above. Cho (1985) believes Rugman’s arguments in support of Internalisation theory make a valuable contribution toward the understanding of international expansion of banks, but it does not explain either the source of the firm-specific advantages or the selection of the host market.

Finally we have the Eclectic theory developed by Gray and Gray (1981) from Dunning’s eclectic theory of international production. This theory has three categories of enabling features that are all required, but sequentially: ownership-specific advantages, such as the size or status of the bank, internalisation incentive advantages, which derive from market imperfections, and location-specific variables, such as market knowledge and cultural differences. In their application of Eclectic theory, Gray and Gray assume that the ownership-specific advantages apply. They then identify six conditions that may induce multi-nationality among banks, but without retaining Dunning’s requirements for sequentiality and inter-dependence. These conditions are:

- imperfections in product markets, such as barriers to entry and product differentiation (also explained by the Comparative Advantage or Internalisation Theories)
- imperfections in factor or input markets, which relate to information (clearly part of the Internalisation Theory)
- economies of internal operation, which relate to cost savings from vertical or horizontal integration (can be considered to be within the Internalisation Theory)
preservation of established customer accounts (effectively the defensive action of the first strand of IO Theory)
entry into a growing or high-growth market, with the classic example being the Eurocurrency markets in the 1960s (also explained by the International Investment Theory)
ensuring control over a raw material source, such as obtaining a reliable and stable source of a currency in which a significant portion of the bank’s assets are denominated (within the fourth strand of IO Theory).

Essentially, as the name suggests, this theory is a combination of other theories. Specifically, it combines both IO and Internalisation theories with the location-specific advantages of International Investment theory. Cho believes the “eclectic theory explains why foreign rather than domestic production is advantageous, what advantages a bank has which enable it to compete against local banks, and why it chooses to exploit these advantages itself” (1985, p. 53). By contrast, Williams (1997) argues that Internalisation theory is superior, as it is based on a more general theoretical foundation of Coasian externalities. Eclectic Theory, by contrast, is seen as having developed against the background of a specific set of conditions relating to multinational enterprises during the era following World War II (p 84).

Outside of these theories, there are other reasons that lead a bank onto a path of international expansion, and not all are economically rational. These include “national prestige, corporate image, or even personal interests of executive management” (Coulbeck, 1984, p. 19). As Walter and Gray (1983) note, “Foreign banks can probably expect to operate at a disadvantage with respect to indigenous banks in most countries because of the intentional and accidental discrimination against them” (p 604), although they go on to suggest that these disadvantages may wane with time. We should not be surprised if banks’ foreign operations are unprofitable, although as Williams (1996) notes, the increase in profitability sought may be for the banking group as a whole on a global basis, rather than just in the new foreign market.

Historical factors may also account for banks’ international operations. However, Coulbeck (1984) points out that these historically-based networks reflect the economic balance of power and the world terms of trade that ex-

121 An often quoted example is of the bank that opens a London office so the Chief Executive’s wife can undertake shopping trips to Harrods.
122 Thus Williams (1998), using Australian data, finds support for the proposition that banks may forego profits in the early stages of business in a new market, so as to be able to establish a beach-head in that market (p. 216).
123 The findings of DeYoung and Nolle (1996) that foreign banks in the United States are less profitable than domestically owned banks is therefore no surprise.
istered at that time, and it can be argued that this falls within the ambit of Internalisation theory, where the bank seeks to internalise the economic advantages of its home country.

We must also avoid the trap of assuming that conditions in international financial markets, which might help or hinder bank international expansion, remain the same. In 1980, at least in Australasia, there were significantly more constraints on cross-border banking activity than there are in 2000. Globalisation has reduced the costs of international expansion, but the consequent freer flows of information may have reduced the need for it. As Saunders (2000) notes (p. 552), there is evidence to suggest that firms that are more globalised are likely to have relationships with a larger number of banks, which would tend to undermine the first strand of IO theory.

We also need to be mindful that the same conditions do not necessarily apply in both wholesale and retail banking. Much of the research that has been undertaken has (intentionally or otherwise) focused on wholesale banking, whereas much of the international expansion of Australian banks has been in retail banking activities. Williams (1997) identifies multinational retail banking as a clear consequence of internalisation, with key factors including knowledge and economies of scale (p. 77). Moreover, as noted by Guillen and Tschoegl (1999), successful international expansion by a retail bank is likely to require the acquisition of market share in significant chunks (p. 13) – organic growth will not suffice.

3. The Australian Banking Market

The Australian banking industry has a history of mergers and international expansion that stretches back to its origins in 1817. The first significant round of mergers was triggered by the financial crash of the 1890s. By the start of World War Two, mergers had brought the number of trading banks down to 9, from a high of more than 30 in the 19th century. From that point industry concentration remained relatively stable until the 1980s, although two significant mergers did occur. The Bank of Australasia merged with the Union Bank of Australia in 1951 to form the Australia and New Zealand Bank, which went on to merge with the English Scottish and Australian Bank (ES&A Bank) in 1970 to form the Australia and New Zealand Banking Group (ANZ).

Brown et al. suggest that the need for the Australian banks to expand internationally is obvious as “there is a limit to expansion within the domestic

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124 The first bank was the Bank of New South Wales, now part of Westpac Banking Corporation, which commenced operation on April 8th, 1817.
market and international banking provides the scope for both growth and high profitability” (1989, p. 25). For all this, the major Australian banks have mainly concentrated on undertaking domestic merger and acquisition activity over the last 20 years. In 1979, the ANZ acquired the Bank of Adelaide, then the country’s seventh largest bank, in a rescue operation (Sykes, 1988, pp. 501-517). A further burst of concentration activity occurred in 1981. The Sydney-based Bank of New South Wales merged with the Melbourne-based Commercial Bank of Australia to form the Westpac Banking Corporation, and the Melbourne-based National Bank of Australasia acquired the Sydney-based Commercial Banking Company of Sydney to form the National Australia Bank.

The next round of mergers occurred in the 1990s. The Commonwealth Bank of Australia (CBA) substantially expanded its business in Victoria by taking over the failing State Bank of Victoria, while a number of smaller regional banks were acquired by major banks looking to expand in those states. Thus ANZ acquired West Australian-based Town and Country Bank, while Westpac acquired Challenge Bank (with its main business in Western Australia) in 1995 and then Bank of Melbourne in 1997. There have also been mergers between regional banks, each of which has tended to increase concentration in the relative banking markets. This process of absorbing regional banks means that there is now less scope for the major Australian banks to expand domestically, other than by merging with each other, which would be expected to raise significant competition concerns. Thus, in 2000, the banks’ options for domestic expansion were targeted at insurance businesses (although, with the CBA’s acquisition of Colonial, there were also ongoing mergers in banking).

The result of this merger and acquisition activity has been the emergence of the Big Four Banks – National Australia Bank (NAB), ANZ Banking Group, Westpac Banking Corporation and the Commonwealth Bank of Australia – all of which operate nationally with full service operations, as well as having operations in New Zealand and other locations around the world. There is also a second tier of regional banks, which limit their operations to particular states and have a focus on retail banking.

The Australian financial system has faced two committees of inquiry in the last 20 years: the Campbell Committee in 1979-81 and the Wallis Inquiry in 1996-97. The first saw significant deregulation of the industry, including the issuance of a restricted number of new banking licences from September 1984, as well as sparking the 1981 mergers in anticipation of the report. In 1990, when faced with a proposed acquisition of a major life insurance company, National Mutual, by the ANZ Banking Group the Australian government instituted the ‘Six Pillars Policy’ which restricted mergers between the Big Four Banks and the two largest insurance compa-
nies “on the grounds that such mergers would lead to a substantial lessening of competition” (Wright, 1999, p. 20; Tripe, 1999, p. 9). The subsequent Wallis Inquiry recommended that the Six Pillars Policy be abandoned, and “that foreign investment policy be applied to the financial system in the same way that it is to other sectors of the Australian economy” (Wright, p. 20). The government was prepared to go along with the second recommendation, but would only go so far as to reduce the ‘Six Pillars’ to ‘Four Pillars’.

Further efforts to pursue economies of scale are thus now likely to be directed internationally, although international expansion has already been pursued. Having discussed the background to bank internationalisation in Australia, we can look and see how their patterns of international expansion relate to the theories.

4. International Expansion of Australian Banks

We begin with a comparison of the relative significance of the banks’ international operations (Figure 1). Since 1993 the rankings of the four banks with respect to the size of their international operations has not changed, although there have been some changes in their individual emphasis. Some of the changes observed can be explained by changes in relative currency values, but others are due to specific events, such as domestic expansion through purchasing insurance companies (as with the CBA and NAB in 2000).

The significant reduction for Westpac from 1992 to 1994 reflects the sale of significant portions of their international assets in an effort to recover from the effects of the financial crisis it experienced in the late 1980s. The further reduction in 1998 was due to domestic expansion, in its purchase of the Bank of Melbourne.
Money and Finance in Transition: Research in contemporary and historical finance

Figure 1. Percentage of assets outside Australia: Major Australian Banks

Source: ANZ, CBA, NAB and Westpac Annual Reports.

ANZ’s international operations have reduced significantly since 1997, partly due to the devaluation of the Asian currencies following the Asian crisis, but the reduction also reflects the sale of some of its international network.

One aspect, common to the international expansion of all the major Australian banks, should be considered before looking at the banks individually. All four banks have relatively long established overseas offices in five key financial centres, namely London, Tokyo, New York, Hong Kong and Singapore. These offices were generally established to support the international profile of the banks and to provide listening posts for them in these key financial markets. Opening of these offices was in many cases a sign that the relative banks had come of age in international banking terms, and was reflected in similar moves to establish international offices by some of the state and regional banks. As such they tend not to have been focussed on profit per se, but rather on establishing communication with other international banks and securing access to Eurocurrency and other key financial markets.125

An active presence in these markets allows banks to reduce their dependence on correspondents and the inter-bank market. These branches contributed only a small percentage of operating profit and accounted for a small

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125 In some cases, branches in such locations provided a vehicle for exemption from interest withholding taxes.
proportion of the banks’ assets, which suggests that they do not represent significant international expansion, but rather allow access to the international money markets to support the banks’ domestic operations. As such the existence of these branches falls under IO Theory.

4.1 The Commonwealth Bank of Australia

Although it is now the second largest of the Australian banks, the Commonwealth Bank of Australia has the least international presence. Some history may assist in explaining the group’s reasons for, and choice of form for, its international expansion. The Commonwealth Bank was established as a government owned institution in 1911, remaining in full government ownership until 1991 when a privatisation process began which was completed in 1996. The Commonwealth Bank has a strong focus on the retail banking sector, where it has the largest market share of housing loans and retail deposits.

The 1989 acquisition of 75 per cent of ASB Bank in New Zealand was not obviously part of a planned international expansion. The acquisition was actually the result of approaches made by ASB Bank (then wholly owned by a community trust), which had recognised the need for international banking affiliations and determined that an Australian bank offered the most advantages. According to ASB Bank’s 1989 Annual Report, the Commonwealth Bank aimed to be a successful bank in Australasia and internationally. The lack of a presence in New Zealand was seen as an obvious gap in its representation “given the economic links that exist between New Zealand and Australia, and the close proximity between the two countries” (ASB Bank Limited, 1989, p. 18). The opportunity to acquire a majority share in ASB Bank allowed it to fill this perceived gap. The Commonwealth’s expansion to New Zealand was arguably thus a reflection of the ‘following the customer’ strand of IO theory, reflecting increased trade and investment between Australia and New Zealand.

A more recent international move was the joint venture in Indonesia, with the banking licence granted in June 1997. Tschoegl suggests that a joint venture of this nature “can represent an exchange of management and tech-

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126 The Commonwealth Bank of Australia information was taken from the Bank’s 2000 Annual Report.
127 It is interesting that Australian government ownership was an initial rationale for some of the Commonwealth Bank’s international expansion. While Papua New Guinea was an Australian colony, the Commonwealth Bank was a major bank there, until the business was acquired by the Papua New Guinea government on independence in the early 1970s. (Bank of Papua New Guinea, 1998).
128 CBA moved to 100 per cent ownership of ASB in 2000.
nical expertise for local knowledge” (1987, p. 80). However, it could be argued that this fits within International Investment theory, with the Commonwealth Bank seeking to take advantage of, what was at the time, a strong and rapidly growing banking market in Indonesia.  

In late 1999 the Commonwealth Bank was once again reported as looking to expand internationally, to avoid being constrained by the comparatively small size of the Australian market (Schnipper, 1999). This would appear to be consistent with the second strand of IO theory, where banks look to expand internationally from a relatively concentrated home market. A lthough the desire to expand abroad may have been assuaged by the acquisition of Colonial, which had a small banking business in Fiji, the Bank’s 2000 Annual Report states a goal of having 25 per cent of market capitalisation represented by offshore retail streams, as opposed to the current 15 per cent (p. 5).

**Figure 2.** Return on assets by geographic region: Commonwealth Bank

![Return on assets by geographic region: Commonwealth Bank](source: Commonwealth Bank Annual Reports)

Despite operating in the New Zealand market for more than 10 years, Commonwealth has been unable to achieve returns on its New Zealand

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129 The Bank’s 2000 Annual Report ascribes a book value to this investment of a mere $10 million (down from $13 million in 1999).

130 HHI statistic for bank assets at May 2000 was 1176.
business to match those achieved in the Australian market.\textsuperscript{131} Even though the ASB’s operations are more profitable than those of the banking group as a whole in New Zealand, these still generally fail to achieve the benchmark 1 per cent return on assets. The lower overall return suggests that the direct lending done in the parent bank’s name is generally less profitable corporate and commercial lending, while the ASB Bank itself undertakes a range of, primarily retail, banking.\textsuperscript{132} The money centre branches are included in the ‘Other’ category in Figure 2. These branches have low profitability as can be seen in the fact that as at 30 June 2000 they made up 6.5 per cent of the assets but contributed only 2.2 per cent of the operating profit for the year ended 30 June 2000. Their contribution is relatively insignificant in terms of the bank’s overall result.

The Commonwealth Bank’s expansion cannot be adequately explained by any one theory alone, nor can the theories really provide an adequate explanation for the individual aspects of the bank’s international expansion.

4.2 Westpac Banking Corporation

Westpac Banking Corporation is the smallest of the major Australian banks.\textsuperscript{133} It has more significant international operations than the Commonwealth Bank, with international assets representing 20 per cent of the group’s assets as at 30th September 2000, and contributing 32 per cent of the group’s net income for that year.

In the 1990s, Westpac appears to have become more focused with respect to its international operations.\textsuperscript{134} Its principal international operations take the form of subsidiaries and multiple branch operations in most countries within the South Pacific. Its preferred option appears to be a branch structure, which gives maximum direct control. However, it has a subsidiary operation in a few locations, and it appears this is likely to be due to regulatory requirements of these host countries.\textsuperscript{135} The focus of its primary expansion

\begin{itemize}
  \item \textsuperscript{131} Returns are compared using Return on Assets (ROA) in the various markets: this eliminates differences due to the size of the banks’ operations as a whole and in individual markets and also eliminates issues associated with branch operations versus subsidiaries.
  \item \textsuperscript{132} ASB’s returns in New Zealand have generally been lower than those achieved by other full-service banks. This is commonly attributed to the bank’s efforts to expand its business to cover the whole of New Zealand, beyond its previous, Auckland-only, base.
  \item \textsuperscript{133} The information about the Westpac Banking Corporation was taken from the Bank’s 2000 Annual Report, and its website at \url{www.westpac.com.au}.
  \item \textsuperscript{134} This is in contrast with much more extensive international expansion undertaken in the 1980s, and which has been argued as lacking in appropriate strategic focus (Carew, 1997). Much of this business was disposed of following the bank’s difficulties which came to the surface in 1992.
  \item \textsuperscript{135} This is certainly the case with the subsidiary in Papua New Guinea, and is likely in due course to be required in New Zealand.
\end{itemize}
within a specific region could probably be seen to fall within the Internalisation Theory, with Westpac building on its perceived expertise in this geographic region.

Westpac’s most recent international move was the 1996 strategic alliance with Standard Chartered Bank. The 1997 Annual Report explained that this alliance was an example of Westpac “delivering creative business solutions that make sense for both customers and shareholders” (p. 28). This report also noted that it provided Westpac’s Australasian based customers with 255 points of representation in 21 Asian countries. This clearly falls within the first strand of IO theory, as a defensive measure to protect the bank’s relationship with its domestic customers (in its primary international markets in the Pacific). Westpac is more of a regional bank than a truly international bank, but its expansion into markets outside Australia clearly falls into either IO theory or Internalisation theory. The fact that both theories are required reflects that the bank has two distinct strategies, dependent upon the country involved.

The other major recent international expansion by Westpac was its acquisition of Trust Bank New Zealand in 1996, which increased its market share in New Zealand from around 10 to 20 per cent. This was perceived as reflecting a need by Westpac to expand its business in New Zealand, which was otherwise too small to justify continued involvement. If another bank had succeeded in purchasing Trust Bank New Zealand, Westpac’s position in the New Zealand market might have been perceived as being unduly weak. The purchase used some of Westpac’s surplus capital, and it might thus seem to be a reflection of IO theory. The purchase also had opportunistic elements, however, in that one reason for the purchase was that Trust Bank New Zealand was available for sale. Figure 3 shows that, unlike the Commonwealth, Westpac has managed to achieve a similar ROA in New Zealand as it has achieved in Australia. This demonstrates that returns need not be different in the two countries.

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136 Interestingly, there is no mention of this relationship in the 1999 or 2000 Annual Reports, and it is doubtful that you would find reference to it on the Bank’s web-site without knowing about it.

137 Westpac’s regional strategy is in line with the approach of an increasing number of global banks. Kahn (1998) cited the examples of ING and Deutsche Bank as two banks that were moving to a regional approach.
Of particular interest are the consistently better ROA figures achieved in the ‘Pacific’ category, which is now essentially Fiji and Papua New Guinea. For example, the ROA for all foreign banks in Fiji for 1997 was 1.88 per cent, with ANZ and Westpac averaging 1.94 per cent for that year. The ROA for Westpac in PNG alone has generally been significantly higher than in the Australia and New Zealand markets.

These results reflect the very high profitability in Fiji and Papua New Guinea, which is primarily due to the very high interest margins in these two countries. Table 1 below provides a comparison of the interest spreads in these two countries and New Zealand, and the disparity is clear. Higher returns earned in the Pacific might, however, be a reflection of higher risk. Recent political developments in Fiji and Vanuatu may be expected in due course to have adverse impacts on the banks that operate there.

**Table 1.** Interest spreads: Papua New Guinea, Fiji and New Zealand.

<table>
<thead>
<tr>
<th></th>
<th>ANZ</th>
<th>Westpac</th>
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<tr>
<td>Papua New Guinea</td>
<td>5.47</td>
<td>5.50</td>
</tr>
<tr>
<td>Fiji</td>
<td>5.65</td>
<td>4.96</td>
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<tr>
<td>New Zealand</td>
<td>1.99</td>
<td>2.83</td>
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*Note:* Figures are for 1997, and are expressed as percentages.  
*Sources:* Bank annual financial statements (for Papua New Guinea and New Zealand), Committee of Inquiry into Financial Services (for Fiji).
4.3 ANZ Banking Group

The Australia and New Zealand Banking Group Limited was the third largest Australian bank in 2000, with an extensive international network. At least until recently, a strong emphasis has been placed on this international network, with ANZ seeking to differentiate itself on its international reach, and claiming to be the leading international banking and financial services group in Australia. 26 per cent of the group’s assets as at 30th September 2000 were generated outside Australia, but the relative profitability by geographic region was not disclosed (presumably because of the distortions that would have arisen in accounting for the Grindlays sale). Like Westpac, the ANZ’s international operations have taken a variety of forms.

ANZ’s history began with the establishment of the Bank of Australasia in November 1835 and the Union Bank of Australia in 1838, with both banks headquartered in London. These banks merged in 1951, but the headquarters remained in London until 1977, when it transferred to Melbourne. Merrett (1985) explains that the transfer of domicile resulted from the disadvantages the group encountered with its status as a foreign company in Australia, the denomination of its capital in pounds sterling when the majority of its business was conducted in Australian and New Zealand dollars, and from United Kingdom restrictions on the export of capital. Merrett (1985) explains the 1970 merger with the ES&A Bank as being a defensive move by both banks due to a need to be larger in order to compete more effectively, and in recognition of Australia’s over-banked status at that time.

The ANZ sought to expand again in the early 1980s. Its attempts to acquire a bank within Australia were unsuccessful, and in 1984 it acquired Grindlays Bank which “allowed the Group to realise its long-held ambition to become a truly international bank by using its new subsidiary’s representation in 40 countries around the world” (Merrett, 1985, p. 318). While this was a deliberate move to widen its international network it is interesting to note that Grindlays’ international network was itself due to an acquisition of branches from Lloyd’s Bank. These branches, which had always been in the possession of an English institution, had their beginnings in a decision to follow the British Army and open branches to provide banking services in the 18th century. This is explained by IO theory, as the bank simply followed its customer(s) abroad.

Since the acquisition of Grindlays, one of the major international expansions undertaken by the ANZ was the acquisition of New Zealand’s Post Office Savings Bank (PostBank) in 1988, which was in due course merged.

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138 The information about the ANZ was taken from the Bank’s 1999 Annual Report, and its website at www.anz.com.
into the ANZ’s existing New Zealand operations. This purchase could to some extent be explained as being due to the New Zealand government looking for someone to buy PostBank, but there was also a view on the ANZ’s part that PostBank was likely to offer a source of cheap deposits. The purchase thus embodied opportunistic elements, and was also an attempt to provide additional strength to an existing non-domestic operation.

Availability was likely to have been a factor in the acquisition of the Bank of New Zealand’s business in Fiji, when that was put up for sale in 1990. One of the side effects of this, however, has been to make the ANZ the largest bank in the Fijian market, where it is said to have a market share of 47 per cent (Committee of Inquiry into Financial Services, 1999). The ANZ has a strong presence in the Pacific Islands, which is explained by Merrett (1985) as being led by the Union Bank around the turn of the century with the intention of capturing the growing trade between Australia and the islands. Clearly, IO theory covers this as the bank followed its customers to new markets.

During 1999, the ANZ undertook some refocusing of its international business, which was reflected in its decision to close its Latin American offices and undertake all Latin American business through its New York office. This process continued with the sale of Grindlays in 2000. This reflects a longer term strategic repositioning, whereby the bank refocuses itself on the Asia Pacific region, cutting the number of countries in which it does business from 33 to around 15. This may not be unrelated to losses made in the Bank’s London-based emerging market trading business in the aftermath of the 1998 Russian crisis, which has led to the major portions of the London trading businesses being closed down (Stewart, 1999).

Like Westpac, ANZ is able to match its Australian returns in the New Zealand market, with the exception of 1993 when the Australian result reflected write-off issues associated with difficulties of the late 1980s (Figure 4). The ANZ also achieves consistently better returns in the Asia Pacific region, with the PNG and Fiji markets playing a major role. The ANZ’s Asia Pacific region is not as purely Pacific as Westpac’s Pacific region, however, and includes Asian markets such as Japan, Vietnam and Singapore. The ‘Other’ category includes the ANZ’s operations in South Asia, the Americas, UK and Europe, and the Middle East, and returns are more volatile. The 1998 figure reflects the Bank’s Russian bond losses. Looking at the remnants of its international network, overall, the ANZ appears to be a classic example of IO theory, with all its strands.

139 The ANZ has been in New Zealand since 1840, when the Union Bank opened its first office.
4.4 National Australia Bank

Australia’s largest bank is the National Australia Bank (NAB),\textsuperscript{140} which describes itself as an international financial services group.

NAB has a long history, extending back to 1858 with the establishment of the National Bank of Australasia in the state of Victoria. The bank had good organic growth, but it also absorbed four regional banks between 1918 and 1955, and was itself formed by merger in 1981 (as discussed earlier).

Following the 1981 merger the NAB sought to apply “…its successful banking formula to institutions outside of its home market” (Annual Report 1984), which began with the establishment of a merchant banking operation and the acquisition of a small finance company in New Zealand in 1985, followed by the acquisition of Broadbank Corporation, a larger finance company, early in 1987. This was seen as a foundation for a retail banking operation that the NAB hoped to be able to establish, following the issuance of the first banking licences to foreign banks, applications for which could be lodged from 1 April 1987. A New Zealand banking licence was granted in July 1987.

A key purpose of the NAB’s initial expansion into New Zealand was a desire to protect its existing relationships with Australian customers under-

\textsuperscript{140} The information about the NAB was taken from the Bank’s 2000 Annual Report, and its website at www.national.com.au.
taking business in New Zealand – a strand of IO theory. This reflected arguments that had been used earlier in support of the National Bank of New Zealand being granted an Australian banking licence when entry to the Australian market had been opened up in 1984.

The first stage of the National Australia Bank’s expansion into European markets also occurred in 1987, when it took the opportunity to purchase some regional banks that were being sold by Midland Bank, then under some financial stress. The NAB thus acquired Clydesdale Bank (operating mainly in Scotland), Northern Bank (operating in Northern Ireland), and Northern Bank (Ireland) (operating in the Republic of Ireland). The name of Northern Bank (Ireland) was subsequently changed to National Irish Bank.

This purchase was followed in 1990 by the purchase of Yorkshire Bank, which operated primarily in the North of England, then owned by a group of British banks. By 30 September 1990, United Kingdom and European assets had thus increased to almost 35 per cent of the bank’s total assets. It was suggested that the international diversification of business gave the NAB advantages of greater stability in its income – if Australian earnings were down because of a downturn in business conditions there, European earnings might be up, and vice versa (Robinson, 1990). This would be an illustration of the portfolio theory as a justification for international expansion, and could be tested by looking at the relative profitability of the group’s European and Australian operations.

The next major international expansion undertaken by the NAB was the acquisition of the financially troubled Bank of New Zealand in 1992. This operation quickly absorbed the group’s existing operations in New Zealand (then trading as National Australia Bank (NZ)), and the profitability of the bank’s New Zealand activities has since been much improved (although considerably assisted by continuing write-backs of previous provisions for doubtful debts).141

In February 1995, the NAB announced the purchase of Michigan National Bank, which heralded its entry into broad market banking in the United States. This was followed in early 1998 by the acquisition of Homestore Inc, a specialist mortgage processing company. The group was not successful in acquiring further banks in the United States, however, and in November 2000 it announced the sale of Michigan National Bank to ABN Amro. The argument was adduced that, without further acquisitions in the United States, the group could not achieve the economies of scale that

141 Prior to the acquisition of the BNZ, the returns on the NAB’s New Zealand business had been very low. This may be an argument in support of the proposition that “following your customer” does not inherently engender an adequate base of profitable business.
would justify its continued presence (despite the consistently high returns observed for its operations in the United States – see Figure 5).

Figure 5. Return on assets by geographic region: National Australia Bank

The preceding discussion suggests that many of the NAB’s international expansion activities have been essentially opportunistic, although that does not mean that they have been unprofitable. It has focused on countries whose operating, regulatory and legal environment is similar to that of Australia. In many cases, they seem to have been driven by a desire to achieve operational scale, which reflects one of the bank’s strategies, to the effect that it will seek out best practice throughout its network and seek to implement that across the group. This approach has certainly been reflected in the acquisition of Homeside, with the United States business being used as a template to build a similar business in Australia. This suggests that part of the bank’s international expansion can be brought into Internalisation theory, on the basis of a perceived competitive advantage in banking. This covers the bank’s expansion by acquisition into the United Kingdom, Republic of Ireland, New Zealand and the United States.

The NAB describes itself as an international federation of regional banks, and the levels of profitability achieved by the individual banks are closer to those of regional rather than money-centre banks. This reduction in emphasis on money-centre type activities is reflected in the decision reported in November 1999 to pull out of activities in Taiwan, India and Thailand (Staff, 1999).
Portfolio theory may also be behind the NAB’s international expansion as it has a “strategy of international diversification”. It may also be possible to argue that Eclectic theory explains the NAB’s strategy, with the three advantages being similar operating environments (location), a successful banking formula (ownership) and the application of core competencies (internalisation). Like Westpac it appears that more than one theory applies to NAB’s international expansion.

Until 1998, NAB was unable to match its Australian returns in the New Zealand market. However, unlike the CBA, this reflects the strength of Australian returns, which have been well above the benchmark 1 per cent, rather than difficulties in the New Zealand market. The returns in these two countries appear to be much more similar in 1998 and 1999, where the Australian return is closer to the average. Higher domestic returns for the NAB are explained by the bank’s more long-term focus on cost reduction relative to its domestic competitors, as well as having a better mix of business due to a stronger emphasis on a sales culture over a longer period of time.

The UK returns, shown in Figure 5, are lower which reflects the generally lower returns in that market. Figure 6 below shows that in fact the NAB banks have outperformed the UK average returns for the period 1988 to 1997, the latest year for which the UK average is available.

It is also interesting to consider whether the advantages alleged by Robinson for greater stability of earnings as a result of the UK acquisitions have been realised. Figure 7 below provides no clear evidence of this. The correlation coefficient is 0.22, which confirms that there is only weak correlation between the returns in the two markets.

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143 As per OECD bank profitability data (OECD, 1999). The comparison is not exactly direct (in that the NAB figures also include Irish and other European business, and figures are for the September years), but these differences cannot explain all the increased profitability (especially as the Irish business would appear to be less profitable, reflecting its smaller scale). It is unclear as to whether the better performance is a reflection of a different mix of business, or whether it is a reflection of superior techniques of bank management that the NAB have taken to Europe with them.
5. Conclusion

The review of the international expansion undertaken by the four major Australian banks highlights the difficulties of trying to find a single explanation for international expansion by banks. While a number of theories
have been proposed, none is adequate on its own to explain this behaviour for a single bank, let alone for a group of banks. The one area of expansion in which some consistent behaviour can be observed is with the establishment of offices in the five key financial centres around the world as a means of communication with other international banks and to provide access to key financial markets. The greatest explanatory ability appears to lie in the four strands of Industrial Organisation theory, but it is clear that each bank has a unique combination of history, environment and management which impacts on its international expansion.

There is a significant difference between the four banks in terms of the importance of their international business, ranging from 46 per cent of NAB’s assets being outside Australia to 14 per cent for the CBA.

While the CBA has indicated an interest in further expansion, its efforts to date have been less than successful (international operations have realised significantly lower ROA’s than its domestic operations). This contrasts with the other banks, which have managed to achieve generally similar results in their international operations as for their domestic Australian operations.

One significant exception is the returns achieved by Westpac and ANZ in the Pacific markets. These suggest a possible profitable avenue for further expansion. However, with their investment in this region representing only around 5 per cent of their total assets, high returns there have only a marginal impact on their overall returns. NAB’s diverse international operations provide the greatest opportunity for study, but the results fail to support the argument that its diversification has improved overall income, although income volatility may have reduced. The pattern of NAB’s expansion might, however be seen as evidence for the bank having to undertake sub-optimal international expansion because of restrictions on further expansion within Australia.

Available information suggests that those Australian banks which have expanded internationally are more profitable than the regional banks whose business remains solely domestic, as shown in Figure 8 below. This does not prove, however, that it is the international expansion that is the cause of the increased profitability as, on average, international operations are no more profitable than domestic operations for these banks. Is the greater domestic profitability a reflection of a different mix of business, with less emphasis on retail banking? Do the banks’ international networks provide a basis for increased profitability in their domestic operations? These are questions for further research.
We also need to be mindful of the changing dynamics of bank international expansion activity. Over the last 15 years, although we have seen Australian banks expanding internationally, we have also seen them go through phases of reducing the scale of their international operations. Is this an indication that globalisation has allowed banks to serve customers in overseas markets through means other than physical presence (if that was the reason why banks had the overseas offices in the first place)? Was the follow-the-customer argument the primary motivation for the international expansion in the first place?

The authors don’t claim to be able to answer these questions immediately, but it is nonetheless valuable to have explored some of the myths regarding banks’ international expansion. There is a perception in New Zealand that foreign banks are here to exploit the local banking market in a way that would not be possible in those countries’ home markets. Such evidence as we have adduced fails to support this perception.

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The International Diversification of Australian Banks

From the early 1980s, largely resulting from financial deregulation, domestic banks in Australia rapidly diversified their borrowing and investment activities. The banking industry became more competitive as a result of the significant increases in the number of banks operating in the Australian market. During this phase also, banks in Australia began to establish operations abroad. By the early 1990s banks in Australia had become not only the most active Australian borrowers on international capital markets, they were amongst the largest investors abroad. Their rapid internationalisation, which may have contributed to the unsound lending practices of the 1980s and forced bank managements to rethink their strategies, raises several interesting questions for policy makers and researchers. Several models of bank internationalisation have been proposed. This paper considers one particular growth/life cycle model in an attempt to shed light on the different experiences of these banks. This particular model has been chosen as the analytic tool because its stage descriptions seem particularly apt to the major banks of the Australian banking sector.

Steven Davis (1982), in discussing where banks would earn future profits, suggested that the international life cycle of banks could be represented by four stages: a foreign department, ‘going international’, multinational, and global bank. In the first two stages banks would be servicing domestic customers, while in the latter two, multinationals and others based in overseas markets would be serviced. The contribution of international activities to profitability would be minimal in the first stage, five to ten per cent in the second stage and a significant share - say twenty-five to thirty-five per cent of the total - in the third stage. In the fourth stage the distinction between domestic and international would be lost, as the focus would shift to customer or product profitability, rather than to domestic and international profitability. The network implications for these four stages would be expected to be none in the first stage, the opening of the first offshore office for funding in the second stage, more offices in major overseas markets in the third stage, and rationalisation and specialisation in the fourth stage. It is
a realistic expectation that the rationalisation and specialisation of the fourth stage may take the bank back to the third stage in some circumstances.

An option for banks wishing to become global somewhat more speedily than this could clearly be to take over another bank or banks to accomplish this end. Whichever route is taken there is a point at which the bank shifts from a mainly domestic focus to an international focus, and a second point at which it becomes global in focus.

In the light of Davis’ four-stage model, this paper investigates the international strategies of the four major Australia banks: two Melbourne-based banks - the Australia and New Zealand Banking Group Limited (‘ANZ’) and the National Australia Bank (‘NAB’) - and two Sydney-based banks - the Commonwealth Bank of Australia (‘CBA’) and Westpac Banking Corporation.

Australia's major banks are not large by international standards, but over the 1980s and early 1990s the banking sector structure developed into a core of four major banks and a fringe of smaller regional, foreign and investment banks. The four major banks have formed from a long history of mergers and acquisitions and dominate the domestic banking sector, offering retail and corporate lending services. The regional banks have a retail focus, such as lending on home mortgages, because they mainly developed from building societies, and some have until recently been geographically constrained by State legislation. The State banks are (or were) government owned institutions which provide more retail than wholesale finance within the geographical area of their home States.

The rest of the banking sector comprises specialised government owned banks, privately owned banks (such as the investment Macquarie Bank), and foreign owned banks. The foreign banks found retail banking relatively unprofitable after deregulation and have since concentrated upon niche areas of the wholesale market, e.g. investment banking, treasury products, private banking and loan syndication. The central bank, the Reserve Bank, adapted to the financially deregulated environment by dropping quantitative lending controls and developing prudential (window) controls. Its prudential supervision is mainly in the areas of the management of liquidity and the maintenance of capital adequacy.

1. The ANZ Bank

In the mergers among the six leading Australian trading banks beginning in 1981, ANZ failed to merge or acquire a bank on offer. It was one of the world’s top 100 banks and was already represented in fourteen countries including substantial banking operations in New Zealand, the United King-
dom, USA, Hong Kong, Singapore, Papua New Guinea and the Pacific Islands. Of its group assets in 1983, 30 per cent were located outside Australia. Profit from its international operations in 1981 comprised 15 per cent of ANZ’s consolidated profit. At this point, ANZ was already a multinational bank (early stage 3) according to Davis’ classification.

Feeling limited in its ability to increase its presence in Australia, which it viewed as becoming ‘overbanked’, ANZ looked for external acquisitions to help it achieve its ambitions. Its criteria for an international acquisition according to its 1984 Annual Report were size (not too large), geographic location (fit with its existing international business, as well as the opportunity to operate in countries otherwise closed to it), language (operate in English) and products (new ones through acquisition).

In 1984 it successfully bid for Grindlays Bank plc, a major London-based international bank, the largest non-domestic bank in India and with a significant presence in East and Central Africa and an operational presence in forty-five countries. Thus the acquisition propelled ANZ into the ‘global bank’ or fourth stage of the Davis model.

In late 1984 the ANZ’s new Managing Director signalled a shift in ANZ’s global ambitions when he said that “We are now a medium-sized financial institution and the Grindlays acquisition represents great opportunities. However as 85 per cent of our profits come from Australia and New Zealand we can’t afford to spend 85 per cent of our time on Grindlays. We are and will remain an Australian bank.”

In 1985 ANZ was represented in forty-seven countries and had some 42 per cent of its assets outside Australia. For a while, the international diversification resulting from the acquisition seemed successful. In 1988, for example, Australia contributed only two thirds of the Group’s consolidated operating profit after tax. Grindlays had a relatively higher exposure to Latin American debt than did any other British bank, and the Group’s exposure to ‘Debt Rescheduling Countries’ would receive a great deal of attention between 1984 and 1989.

In its 1989 Annual Report ANZ recognised that it was still an internationally-oriented bank by commenting that “…domestic strength drives international success, we aim to be the leading provider of a comprehensive range of financial services in Australasia… and to leverage off the strength provided by a sound domestic base into profitable niche banking activities primarily built around the trade and capital flows between Australasia and the rest of the world…”.

1989 was in fact the end of a boom period for banking. In 1990 Australia began a slide into recession, while many of the offshore economies in which the ANZ operated also deteriorated, particularly the English-speaking countries. Of its 1990 profit after tax, only 25 per cent was earned by Aus-
tralia, 20 per cent by New Zealand, and 53 per cent by other International markets. A mounting portfolio of unproductive loans and provisions for bad debts also adversely affected ANZ. ANZ began selling to downsize or dispose of businesses not consistent with its strategic direction, including some of its operations from the Grindlays acquisition. Consistent with the principle that international success can only spring from strength in home markets, it also acquired businesses that strengthened its financial services position in Australia, New Zealand and the Pacific.

In 1991 the high level of provisioning for bad and doubtful debts coupled with the level of non-accrual loans in Australia led to a very low profit result. The contribution of the Group’s Australian operations at 2 per cent of total profit before abnormal items reflected a crisis at the core of the ANZ. By 1992, ANZ had put in place some recovery strategies, allowing it to move on with its global strategy. However at this point ANZ seemed to be focusing again on being international rather than global. “It is our commitment to meet the international needs of our customers through an active offshore presence that sets ANZ apart from our domestic peers” (Chairman’s Report 1994). In 1994, Australia accounted for 62 per cent of the ANZ Group’s assets and only 57 per cent of the Group’s profit before abnormal items, while New Zealand accounted for 12 per cent of Group profit from 13 per cent of Group assets. The International network accounted for some 26 per cent of the Group’s assets and generated 31 per cent of the Group’s profit after tax. Thus 43 per cent of the Group’s 1994 profit after tax was derived from overseas operations from 38 per cent of Group assets.

One change in focus of the international network was the building of “significant commercial banking businesses including high net worth personal business complemented by wholesale operations in the major financial centres”; this was consistent with its aim to have a network of niche banking operations. It was constantly emphasising the broadening and deepening of its expanding international network.

In 1997 there was strong business growth in South Asia, Middle East and Asia Pacific, and Grindlays Private Bank expanded. In its Annual Report of that year, ANZ stated that it was once again focusing on global growth. Under the new strategy all businesses moved to functional organisation (global management and reporting), rather than operating as previously according to geographic areas with independent country management. This reflects the last stage of Davis’ model, where the distinction between domestic and international ceases to be important.

1998 was another turbulent year in international financial markets, which had a strong adverse impact on ANZ’s overseas profits. In particular, ANZ was affected by the riots in Indonesia; the nuclear tests in India which scared off investors, and the quickly deteriorating political and economic
environments. The collapse of emerging bond markets, notably in Russia, resulted in sizeable trading losses for the ANZ operations in London. ANZ took on the costs of exiting, including the write-down of the residual bond portfolio and exiting institutional broking, to withdraw from this business. As a result, by 1998 ANZ stated it was now pursuing a strategy to reposition towards domestic consumer banking and small business, but that intended to maintain its corporate banking activities. More importantly, ANZ announced that it would use its international presence, particularly in South-East Asia, as part of its marketing edge.

It appears that ANZ has moved back to the third stage in Davis’ model, that is, a more domestically-focused multinational rather than global bank. ANZ may even move back to Davis’ second stage to become a bank ‘going international’. “The continuing ANZ is more of a domestic bank than the old ANZ, and the mix of its operations is evolving towards a stronger retail/commercial presence and away from the largely commercial/corporate bank ANZ has traditionally been.” (McFarlane quoted in Bartholomeusz 1998).

At the end of 1998, the strategy changed once again. Instead of conducting costly foreign acquisitions, the Bank aimed to increase business in less risky domestic retail banking. At the same time, ANZ launched a strategic review of its international network, in which it would consider broadening its operation in fewer countries or continuing to expand with its present network (Flint 1998). In early 1999 ANZ increased its stake in Indonesia’s PT ANZ Panin Bank. ANZ announced that the bank would expand into Asia using more joint ventures and equity investments rather than seeking new licences. It has since purchased the credit card operation of failed local institution PT Bank Papin Sejahteras’s, and it may use its joint venture partner, Panin Bank, as its main vehicle for expansion in Indonesia.

In May 1999 ANZ announced that it would “simplify” its international network to focus on Asia and the Pacific, a step that implies it will sell its holdings in the Middle East, excluding Pakistan, in effect disposing of another leg of the Grindlays business bought fifteen years ago. It would also wind back activities in Latin America, North America and Europe. Later that month the bank closed its five Latin American offices as the first step in narrowing the network’s focus.

In McFarlane’s view ANZ in the late 1990s was still was emerging from a business mix that was a “real pickle ... from international and corporate and investment banking.” He said that he favoured organic growth, mainly in consumer markets in Australia and New Zealand, and indicated no appetite for expensive acquisitions (Rogers 1999). In July 1999, ANZ indicated that the Bank’s strategy would include reducing the scope of its offshore activities by more than half (Boreham 1999). In April 2000 ANZ sold its
overseas subsidiary, Grindlays. Thus ANZ’s strategy has retreated from the diversified international global bank towards a version of going international.

2. National Australia Bank

By the mid-1990s, the National Australia Bank (NAB) was perhaps the only Australian-based bank that had successfully internationalised its retail banking activities. In this strategy it was almost unique - only Citibank has sought to migrate its retail banking expertise internationally, and become “global local operations” (Maiden 1996). NAB’s prudence meant that it emerged best out of Australia’s big four banks from the debt frenzy of the 1980s.

It was not until the late-1980s that NAB began to internationalise its retail banking, when it acquired three long established subsidiaries of Midland Bank - Northern Bank Limited of Northern Ireland, Clydesdale Bank of Scotland and Northern Bank of the Republic of Ireland. In January 1990 the Group acquired Yorkshire Bank. The result of the acquisitions was that the United Kingdom became the NAB Group’s second major market after Australia. On a Group basis, 36 per cent of NAB Group profits came from the British and Irish banks from only 32.0 per cent of Group assets. International banking was restructured during 1991 to provide a more concentrated geographic focus to the Group’s international business.

In late-1992 the Group acquired the Bank of New Zealand, thereby increasing the size and scope of the Group’s activities in New Zealand. The Bank of New Zealand was the country’s leading bank with about a quarter of the domestic market share.

It is clear even at this stage that NAB was well on the path to global banking. In 1993 NAB Group reported an operating profit after tax of $1,070.1 million, the first time an Australian-based banking organisation had reported an after tax operating profit of more than one billion dollars. Offshore businesses accounted for nearly one-third of the Group operating profit, with almost a half of Group assets held outside Australia.

By 1995, some 42 per cent of NAB’s assets were held outside Australia. NAB also increased its presence in the United States banking market with the acquisition of Michigan National Corporation, which offers commercial and consumer banking services. The acquisition added approximately 7 per cent to the NAB total assets, and brought the proportion of the Group’s assets domiciled in the United States to approximately 10 per cent.

According to the 1995 Annual Report, the activities demonstrated “…the international nature of the Group and our different growth strategy com-
pared to other Australian-based banks”. The acquisition had another spin-off: to operate a global business in today’s environment, it gained unique technology links to IBM.

In 1996 overseas assets accounted for 46 per cent of the Group’s assets. Under a strategy of overseas expansion pursued over the preceding decade, the Group identified the United Kingdom, Ireland, New Zealand, the United States and Asia as preferred overseas markets.

In 1996 at the International Monetary Conference, John Reed, chairman of Citibank, observed that NAB had achieved the financial mass necessary for an attempt to crash the elite club of truly global bankers, but that NAB was not yet “on the radar screen” and doubted whether NAB would ultimately join Citibank as “global local operations” (quoted in Maiden 1996).

In October 1995 National Australia launched a range of life insurance and investment products, marketed through Clydesdale Bank, Northern Bank and Yorkshire Bank. The decision to establish a new life insurance business provided the UK/Irish Group with significant advantages over established competitors, who found it difficult to lower their relatively high cost structures.

One of NAB’s fortes is to develop consumer markets by capitalising on product offerings and expertise that are proven in other markets. It has done this with the technology and expertise, which it exported to the UK and Irish Banking. Similarly it develops consumer banking markets by, for example, launching in the Hong Kong and United States markets in 1996 the Tailored Home Loan, which had been highly successful in Australia, UK and New Zealand.

NAB reviewed and adopted a new Vision in 1997. While Australia still accounted for the majority of its business, overseas activities had grown to account for around half of the Group’s assets, “The Group has for some time held to a core strategy of achieving growth organically and through well considered acquisitions.” In 1997, the Australian Bank reorganised, moving from a geographical-based structure to a market-based structure to integrate fully financial services with the National’s traditional products. This formed part of NAB’s strategy to grow fee income from both traditional “bank” and financial services income streams.

In 1997, NAB acquired the investment management company County NatWest Australia Investment Management Limited (now known as County Investment Management Limited) to promote Australian and international funds management and build non-interest income. In February 1998 the NAB also purchased HomeSide Inc., one of the leading United States residential loan producers and services.

By 1998 the National had operations spanning four continents and fifteen countries offering a broad range of financial services, and hence chose to
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refer to itself as “The National” rather than making reference to its banking origin. The shift towards financial services had in fact begun over a decade ago with the establishment of a wholly owned subsidiary, National Australia Financial Management Limited, to provide personal financial planning, life and disability insurance, superannuation and a range of managed investment funds. In support of its claim to be truly “international” in the spread of its operations and the sources of its income, the National’s Annual Report cites the statistics: 55 per cent of revenues, 51 per cent of total assets and 54 per cent of employees are outside Australia. In March 1998 the Group announced a new operating structure to support the transformation of the business from separate regional operations to global lines of business. There may well be a strategic shift in the air. In May 1999 NAB said it was contemplating alliances rather than acquisitions as it found its options in Europe, North America and the domestic market were either too expensive or too elusive. However, in April 2000, NAB made a local acquisition, purchasing Lend Lease's subsidiary MLC, a life insurance, superannuation and funds management company. In 2000, NAB underwent a global review to find ways to improve all aspects of its processing. It also decided to restructure its Asian operations to a wholesale-focused regional business and stop trying to build a retail presence in Asia.

NAB is an excellent case of a clearly focused strategy to be a global bank. The alternative of shifting its headquarters from Australia as part of a dual stock-listing plan has been mentioned, providing further evidence of its increasingly global nature.

3. CBA

Until the early 1990s, the Bank was essentially a state-owned domestic retail bank with only a foreign department - stage 1 of the Davis model. In 1989 the Commonwealth Bank had acquired a majority shareholding in the New Zealand ASB Bank. In late-1990 the Commonwealth Bank Restructuring Act 1990 was passed, enabling the conversion of the Bank from a statutory authority to a public company with conventional share capital, and permitting the partial privatisation of the Bank.

In 1991, CBA acquired the fifth largest bank in Australia, the State Bank of Victoria, making the Commonwealth Bank the largest domestic bank in the country. During the year the bank re-examined its overall strategies for international business, resulting in offshore lending policy that concentrated on trade finance and the support of Australian-related corporate activity. Particular attention was also given to customers with business in Asia. The Bank had representation in Asia, Europe and North America, plus over
1,300 correspondent banking relationships in 155 countries. The Commonwealth Bank decided to list and undertake partial privatisation.

By 1993 the Commonwealth was ‘going international’ (early stage 2) according to Davis’ classification. The 1993 Annual Report noted that (1993 p30), “The Commonwealth Bank’s business is heavily concentrated in Australia, where we are the largest domestic bank providing many different services to individuals and businesses across the whole economy.”

1996 saw the Commonwealth sell its remaining shareholding in the CBA, completing the privatisation begun in 1991.

The Bank noted that with market boundaries becoming increasingly blurred, the definition of ‘competition’ could no longer be limited to traditional financial services providers. In the emerging world of direct/on-line communication, potential competitive threats arose not only from the financial services sector, but also from the telecommunications and information processing industries (1996 Annual Report, p20).

In 1997 the Overview of the Bank’s Business in the Annual Report still revealed its primarily domestic focus. The Bank obtained a large proportion (70%) of its funds from domestic retail sources - term, demand and non-interest bearing deposits.

In 1997 the Commonwealth Bank Group ranked among the world’s sixty largest banks in terms of shareholders’ equity, and its services included banking, finance company activities, life insurance and funds management. The Group’s operations were conducted primarily in Australia. In June 1997, CBA began a joint venture together with an Indonesian bank in the commercial banking sector in that country. As at 30 June 1998, the Group was the second largest retail fund manager in Australia. During 1998, the Bank undertook two major strategic initiatives. In New Zealand ASB, the oldest locally established bank, continued to be the country’s fastest growing bank.

In its 1999 Annual Report the Bank admitted that its business had been focused on Australia and New Zealand, but that it needed to supplement this business with new revenue streams from larger and faster growing markets. Its online communication technology as a means to leverage into emerging high growth online markets was seen as one way of meeting a long term goal of deriving 25 per cent of its market value from offshore businesses. In 1999, the Bank was also the first Australian bank to obtain a full Japanese Securities registration to strengthen its ability to offer Japanese investors access to Australian and New Zealand debt markets. To meet the demands of clients for international investment opportunities, Commonwealth Securities launched a twenty-four hour service for trading shares on the major US Stock Exchanges. While in terms of geographic location the CBA may at first glance appear to be multinational, the fact that the Bank is still serv-
ing predominantly domestic customers and that the contribution of international activities to profitability is not a highly significant share suggests the CBA is still in the second or ‘going international’ stage of the Davis model.

It is apparent that the Commonwealth Bank is trying to lose its traditional image of just a commercial bank and is trying to make a new assault of the highly competitive area of finance markets. In 1999, CBA was the largest home loan lender in Australia with 20 per cent of the mortgage market (AAP, 1999).

In 1999 the CBA began its global funding strategy with a $US500 million fixed-rate Eurobond issue. This was quickly followed by a $HK1.2 billion floating rate note issue in Hong Kong, and in the Japanese retail market with a $120 million issue.

In October 1999 the Commonwealth Bank reported that its push into Britain’s crowded banking market would be up and running by early 2000, as the bank was more advanced in developing an e-commerce bank in Britain that in any other country (Aylmer 1999). The CBA signalled its intention to lift the international proportion of its revenue from 8 to 25 per cent (van Leeuwen 2000). At the half-year 2000 profit announcement the Commonwealth Bank’s CEO outlined plans for attack on new, overseas markets by becoming part bank, part internet company (Aylmer 2000a, 2000b). The CBA made a strategic investment in one of the UK’s leading property Internet companies, Property Internet plc, giving the bank 23.5 per cent of the company and an entry into the UK market. The investment will see the two develop a mortgage referral service, and marks the first step of the Bank’s plans to enter European financial services markets (Hughes 2000b).

In February 2000 the CBA linked up with Supply Search, the Perth-based technology company, to enter the rapidly emerging and potentially lucrative business-to-business online service market. CBA expects to take the service offshore.

The CBA has become one of Australia’s major issuers of mortgage-backed securities. It made the first global MBS transaction to include an AAA-rated senior tranche issued by the Australian domestic market (Hogan 2000). In March 2000 it gained access to the world’s biggest bond market through its first-ever global issue of mortgage-backed securities. This global issue is an integral step in the ongoing diversification of the bank’s funding strategy.

In June 2000 the CBA undertook a $10 billion friendly takeover offer for Colonial Ltd, the parent company of the Colonial State Bank (formerly the State Bank of NSW), creating the country’s largest financial services company. It would boost the Commonwealth’s presence in NSW lending, increase personal financial services and boost funds under management. “Colonial brings with it a UK platform, admittedly of ordinary quality, and
a developing banking and insurance network in Asia. For the first time CBA will have a meaningful presence outside Australasia on which to build an international strategy that is clear and simple to sell to the market” (Bartholomeusz 2000). “The reason that we’re interested in the merger is that superannuation and funds management is going to grow much faster than traditional banking and we want to change that mix and also add some global activity to our business mix” (Mellish 2000). In May 2000 Colonial sold its UK life insurance business, but retained its funds management presence there for the CBA takeover at the end of June (Hughes 2000a).

In June 2000 the Chinese Government gave a licence for the CBA’s Shanghai-based life insurance operation. The CBA was granted a full banking licence in New Zealand, which paved the way for a full rollout of an institutional banking operation (Lekakis 2000). In July 2000 the CBA bought out its Indonesian joint venture banking partner, now owning 99 per cent and with 1 per cent held in trust for regulatory reasons.

To sum up, CBA had widened the business into most domestic financial market segments as well as some offshore operations. According to the Davis model CBA is still in the ‘going-international’ stage.

4. Westpac
Westpac had begun opening branches interstate and overseas in the mid-nineteenth century. Westpac Banking Corporation formally came into existence in 1982, following the merger of the Bank of New South Wales with the Commercial Bank of Australia. By 1982, Westpac provided comprehensive banking, investment, travel and related services in Australia, New Zealand, Papua New Guinea, Fiji and the West Pacific region. At this time, however, Westpac was only just beginning to move beyond the first Davis stage of a bank with a foreign department into the second stage of ‘going international’.

1984 was a year in which Westpac purchased a 50 per cent interest in leading Australian stockbroker, Ord Minnett Limited, and a 75 per cent interest in gold and silver bullion dealer, Mase-Westpac Limited.

By 1985, claimed to be “Australia’s world bank” (international or at the upper end of the second stage of Davis’ model). In terms of internationalisation, it claimed to be significant in size (68th in size of assets, 43rd in size of capital and reserves and 20th in size of pre-tax profits), and a leading underwriter on the international bond market.

In 1986 Westpac purchased selected parts of Johnson Matthey Bankers (UK), including the bullion business and associated treasury and foreign exchange businesses. It also reached agreement to acquire William E. Pol-
lock Government Securities, a primary dealer in US government and agency securities. Westpac was listed on the Tokyo Stock Exchange and also opened branches in Hong Kong, Seoul and Taipei. At this point the Bank could be classified as early ‘multinational’ (Davis’ third stage) both in terms of geographical representation and contribution of international activities to profitability.

Beyond Australia and New Zealand, Westpac’s operations extended to 23 countries. One of the apparently new aims of the Group was to target high-quality customers in the Western Pacific, North America and Europe, and this was consistent with its established and profitable position in selected global markets.

The increasingly international outlook of Westpac during the late 1980s is apparent in its 1988 Annual Report: “Westpac is an international financial services group headquartered in Australia”. It noted that because size was critical to its strategy, Westpac no longer had the option of remaining essentially a domestic bank. By the end of 1988, Westpac believed itself to be in a position to export its expertise, with its product range, technology, delivery systems and customer service comparable with those provided in the major financial markets. Its strategic focus was to remain on obtaining the size and profitability to position Westpac in global financial markets. Westpac listed on the New York Stock Exchange in March 1989.

1990 proved to be a difficult year for Westpac Group, but one that heralded tougher times to come. It reported a 15 per cent decrease in after tax profits. In 1991 mainly due to over-exposure to the commercial property market, the failure of many small to medium commercial companies, and profit exposure, AGC managed operations cost the Group $386 million. Westpac endorsed a strategic redirection to concentrate on the Bank’s core franchises in retail and corporate banking in Australia and New Zealand and the global financial markets business. In 1993 Westpac returned to profitability, with all operations within the Bank contributing to earnings. The Managing Director noted that in its recent past, Westpac “suffered from an implicit strategy that was too unfocused and too unrelated to our natural advantages” (p7).

In terms of divesting non-core businesses and assets outside retail and institutional banking, Westpac either sold or arranged to sell Television and Telecasters Limited, Ord Minnett Group Limited, gold bullion banking and trading subsidiary Mase Westpac Group, the Bank’s 85 per cent share in PT Westpac Panin Bank in Indonesia, the Taipei operations, many of the assets of the Seoul operations, minority interests in the ANZ, Bank of Melbourne and Challenge Bank, Westpac/AGC’s finance company subsidiaries and businesses in Thailand, Hong Kong, Taiwan and joint ventures in Indonesia,
Malaysia and Singapore. This divesting showed clearly that Westpac was not moving towards becoming a global bank (fourth stage of Davis’ model).

In 1995 Westpac recorded a large increase in profits and used this success to launch a merger with Challenge Bank in Western Australia, a bank with a regional focus. In 1997, Westpac established a strategic relationship with Standard Chartered Bank, which gave customers access to an Asian network larger than all other Australian banks combined. It also successfully merged with the Bank of Melbourne.

The severe Asian recession in 1998 strained the global economy and Australian banks were faced with a new challenge. Westpac decided to invest the bulk of its talents and financial resources only in markets it knew well, that is, principally Australia and New Zealand.

Since the late 1980s until the present, Westpac has remained a multinational bank (third stage) according to Davis’ classification. Although there has been some shift in Bank focus towards customer and product profitability, rather than to domestic and international productivity, the distinction between domestic and international has certainly not been lost. In fact, Westpac seems to state more emphatically in the recent years that it is a bank primarily servicing the markets of Australia and New Zealand and the customers both locally and overseas that has dealings with these markets.

5. Conclusions

If we reflect on the experiences of the four banks in the international arena, we can flesh out Davis’ model of four stages to incorporate some important elements.

First, as with any company management, it is important to know in which business/es the company is working and to know the markets. This is particularly important in the transition between the second and third stages, and is essential if the company is to move to a successful global banking structure. In the early 1990s the combination of a loss of consistent focus and a lack of comprehension of the entrepreneurial risks taken by bankers who were used to traditional, conservative, predictable banking practice in relative economic stability resulted in the near collapse of companies such as Westpac.

Second, Westpac’s experience and financial distress in the early 1990s suggest that a successful global strategy depends upon there being no serious difficulties in the home market(s). ANZ’s experience also suggests that it is hard to focus on a global banking strategy when there are serious difficulties in the home market, but it should be remembered that had ANZ and
National Mutual been allowed to merge fully, the global focus might have been quickly resurrected.

Third, the lesson from NAB’s experience is to have been successful domestically before shifting overseas. If we reflect in contrast on ANZ’s experience, there appears to have been a lack of focus on what the bank could export successfully, and that may explain its shifting strategic approaches to internationalisation.

Fourth, it is important to predict and evade new threats to traditional businesses. Whereas in the past it was primarily non-bank but still financial institutions (buildings societies, credit unions, etc.) that were banks’ major competitors, these days it can be new competitors such as Australia Post and Telstra with their electronic bill paying.

Fifth, the creation of a common technology platform as early as possible, but certainly in the transition between the second and third stages, is an essential prerequisite to a successful global banking structure.

Sixth, it is important to move with the times if a company is to survive. For example, banks are no longer required to ration credit but to be marketers of financial services. Once the bank has made a sound foundation, as the Commonwealth Bank currently seems to be doing with its electronic network, it is possible to expand around that network.

Seventh, focus has to remain consistent. ANZ appears to have had misgivings at various points concerning their international focus and not to have focused on the cost of it. A major opportunity offered by Grindlays, but not taken up by ANZ, was to be a market maker in exotic currencies. Were the strengths of Grindlays’ international network actually appreciated by ANZ? Because various managing directors had different approaches to internationalisation, the head start towards a global bank that the acquisition of Grindlays offered seemed to be dissipated.

Eighth, difficulty with starting new ventures in overseas banking markets may necessitate cost-effective acquisitions for a bank to move from stage three to four of Davis’ model. The point of John Reed’s comment about NAB may well be taken to mean that he does not think there are enough cheap acquisition opportunities to allow NAB to progress to being a global local bank.

Davis’ model can assist with the analysis and interpretation of the strategies of banks as they move into international markets to become global. However, three limitations should be stressed. In a dynamic environment like banking in the last 20 years, stages can be moved through quickly, with both forward and backward movements occurring. This may render the categories less robust. The fact that the process has not been linear suggests that the categories are not so much a life-cycle process as a matrix of possible strategies. Internationalisation models such as Davis’ also tend to ne-
glect the role of domestic banking in internationalisation. In many cases the 
retreat or advance of international banking has come from domestic factors, 
just as the retreat and advance of domestic banking has had international 
causes. As with Tripe and Matthews in this book, the results suggest that no 
single model of bank internationalisation can predict or explain all cases. 
However, Davis’ model has been shown here to provide a useful start.

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1. Introduction

This paper presents research on foreign investment in the financial sectors in the Baltic States, i.e. Estonia, Latvia and Lithuania. The role of banks and insurance companies are crucial in a market economy, in the intermediation of capital in the restructuring of economy, creation of viable payments system, and also to spread household and firm risk over time and space. The stability of the financial sector and public confidence in the sector are crucial to economic growth, and research has shown that these issues have been especially relevant to economies in transition. A common feature of transition economies has been that foreign multinational firms have taken a great interest in restructuring the economy.

One of the most popular responses to the growing integration of capital markets has been for financial institutions to adopt regional integration strategies. The Baltic region has been mooted as one such financial region. This has important implications for the financial system in the Baltic region, for example for the forms through which diffusion of experiential knowledge to domestic actors in the transition economies occurs (Hansson and Tombak, 1999). Hence, the financial system of transition economies will be affected in important ways by the interaction of foreign investors, attempting to meet an evolving institutional set-up with structural uncertainty, and on the other hand domestic actors confronting international competition.

The research problems are two-fold, firstly to understand the motive for foreign enterprises entry in uncertain and evolving markets and secondly the problems facing domestic financial institutions dealing with fierce competition from firms with long experience of the market economy (van der Hoek and Miltenburg, 1996). On the latter issue a major topic is to study if a crowding-out effect has occurred for domestic firms with foreign bank entry, e.g. can foreign banks make it harder for domestic industrial firms to raise capital for investment? Hence, the structure of the financial markets can to a large extent affect the efficiency of economic activity as a whole (Meyer, 2000).
To date, the much-heralded regional financial integration possibilities have not been very well documented. A first step in the research is therefore to describe the structure of financial interaction both within the region and globally. The identification of foreign firms in the Baltic financial systems provides a crude pointer to regional integration. At the same time, there is a real need for study of the entry of service firms in foreign markets to understand the driving forces behind the investments. It is also important to consider how regional integration, for example mergers among Scandinavian banks, affects their conduct in Baltic financial markets.

One of the few studies of the behaviour of foreign financial firms in the Baltic countries (Hellman, 1996) found that Finnish financial organisations saw their establishment in the Baltic area as a response to their domestic clients’ behaviour. On the other hand, the non-financial clients had a completely different view of the matter, and instead of using domestic banks on foreign market; they preferred to use domestic bankers in foreign markets. Therefore, of crucial importance is the study of relationships between financial and non-financial firms on foreign markets to get a more adequate picture of the actual pattern of the internationalisation process. One question connected to this discussion is, do financial firms follow their clients abroad as a way to defend the market share on the domestic market, or are their other forces driving regional internationalisation?

If foreign insurance corporations and banks establish a dominant position in a transition economy does it also affect the structure of the industrial system? Do foreign financial actors help to finance new business and markets with high degree of uncertainty or do they prefer more traditional and safe investments? (Buch, 1997; Pye, 1998). The answer to this question can also serve as an indication to what extent foreign firms take responsibility for developing transition economies. A first step to investigate this matter is to study the market structure of the financial system, especially the degree of internationalisation. Given the high degree of concentration in financial markets, it becomes vital to investigate the internationalisation strategies followed by individual financial institutions.

A positive effect of foreign financial firms on transition economies is the diffusion of new and modern risk management techniques (i.e. hedging and exposure management in derivative markets) to the evolving markets. If we assume that foreign firms are important in transition economies, the question becomes what is the role of national regulatory structures in retarding or promoting regional and wider internationalisation processes? It has already been shown that the national institutional set-up can affect the behaviours of foreign enterprises in many ways, (Mullineux and Green, 1999; Bonin and Abel, 2000), but is it possible to find a legal system that both
considers the need for domestic firms and the need to govern the activities of foreign financial organisations?

There is now a wide spectrum of theoretical concepts that can be used in this area of research. One example is the question of the behaviour of foreign financial organisations, and whether they are client-followers, adopt a follow-the-leader strategy, i.e. oligopolistic reaction, or do internationalisation initiatives arise as a way to find new markets, i.e. as a market-seeking strategy? (Erramilli, 1991). Another theoretical assumption has been that internationalisation is only a response to profit-maximising behaviour. Therefore, the profitability of international versus domestic business is an important research issue, though not one undertaken in this paper.

Another theoretical problem concerns the question of what factors are considered important for successful establishment abroad? In this respect, is a regional integration or a move to a further global integration the main driving force? Furthermore, is internationalisation a defensive (e.g. to protect domestic market share) or an expansionary (market-seeking) activity of these firms?

Foreign financial institutions have already established a presence in the Baltic States. Of course these markets are all of limited size and scope, but they differ in the structure of their business, religion and language, making it harder to secure economies of scale and/or scope. Not surprisingly, financial institutions conduct their business differently in each of these markets. Many companies started by investing in one Baltic country, then expanding that brand name in the whole region. Others have instead invested in one local firm in each country; sometimes at a higher cost but at the same time securing a stable market share in an early phase. The least common way of establishing foreign business has been through greenfield-investment. The differing reasons behind these individual internationalisation strategies are an important research question.

The extensive establishment of foreign insurance companies and particularly foreign banks in Baltic markets has started a debate about the consequences in host markets (c.f. Mathias, 1999). It is thus important to learn more about the consequences and international impact of international financial institutions on transition economies. A longer-term goal of this study is to determine whether there is any correlation between the degree of international integration and the level of economic development.

This paper discusses the internationalisation of Swedish banks into the Baltic financial sector. Swedish banks have already invested heavily in these three countries, while the involvement of Swedish insurance companies remains limited. The paper is organised as follows. Section two introduces the theoretical approaches used in the study. Section three provides a short overview of the development of the financial sectors in the Baltic
States. Section four presents data on the investments of Swedish banks in the Baltic States. Section five provides a summary of the results and a concluding discussion.

2. Internationalisation theory

The field of internationalisation theory has seen an enormous amount of literature produced in the last two decades (c.f. Cantwell, 1991 and 2000). This paper concentrates on two different theories that focus on the issue of why financial enterprises establish in foreign markets. In these theories, there are three theoretical concepts used to describe the internationalisation of service firms: (i) client-following; (ii) follow-the-leader; and, (iii) market-seeking. A client-following strategy means that the firm goes abroad to maintain its existing customer network. The follow-the-leader strategy (or oligopolistic reaction) occurs when a firm expands abroad to avoid losing market share to another domestic competitor expanding abroad. The market-seeking concept describes firms that establish business in areas without any direct relation to their customer or competitors (Erramilli, 1991; Hellman, 1996).

A problem is that if we only analyse the internationalisation process from this point of view several important aspects of the issue are neglected. In order to resolve this limitation, the so-called ‘Uppsala internationalisation model’ (a.k.a. the Nordic model) is introduced. The model suggests that the process of internationalisation is the consequence of the acquisition of experiential knowledge, in particular market-specific knowledge. Knowledge acquired from operating in a specific market enables a company to gradually increase its commitment to that market. The model suggests that firms go through a sequential expansion process, the so-called ‘establishment chain’. Due to psychic distance and uncertainty, firms in the beginning of their internationalisation will limit investment and stay close to their domestic market (Johanson and Vahlne, 1977; Eriksson and Johanson, 1997; Forsgren, 2000; Björkman and Forsgren, 2000). The prediction that can be made from the model is that firms, after gaining international experience, will gradually invest further away (and on an increasing scale) from the domestic market.

The literature about international business is now extensive and many contending theories exist. A problem with the models has been that ex post testing suggests that all have some explanatory power. Support can thus be found for most of the explanatory models. This paper concentrates on testing the marketing approach to explain internationalisation of service industries; that is the idea that the process can be explained by client-following,
following-the-leader, or market-seeking. The research also uses the related Uppsala model of incremental internationalisation. The possibilities and limits of the theories to explain the internationalisation process in the Baltic States are also discussed.

3. The Financial Sector in the Baltic States

This section serves as a short description of the development of the financial sector in the Baltic countries. Before independence financial markets in the Baltic States were served by the single USSR state owned bank, Gosbank, which conducted business in accordance within the parameters of central planning. The first step to transform the bank system was with a ‘two-tier’ system, which consisted of a single central bank and several competing banks (Jaffe and Levonian, 2000). This process started, in the Baltic’s and other Soviet republics, in 1987-88 with the separation from Gosbank of five specialised banks, the Bank of Industry and Construction, the Saving Bank, the Housing and Social Bank, the Agricultural Bank and the Foreign Trade Bank. In spite of the specialisation of the different banks, the intention was to create a banking system with some kind of competition (Meyer, 1998).

The Baltic States later brought the local branches of these banks under local jurisdiction. These five banks formed the core of the new commercial banking sector (Hansson and Tombak, 1999). The process included founding of a central bank, completely new set-up of laws and regulations, leaving the Russian rouble zone and introducing new currencies in one and each of the Baltic countries and privatisation of state-owned banks and insurance companies. (Lainela and Sutela, 1993; Borish, Ding and et al., 1997).

The development of the banking sector has varied across the three countries. In the beginning of the transition process all Baltic States kept the saving banks under state ownership. Only later did privatisation of these banks commence. The other banks were instead divided into a number of local banks. In the beginning of the privatisation phase, domestic industrial firms often acquired banks in order to secure capital for their core business. In this way, the ties between the industrial sector and the emerging banking sector were established very early. These very strong links became a major problem during the financial crises in 1995 and in 1998 (Claessens, 1996).

By contrast, foreign bank (and insurance) entry, sometimes with international monetary funds (as Swedfund and Finnfund), often occurred though opportunities for buying minority stakes in insolvent financial organisations (Hansson and Tombak, 1999). For foreign banks already in these markets, the financial crises enabled them to increase their stakes in the Baltic banks at very low costs.
In the Baltic States new commercial banks were established in 1988. State enterprises or co-operatives, with the aim to function as internal banks, established several banks. Other banks were established by private enterprises and acted as ‘house-banks’ with the purpose to raise deposits to finance the core business of the owners. The Baltic States had a liberal policy with regard to licensing of new commercial banks. The purpose of this policy was to create competition amongst banks to finance the emerging non-banking private sector. In contrast to the expected direction of causality, many banks were founded by private enterprises as a means to gain lower cost funding. This explicit connection between industry and banks has been found to be a factor that undermined the development of sound risk management in the banking sector (Fleming and Talley, 1995; Fleming et al., 1996).

3.1 Estonia

There were of course important national particularities in the development of financial markets in the respective countries. The emergence of the Estonian banking industry can for instance be dated from 1988, when permission for establishing commercial banks was granted for the first time in the Soviet Union. The commercial banks established by this reform were either new organisations established by domestic industry or privatised branches of the former Soviet banks. Estonia was also the first country within the Soviet Union with a Banking Act, and as early as the end of 1989 it began to monitor the activities of the commercial banks.

By the end of 1990, there were 12 commercial banks in Estonia and several other banking companies were established by 1991. Even though several of these banks were quite short-lived and had to be liquidated in an early phase, the number of commercial banks in Estonia had risen to 41 at the end of 1992. The lack of proper banking legislation and experienced managers nevertheless made it a very unstable market. Another problem during this early phase was that Estonia, despite formal independence, remained effectively part of the Russian rouble-dominated economic sphere and thus strongly affected by its inflationary environment. At this stage also the Russian banking authorities did not have a proper accounts clearing system, and frozen money of Estonian firms summed up to $20 million.

A first step in breaking with the increasingly unstable rouble-zone, and create credible financial institutions, was that Estonia severed its link with the rouble on June 20, 1992. The Eesti kroon, linked to the German mark through a currency board system, became the only legal tender in the country. Maintaining the kroon’s stability required additional measures to balance the state budget, abolishing state subsidies to agriculture, imposing
restrictions on exports and imports, and setting limits on the salaries of state employees, and price liberalisation – except for electricity, local taxes, community transport and rents.

Though these reforms were necessary to reshape the economic framework, they caused a major shock to the economy in Estonia. Among other things, this manifested itself in declining production, a liquidity crisis for enterprises and pressure on the fragile banking system. The crisis was magnified by the inadequate legal framework and inexperienced bank management. Together with the ongoing effects of economic reform, frozen Moscow accounts and heavy losses due to excessive risk exposure, the Estonian banking sector entered a deep crisis in the summer of 1992, resulting in a liquidity problem in the bank sector (Sorg, 2001).

The banking industry suffered a massive deterioration in 1992 and three major domestic banks (Union Baltic Bank, North Estonian Bank and Tartu Commercial Bank) became insolvent. As a result the Bank of Estonia declared a moratorium on these three banks, which led to liquidation of the then largest commercial bank, Tartu Commercial Bank. To avoid a similar fate, Union Baltic Bank and North Estonian Bank merged and took the latter bank’s name to become a single state-owned bank. In spite of the effort from the Bank of Estonia to avoid a general bank run, the problems for the earlier mentioned major banks and further eight smaller banks, lowered the credibility of the Estonian banking industry.

Problems within the banking industry also made it necessary to restructure financial management among non-bank firms. It became more important to pay close attention to risk analysis of credit granting and to spread and diversify commitments to different sectors within the economy. A shift from speculative lending to a more cautious risk management was a result of the financial crisis. As a result, the number of credit institutions in Estonia dropped dramatically from 42 banks in 1992 to 11 by the end of 1997. An important factor behind the concentration in the banking sector was increased minimum share capital, first imposed in the beginning of 1993.

These changes, together with a central bank decision to freeze the issue of new banking licenses, led to the decrease in the number of Estonian commercial banks, from 41 to 21 between 1992 and 1993. The so-called second-wave restructuring after the banking crisis, especially due to the financial crisis Russia, in 1998 decreased the number of banks to 6. In 1999 a new bank was licensed and the market structure have since then been stable (Sorg, 2001).
3.2 Latvia
Before 1988 there were no independent banks in Latvia, and only the USSR State Bank and specialist branches under its supervision, as well as a wide network of thrifts existed to channel investment. The modern commercial banking sector in Latvia began in 1988 when the first commercial banks were founded, notably the Riga Inter-regional Bank Baltija (later Bank Baltija) and the Innovation Bank (later Bank for Reconstruction and Development of Latvia). In 1989 four new banks were established, but the organisational procedure for establishing the first banks was complicated because the foundation licences were issued by the USSR State Bank in Moscow. This was changed after Latvia regained independence in 1991. After this, the Bank of Latvia, founded in late August 1990, began to issue licences. As a result, a large number of new banks appeared on the market in the early 1990’s. After 1992, commercial banking began to develop when forty-five branches of ex-soviet banks (excluding the Savings Bank) merged into the Bank of Latvia. Nine of the branches Fifteen were consolidated into eight banks and sold through share offerings. The remaining 23 branches were merged in to a state-owned bank, Unibank. (Fleming and Talley, 1996).

The Latvian government attempted to liberalise entry into commercial banking, and by 1993 more than sixty new banks had gained licenses. As with financial sector development in Estonia, a large number of ‘house banks’ were formed in Latvia, to facilitate cheap finance to their state and private industrial owners. By the end of 1999, the Latvian banking market consisted of 23 banks.

3.3 Lithuania
As in Estonia, the government in Lithuania reconstituted the specialised Soviet banks as national state banks and gradually privatised them by selling shares to domestic interests. The first new commercial bank in was started in 1989, a figure increasing to 28 by 1994. In 1991, the new central bank of Lithuania was established along with local branches of the Social Bank and the Industry and Construction Bank. A year later it also absorbed the local bankrupt Foreign Trade Bank, but leaving the Agricultural Bank as an independent state-owned bank. With time many of the so-called ‘house-banks’ went out of business and the market gradually consolidated through mergers. The result was that the number of banks had decreased to 16 in 1995. At the end of 2001 the situation was such that 9 commercial banks, 4 foreign bank branches and 5 foreign bank representative offices held license to operate banking business in Lithuania.
3.4 Internationalisation

The initial pattern of foreign influence in the financial sector varied among the Baltic countries. In Estonia it was already legally possible by 1992 for foreigners to purchase shares in banks. The first bank owned by foreigners was the American Baltic Bank, which started business in 1993. In the same year three Finnish banks opened agencies in Estonia. This can also been seen as an indication, following the institutional changes after the financial crises, of the improving soundness of the Estonian banking sector. A year later the Bank of Estonia granted the first banking licenses to foreign banks; Finnish KOP and SYP (which later merged to Merita Bank and also participated in forming the Swedish-Finnish bank Merita-Nordbanken) and INKO Baltic Bank from Ukraine.

An important step in the development of the financial sectors in the Baltic States, but also for the internationalisation of ownership, was the entry of western European controlled funds such as the EBRD, Swedfund, Finnfund and Germany’s DEG. Each of these government-controlled agencies acquired minority stakes in the respective investment banks in the three countries. The EBRD and Swedfund also invested in privatised banks. Swedfund, for example, made investments in Uhispank in Estonia, Unibanka in Latvia and Vilniaus Bankas in Lithuania.\(^{144}\) Taken together these investments helped to stabilise the financial system in the Baltics.

In 1995 the influence of foreign banks increased. In that year OKO Bank, Baltiiski Bank, Svenska Handelsbanken, Siberian Trade Bank and Basis Bank all began business in Estonia. The first foreign bank to establish a branch office in Tallinn was Merita Bank at the end of February 1995. In 1996 bank legislation was changed so that minimum share capital and equity requirements were increased. Especially the latter caused disturbances on the market. This was also the starting point for domestic banks to establish alliances with foreign strategic investors (Cavalcanti and Oks, 1998).

These changes also prompted a further round of mergers among domestic banks. The only bank that failed to follow the new equity requirements was the first foreign bank in Estonia, American Baltic Bank. In recapitalising the banking system after the Russian crises in 1998, several Swedish banks came in as strategic investors, a development explored later in this paper, but which has seen foreign institutions own much of the banking system. By the end of 2000 for instance, non-residents held almost 84 per cent of the Estonian banking sector’s share capital and the majority of the banks were foreign credit institutions.

\(^{144}\) The Swedish bank SEB bought all shares from Swedbank at the end of 2000, at the same time as SEB took full control of the three banks. Annual report, Swedfund 1997-2000.
Foreign entry has also been high in the Latvian banking system. At the end of 1999, there were 23 banks in Latvia. Foreign investors had acquired a stake in 20 banks; and in 12 of these, foreign shareholders owned over 50 per cent of the share capital. Six banks were wholly-owned subsidiaries of foreign banks. As at the end of 2001, there were 22 banks, and foreign shareholders owned about 68 per cent of the sector’s total share capital. In 10 banks, foreign shareholders held over 50 per cent of share capital. In the Latvia, foreign entry was also seen by the central bank as a necessary step in the restructuring of the banking sector. The industry is now almost entirely in private hands, the state owns less than 5 per cent of the bank sector’s total share capital with a controlling stake in only one bank, the state joint-stock company Latvijas Hipoteku un zemes banka, and a minority stake in the joint-stock company Latvijas Krajbanka.

With over 65 per cent of the share non-residents now own capital of the banks, the Latvian banking sector is strongly influenced by foreign interests. Consolidation of the banking sector is ongoing but the four biggest sectors now account for 50 per cent of the total assets, while the ten biggest control 75 per cent. Legislation at improving capital adequacy is also a factor that is likely to spur further consolidation.

In Lithuania foreign investors have been slower to acquire equity positions in local banks. In 1996 foreign institutions owned only 16 per cent of capital in the banking sector shareholdings. By 2000 this had grown to slightly more than 35 per cent. The big jump in foreign participation in the Lithuanian banking system came in 2001 when foreign institutions raised their equity holdings to almost two thirds of the industry’s capital. In 2002, after the privatisation of the Lithuanian Savings Bank, the share of foreign investors in the bank share capital increased again. Currently, foreign banks hold a majority stake in six out of Lithuania’s nine commercial banks.145

The policy framework in the Baltic States has been favourable for international business, in at least two respects. Liberalisation of foreign investment regulation, along with the need to find equity capital for reconstruction of the banking system after the Russian financial crisis has both been important. Latvia and Lithuania waited longer than Estonia to liberalise their foreign investment controls in the banking sector. But after the financial crises, the two chose to follow Estonia’s example (Djankov, La Porta, Lopez de Silanes and Schleifer, 2001; Lavigne, 1999).

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145 In addition, negotiations with the German bank Nord/LB are currently going on concerning the sale of state-held 76 per cent in the Lithuanian Agricultural Bank. If this sale will go, the proportion of commercial bank share capital held by foreign investors would go up to 89 per cent.
To sum up, the financial sectors in Baltic States have gone through several restructuring phases, which started with privatisation of the bank sector and the establishment of a large number of private banks. In the consolidation that followed, foreign investors came to play a key role. The banking sector is now highly concentrated, and foreign banks dominate in most of these markets. The main entry strategy of foreign banks has been through ‘brownfield’-investment whereby foreign investors especially from Sweden, Finland, Denmark and Germany have acquired shares in domestic corporations. Domestic management still plays a key role in the management of the financial companies in the Baltic States, with supervisory boards representing the foreign owners. Banking markets in all three markets are now characterised by strong domestically oriented banks, owned by foreign investors.

4. The Swedish banking market and investment in the Baltic States

Four major banks in Sweden, account for almost 90 per cent of the capital in the banking sector. All major banks in Sweden are now limited liability banking companies after the de-mutualisation of Swedbank in the 1990s. There have been several mergers and take-overs in the commercial banking sector. The Saving Bank (Sparbanken) and the Agricultural Bank (Föreningssparbanken) merged in 1997 to Swedbank (Föreningssparbanken). In the same year Svenska Handelsbanken acquired Stadshypotek, a mortgage credit organisation. MeritaNordbanken (hereafter Nordea) was formed in 1998 by the merger of Swedish Nordbanken and the Finnish bank Merita Bank. Nordea subsequently acquired banks in Denmark and Norway and thereby posses a strong position on the Scandinavian bank market. Finally, in 1998 S-E-Banken acquired the Trygg-Hansa insurance company and the group renamed SEB. The new bank sold the non-life insurance department to Danish Codan (owned by British Royal and Sun Alliance) but included life insurance in their business (and bought Codan’s bank business in Denmark). These four banks have also expanded their banking activities into the Baltic States, but in different ways.

Swedbank is a merger between two banks that had not until that time focused on multinational customers. Nordea had the heritage of state ownership in the banking sector, and after the financial crisis in the beginning of the 1990s the government had to intervene and assist in recapitalising the bank. Nordea has since become much more internationally oriented and has undertaken mergers and acquisitions of banks in Finland, Norway and Denmark.
SEB is the product of more than 60 merged commercial banks, and has had a strong connection to several large Swedish multinational industrial firms. In 1999, SEB sold the non-life insurance division of Trygg-Hansa to the Danish insurance company Codan (which in turn is controlled by the British Royal and Sun Alliance. Except for the branches of life and non-life insurance in Poland, Trygg-Hansa’s establishment in the Baltic region were transferred to Codan. Because Trygg-Hansa was the only Swedish insurance companies with formal commitments in the Baltic States, the sale also ended the presence of Swedish insurance companies in the Baltics.

Like SEB, SHB had long-standing relations with Swedish industry. And since SHB was the only bank that did not experience severe losses during the financial crises in 1990s, SHB was able to strengthen its position on the Swedish financial markets.

Swedish banks were active in international business in the 1960s with representative offices in international financial centres and in countries with favourable taxation, like Luxembourg and Switzerland. But after the financial crisis in Sweden in the beginning of the 1990s, Swedish banks withdrew operations from several foreign markets while maintaining their presence in international financial centres (Engwall and Wallenstål, 1988). The Swedish banks have however, strengthened their regional positions in the Nordic banking markets. The next section provides case studies of the internationalisation experiences the four main Swedish banks. Swedbank, SEB, Nordea and SHB.

4.1 Swedbank

Swedbank’s geographic sphere of interest in the second half of the 1990s could be defined as the Nordic region and Baltic countries. The bank’s strategy here has been to expand by entering into alliances with strategic partners in each market and to acquire an interest in the allied banks. Besides its involvement in the Baltic’s, Swedbank also has stakes in Finland, where it controls 25 per cent of the Aktia Sparbank (Savings bank). Swedbank also has another co-operation agreement and minority stake in Austria’s second largest bank, Erste Bank. The most important reason for Swedbank’s interest in the Austrian bank was its network in Central Europe. Swedbank also has branches in London and New York and a representative office in Tokyo. In 1998, Swedbank agreed to acquire 25 per cent of the shares in the Norwegian saving bank Sparebank 1 Group.

Swedbank started their business in the Baltic States 1997 through a cooperation with the Estonian savings bank Eesti Hoiupank and at the end of 1997 raised its initial stakes to almost two fifths of the Estonian institution’s
share capital. The same year Swedbank also became part owner of Poland’s Bank Handlowy.¹⁴⁶

In the 1998 Hoiupank and Hansapank merged and Swedbank received shares in the new Hansabank corresponding to almost 7 per cent of the total shares and voting rights. Following the merger Swedbank gradually increased its stake, through share purchase in the stock market, by acquiring Hansabank shares from SEB and through a new share issue. At the end of that year, Swedbank had increased its stake in Hansabank to 55 per cent, but aimed was to reduce its ownership to around 30 per cent over time by selling shares to strategic partners. One consequence of this strategy was that the Polish Bank Handlowy acquired 5 per cent of Hansabank from Swedbank, and thereby a strategic alliance was created between Swedbank’s foreign subsidiaries. The ownership ties between Hansabank and Bank Handlowy was however terminated in 2000 when Swedbank repurchased the shares of Hansabank from Bank Handlowy. At the same, Swedbank sold its stake in Bank Handlowy to the US Citibank.

At the end of 1998 Hansabank increased its share capital, with the new shares acquired by the EBRD. In 1999, however, Swedbank again increased its stake in Hansabank by way of a call option on Hansabank’s shares. Swedbank’s stake in the company now increased to over 50 per cent.

Hansabank itself had begun to expand its business to Latvia even before Swedbank had any interest in the bank. Hansabank opened a representative office in Riga 1995 and the year after the bank bought 100 per cent of the Deutsch-Lettische Bank. The bank was renamed to Hansabank-Latvia. The representative of Hansabank Latvia acquired Zemes Banka in 1998 (Annual report 1998).

In the middle of 1999 Hansabank started a subsidiary in Lithuania. A year later Lithuanian State Property Fund decided to privatise the Lithuanian saving bank (LTB) and started negotiations with Hansapank. This was concluded at the end of 2001, and Hansabankas and Lietuvos Taupomasis Bankas (LTB) merged and to form Hansa-LTB. In effect, this also meant that Swedbank had acquired an existing bank in Lithuania, but all their investment in the Baltic States are governed from Hansabank head office in Estonia.

The Hansabank group now comprises universal banks in Estonia (Hansapank), Latvia (Hansabanka) and Lithuania (Hansabankas), and owns Hansa Capital, the largest company offering leasing and factoring services in the

¹⁴⁶ Swedbank concluded an agreement with the Polish Government to acquire 3.5 per cent of the capital and voting rights in Bank Handlowy in connection with is planned privatisation. Swedbank was part of a group of investors led by the investment bank JP Morgan. At the same time Swedbank agreed to acquire convertible debentures in the Polish bank, and when converted Swedbank should hold total 6 per cent of the banks shares.
Baltic States, with subsidiaries in Latvia, Lithuania, Russian and the Ukraine. It also owns Hansabank Markets, which is currently developing into an investment bank, and an insurance division targeted at the life assurance market.

According to Swedbank the forming of international alliances was undertaken in an attempt to meet its customers changing needs. Expansion into other Nordic countries and Baltic Sea region was itself reflective of the fact that key customers had or were expanding from their home market. Swedbank also saw financial advantages to geographic expansion. The aim was also to expand the customer base and thereby create economies of scale in technical development, products and distribution (Annual Report 1997 and 1998). That is the official statement of Swedbank was that its internationalisation process could be mainly attributed to customer-following behaviour.

To sum up, Swedbank expanded abroad during the 1990s through strategic alliances in combination with acquisition of shares in key banks as a way of establishing a regional platform. But the key investments of Swedbank in Norway, Finland and the Baltic States have also been re-defined as the bank’s new ‘home’ market. Of Swedbank’s total foreign investment, the Baltic region has consumed more than 60 per cent. According to Swedbank, co-operation through alliances instead of acquisition has several advantages, including local knowledge of the allied bank and lower investment requirements. But their investment in the Baltic States, through Estonian Hansapank, has led to strong ownership ties and further commitment to the area.

4.2 SEB

Swedish SEB is an international finance group with more than 600 branches in Sweden, Germany and the Baltic States. SEB also operates in the other Nordic countries, Great Britain, Luxemburg and Switzerland.

On the Nordic market SEB have since 1997 operated in Denmark through a local branch in Copenhagen. SEB began operations in Norway in 1981 through a representative branch, and since 1994 the bank has offered complete banking operations in the country. Finally, SEB Helsinki was established in 1994.

In Europe SEB have operated in England since 1964, and as the only established Nordic corporate bank in Paris, since 1991, SEB especially serves Nordic companies to do business in France and French firms conducting operations in the Nordic countries. For a long period SEB have served Nordic subsidiaries in Germany and also performed as a financial partner for German firms in the Nordic countries. SEB strengthened its position on the market through the acquisition of the bank formerly called BfG in 1999, now SEB Germany, which market share is around one percent of the Ger-
man market. Through SEB Private Bank the bank also serve customers with international asset management. The first international office in this field was established in Geneva 1965, and later on offices been started in Luxembourg, Nice and Marbella.

Outside Europe SEB opened a representative office in Brazil back in 1972 to support Nordic commercial activity in the area. The bank also started operations 1979 in South-East Asia (when an earlier representative office in Singapore was replaced by wholly-owned subsidiary bank, which became the first Swedish bank in Asia), which involves advisory and financial services mainly for Nordic firms in the region. Another representative office was established in Beijing 1983, which especially offer commercial lending support for major Scandinavian companies concerning infrastructure, telecommunications, services and industry. Operations in New York started 1980 and are focused on Nordic-related operations in the USA. To sum up, SEB international business has to a large extent been a strategy to serve Scandinavian enterprises on local markets, as well to support foreign firms on the Nordic market.

The first SEB representation offices in the Baltic countries were inherited after the merger with the Swedish insurance company Trygg-Hansa in the end of 1997. But because of the sale of the non-life sector of Trygg-Hansa to Zurich group in 1998, these offices could not be used by SEB as the basis of regional expansion. In November 1998, however, SEB signed cooperation agreements with Eesti Uhispank (Estonia), Latvijas Unibank (Latvia) and Vilniaus Bankas (Lithuania) and before the end of the year SEB acquired minor shares in each company. To control the interest in the Baltic region SEB’s shares in the banks were consolidated into a new company, SEB Baltic Holding AB.

As stated, in 1998 an agreement of strategic co-operation was signed between three Baltic banks, Eesti Uhispank, Latvia Unibanka, Vilniaus Bankas and SEB. At the end of the year a more explicit agreement was signed, which stated that SEB would become the strategic stakeholder of Vilniaus Bankas. At the end of 2000 Union Bank of Estonia became wholly owned by the Swedish bank SEB, and only 3 per cent by other shareholders. At the same time, SEB bought the outstanding shares of both Latvia Unibanka and Vilniaus Bankas and the firms were de-listed from their respective stock exchanges.147

SEB came to Lithuania at the very end of 1998 in the wake of Russian crisis and became a strategic partner of Vilniaus Bankas (VB). Through financial and technical support from the Swedish bank, the competitive posi-

147 In the same year SEB also increased the ownership in the Polish Bank Ochrony Środowiska (BOS) to one third of the shares.
tion of the VB bank was restored and this prepared the ground for further its expansion. In 1999 Vilniaus Bankas, supported by SEB, acquired the second largest private bank in Lithuania - Bankas Hermis, and became the leading institution in the Lithuanian banking market. Following the Skandinaviska Enskilda Banken’s acquisition of more than 98 per cent of shares in the bank, Vilniaus Bankas de-listed its shares from the official list.

The two major Swedish investors in the Baltic banking industry, SEB and Swedbank, signed a letter of intent to merge. This would have meant that 80 per cent of the bank sectors in Estonia and Lithuania would have been controlled by one bank. Due to problems with the merger process, mainly on the home market, SEB and Swedbank did not merge. But it did show quite graphically that emerging markets could be vulnerable in a situation where foreign operators are not just significant actors, but also in changing the rules of the games. A merger of SEB and Swedbank would have created an unstable situation on markets with all three banking sectors dominated by one foreign bank.

By contrast with Swedbank, SEB had long-lasting relations with Swedish multinational firms, and thus has had a long history of presence and representative offices in international markets. SEB has also recently acquired BfG, the fifth largest private bank in Germany, and has started to establish strategic alliances on important foreign market. Since the financial crisis in the 1990s, SEB has however been careful with its foreign investment activities.

To sum up, SEB have moved incrementally to take control of one major bank in each Baltic country. Thereby it has been possible to benefit from a domestic brand name; at the same time as SEB has the advantage of being a well-known and stable banking organisation.

4.3 Nordea and Svenska Handelsbanken

Another example of a bank expanding into all three countries almost simultaneously, like SEB, is the Swedish-Finnish bank Nordea. For Nordea, the Baltic area is a market with high growth potential and is becoming more important for both Finland’s and Sweden’s foreign trade.

Nordea is the result of several larger mergers among Scandinavian banks. Merita Bank was formed in 1995 following the merger of Kansallis-Osake-Pankki and the Union Bank of Finland, previously Finland’s oldest commercial banks. After merger in 1998 with the Swedish bank Nordbanken, Merita Bank became a partner in the MeritaNordbanken Group. In 2000 the Unidanmark (Denmark) merged with the MeritaNordbanken and formed the Nordic Baltic Holding, to become the biggest financial group in the Nordic
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and Baltic region. Finally, Christiania Bank og Kreditkasse joined the Group on October 2000.

Merita bank was the first foreign bank to establish a branch office in Estonia in 1995. With the merger of Merita Bank and Nordbanken, the new bank intensified its strategy of strengthening its position in the Baltic region. The main reason Nordea has given for this expansion was to match the growth of Swedish and Finnish commerce and industry in to the Baltic area. In order to achieve its goal, Nordea established a new regional bank for the area, as well a new bank in the Polish market. Nordea also now considers the Baltic States and Poland as a part of the bank’s home market. In the beginning of 2000 the bank also acquired the portfolio of the French bank Société Générale in Riga and Vilnius. But Nordea has not bought any shares in national banks and instead uses representative offices and branches to conduct their business in the Baltic States. Nordea has two branches in Vilnius providing a full range of financial services to personal and corporate customers. In addition, Nordea has a leasing company in Lithuania, Nordea Finance Lithuania.

In Latvia Nordea has chosen another form of expansion. The history of MeritaNordbanken in Latvia started in 1992 when the Investment Bank of Latvia was founded under the aegis of the Baltic Investment (BI - Northern Countries Aid Programmes for the development of market economy in the Baltic Countries). The shareholders of the bank were the Latvian State, EBRD (European Bank for Reconstruction and Development), Finnish Fund for Industrial Cooperation, Swedfund International and Deutsche Investitions-und Entwicklungsgesellschaft. The shareholding structure of BI changed a the end of 1997, when the Finnish Fund for Industrial Cooperation together with the Swedish-Finnish consortium Meritanordbanken bought shares from EBRD, Swedfund and Deutsche IE, and became the major owner with 66 per cent of shares. In March 1999 MeritaNordbanken became the only shareholder of the bank, and a month later the bank’s name was changed to MeritaNordbanken Latvia. The licence of the JSC MeritaNordbanken Latvia was revoked in May 2000. The bank’s assets were taken over by the newly established Riga Branch of Merita Bank Plc. At the same time Merita took over the assets of the Riga Branch of Societe Generale. The bank also changed its name to Nordea Latvia.

Nordea has also started to conduct insurance business in the Baltic States. The Nordic banking organisation Nordea entered the general insurance market, mainly commercial insurance, in Estonia. In October 2001, Nordea’s Danish insurance company, Tryg, signed an agreement with the Estonian Insurance company Nordika Kindlustus, to take over its general insurance operations. The name of the new subsidiary, wholly owned by Tryg, was Nordea Kindlustus. The life insurance company, Nordika Elu-
kindlustus, was not part of the agreement and continued to operate as an independent company. Nordea Kindlustus became the fifth largest general insurance company in Estonia but still had only 5 per cent of the insurance market. The primary focus of the new insurance company was commercial insurance, but it also began to offer personal insurance products. Nordea, it will be recalled had been conducting banking business in Estonia since 1995.148

To sum up, Nordea has through several mergers in the Nordic countries now established a strong position in the Scandinavian region. Nordea also has offices in several other markets, e.g. China, and has started to sell life insurance products. It is therefore expanding both geographically and diversifying into several lines of business in the financial sector.

Svenska Handelsbanken (hereafter SHB) has, like Nordea, built a strong position on the Nordic banking market, with regional banks in Norway, Denmark and Finland. The first foreign bank that was acquired was Norwegen Oslo Handelsbank in 1990, a year later also Stavanger Bank and 1999 SHB purchased another Norweigen bank, Bergensbanken. In Finland SHB started business in 1985 but it was not until 1995 before SHB acquired a Finnish bank Skopbank. Finally, the Danish Midtbank was acquired in 2001.

All business outside the Nordic countries is part of SHB Markets organisation. There are units in several European countries, as well in Asia and USA. Svenska Handelsbanken Mid-Europe includes the Corporate Banking units in Amsterdam, Frankfurt, Hamburg, Luxembourgh, Paris, Vienna and Zurich. The Mid-Europe organisation supports local corporates with Northern European interests as well as Northern European corporates with interests in the Mid-Europe region. The regional office is located in Frankfurt am Main, Germany. An important market for SHB is UK where it started business in 1982. In the last couple of years, however SHB has expanded to 8 offices in the UK. In the Baltic region, SHB established a branch office in Tallinn, Estonia. SHB’s units outside the Nordic banking market focus on Nordic companies with operations abroad and non-Nordic firms with business in the Nordic region (Euromoney, 1998). So, from a theoretical point of view, the driving force behind SHB’s office in the Baltic region seems to be following customers abroad and to attract inward business to the Nordic region.

148 Nordea’s business area General Insurance comprised of Tryg, the largest general insurance company in Denmark, Vesta, the third largest general insurance company in Norway and operations in Finland and Poland. Nordea have also acquired a life insurance company in Poland.
Svenska Handelsbanken has chosen to expand not through ‘brownfield-
investment’, but instead started new banks or branches on local markets and
then grown them internally (Euromoney, 1998). This strategy has partly
also been used in the Nordic countries, but in the Baltic markets it has
meant that their competitors, especially Swedbank and SEB, have built up
market shares more quickly. This is also an indication that SHB’s main goal
is to use their presence in the region to server mainly domestic clients. They
have for instance shown no interest in expanding their market share through
expensive acquisitions. Though, of the bank’s 87 offices foreign offices, 34
have been purchased and the rest been established by the SHB. But outside
the Nordic countries the bank’s strategy has been to solely serve customers
with connections to the Nordic market. This strategy has only been changed
on one market, the British, and SHB have established several local banks to

To sum up, both Nordea and SHB have chosen a careful position in the
emerging countries in the Baltic States. SHB has also established business
inside the European market, especially in the UK, and thereby not only fo-
cused on the emerging countries in the Baltic’s. Nordea’s branch office was
also a consequence of the merger with the Finnish Meritabank, but has es-
established several new offices in the region without racing for a quick expan-
sion of market shares. As stated before the main driving force behind the
expansion of SHB, seems to be a way of offering service to domestic cli-
ents.

5. Conclusions

This paper has mainly focused on how we can understand and interpret the
pattern of international investment in the financial sector in former Soviet-
States of Estonia, Latvia and Lithuania. From their independence in the
early 1990s, the markets have seen the introduction of new national curren-
cies, a complete revamping of the legal system, a total restructuring of the
financial market and an increasing amount of foreign ownership. One of the
most popular responses to the growing integration of capital markets has
been for financial institutions to adopt regional integration strategies. The
Baltic region is mooted as one such financial region. This has important
implications for the Baltic financial system, for example through the diffu-
sion of experiential knowledge to domestic actors in the transition econo-
 mies. Hence, a process can be seen where foreign investors are part of an
evolving institutional set-up with structural uncertainty and on the other
hand domestic actors have had to face international competition in an early
phase of their development (Weller and Scher, 1999).
The paper focused on the four major Swedish banks, which all have established some form of representation in the Baltic States. Swedish investment in the banking sector started relatively late. The banks that were acquired by Swedbank and SEB had themselves gone through several waves of restructuring.

Considering that all major Swedish banks have in one way or another expanded to the Baltic States, it is surprising that Swedish insurance companies have not yet shown any interest. It might have been expected that, at least through their close connection to the Swedish banks, they would also have made foreign direct investment in the Baltic States. But for the moment, none of the Swedish insurance companies is present in the area. This is even more striking considering that SEB in 1998 merged with one of the biggest insurance firms in Sweden, Trygg-Hansa. The explanation for this is that the new bank-insurance company SEB sold all their non-life insurance portfolios to the Danish insurance company Codan, and has concentrated on life insurance and capital deposits. The simple explanation for the other Swedish insurers avoiding the Baltic markets is connected to bad experience. At the end of the 1980s, before the breakdown of the Soviet Union and independence for the Baltic States, several Swedish insurance companies started to write direct non-life insurance in both the Baltic’s and in Western Russia. Because there was no possibility to buy shares in national firms these insurers had to invest enormous sums in their organisations. They lacked the necessary experience to set accurate premium levels, and the outcome was that the companies suffered severe losses. In order to avoid further losses in the future, the area more or less became forbidden.

A differentiating factor between Swedish banks and insurance companies is that the latter moved to quickly in the new markets. Swedish banks on the other hand mostly waited until the financial crises in 1998, and could then incrementally take over banks that had been restructured, were surrounded by a western-like financial legislation, had relatively stable currencies, and support from the national government. They also bought the banking assets at financially distressed prices, thus securing a low-cost entry. Another explanation of the difference between Swedish banks and insurance companies is big changes that have occurred in the insurance market in Sweden. Several insurance companies have sold their non-life insurance portfolios and instead concentrated on life insurance and savings products. This can easily be explained by the difference in the rate of return, where the non-life

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149 In 1998 the only Swedish insurance company on the Baltic markets, Trygg-Hansa, left the market. The Swiss Zürich Group purchased the commercial and marine insurance portfolio of Trygg-Hansa in all three countries. The largest Swedish insurance company, Skandia, have only co-operation with the Finnish insurance company Sampo on the Baltic markets.
insurance products having problem to generate profits and life insurance and savings products are now seen as the core business. Because the life insurance markets in the Baltic States are expanding at a slow pace, the incentives to expand insurance business to Baltic States remains low. Changes on both the home and host markets have reduced the incentives to expand to foreign markets.

The influence of Swedbank and SEB is striking, but they have had different strategies to reach that position. Swedbank has used Estonian Hansabank to acquire local banks in Latvia and Lithuania, but also bought major banks in the two latter countries. All of Swedbank’s investments have on the other hand been made in the name of Estonian Hansabank, and thereby a well-known trademark has facilitated the expansion in the region. SEB has instead taken the role as strategic investors in one bank in each country and thereafter merged with other national banks. The other two major Swedish banks have established branch offices and green-field investment, and thereby searching for an organic growth of the business in the region.

Another conclusion is that the degree of internationalisation has increased after the 1998 financial crises in all three countries. This has meant that the governments in the Baltic States as well as private owners of financial organisations have turned abroad to solve their problems through strategic investors. The major difference concerning the degree of internationalisation can be explained by differences in legislation. In an early phase Estonia abolished barriers for foreign shareholders in national banks, while Latvia and Lithuania maintained barriers for international investment in the banking sector.

Several theoretical conclusions can be drawn. The driving force behind Swedish banks expansion, according to official statements, has been to follow their customers abroad, as well as a means to build new markets. In none of the cases did the banks’ say that their expansion was influenced (in a follow-the-leader way) by domestic competitors moving abroad. This can be questioned because the presence of all Swedish banks in the area implicitly means that home-market competition has been exported to the Baltic States. The expansion of Swedish banks in the Baltic States can thereby also be considered as market seeking. One important paradox here is that Swedish banks have largely avoided expansion within the European Union. It may be reasonable to conclude that investment in the Baltic’s is in part a defensive strategy to sustain a sufficient growth to avoid take-overs from more solvent European competitors.

An interesting aspect of the establishment of foreign financial actors in the Baltic States is that a large number of them began business in all three countries. An important reason is of course the limited size of each market; on the other hand there are fundamental differences between the countries.
This concerns for example language, religion, business and population structure. These differences make it hard to treat the countries as a single market, and would have made it necessary to conduct market investigation on each market.

There have also been some striking features to the pattern of investment. For example, Swedbank and SEB have invested heavily in the Baltic’s as to some extent have Nordea and Svenska Handelsbanken, in the Baltic’s. Considering this investment pattern it is quite easy to see that there is evidence that banks have been following each other’s behaviour, i.e. oligopolistic reaction.

The Uppsala internationalisation model suggests that firms go through a process, the so-called establishment chain. Due to psychic distance and uncertainty firms start their foreign business on markets close to home and with limited capital investment. Over time, and thanks to experiential knowledge, internationalisation is extended and establishments are made further away from the domestic markets. Regarding the Swedish banks it is possible to see, in respect to the Uppsala internationalisation model, an incremental internationalisation process.

Another question, that will need further attention in the future, is what kind of an impact can be detected on the Baltic financial markets due to the massive international investment in the area? One of the possible negative influences of foreign ownership is that it can be harder for new enterprises to acquire loans, thereby reducing the pace of the economic development. One argument is that foreign financial actors will only conduct business with established industry, which in turn has large foreign interest, and undermine the possibility for small domestic firms to finance their investment and achieve sound risk spreading through insurance contracts. This argument has been strongly rejected by the supervisory boards in all three countries. The strongest argument is that the development of brokerage business, both concerning lending and insurance, will correct any tendency in this direction. But, this topic will be further investigated in the future, because of the presence of an imperfect financial market, together with a strong impact of foreign financial firms.

One important conclusion is that the development of foreign actors on the Baltic financial markets, raise the question as to the extent to which domestic banks and insurance companies, though owned by foreign capital, should be strictly defined as foreign controlled. Domestic management and staff operate almost every foreign-controlled financial organisation in the area. The main difference in their organisations has been the introduction of a supervisory board, where the Swedish owners have been able to supervise and control the conduct of the banks. Thereby it is possible to question if
the banks more are acting like local enterprise with the back-up by foreign capital.

This is also important to further investigate, because if we can find evidence that foreign-owned banks are acting as a domestic actor rather than as an international enterprise, maybe we are asking the wrong questions. Then we are not strictly talking about international business, but instead of a new form of portfolio investment, which in this case happens to include a transfer of capital, technology and competence. This may also be a new form of regional internationalisation, where the Swedish banks have reached a strong position on the evolving new economies in the Baltic States. But conducting business like a local bank, rather than international banks that take no interest in the development of the financial system. In the future, after the enlargement of European Union, the organisations in Baltic States may be used to increase business with countries like Russia, Belarus and Ukraine. It is also likely that the enlargement of European Union will increase the economic growth in the region, and the Swedish banks can thereby secure a stable market shares on fast expanding markets.

A wider conclusion is that the rapid changes in the financial sector in connection with privatisation, liberal legislation concerning inward FDI and financial crises have combined to produce a situation where all three Baltic States have a high concentration of foreign financial organisations. A positive effect of these events has been a successful transformation of the financial system, but to be able to say anything about the long-term effects of a financial sector dominated by international actors, will need further research. Another conclusion is that the theoretical understanding of the foreign investment process needs to be re-evaluated. To be able to say that a foreign bank is using some kind of strategy or going through a certain phase of development, does not give us a sufficient understanding of foreign direct investments.

To sum up, the driving forces behind the internationalisation process and the impact on the host markets financial and economical development are research agendas where our knowledge is very random and further research can give us more insights about international business, regional integration and economic transition. This paper dealt with both empirical and theoretical topics concerning foreign actors on the Baltic financial markets. Its aim has been to discuss whether foreign direct investment in transition economies can give us new insights to the old questions about international business.
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Reform, Crisis and Adjustment in the Transition Economy of Laos

1. Introduction

Since the late 1980s a program of market-oriented economic reforms, known as the New Economic Mechanism (NEM), has transformed the Lao economy from the rigidly socialist pattern instituted immediately after the declaration of the Lao PDR in 1975. Nevertheless, although it is richly endowed with natural resources, especially water and forests, the Lao PDR remains a poor country. Its population of 4.6 million remains highly rural-based, with only 17 per cent residing in urban areas. Agriculture dominates employment, accounting for over 70 per cent of the total workforce, and producing 52 per cent of GDP. Poverty within Laos is especially concentrated in the more remote parts of the agricultural sector. The reform process has been highly successful, but it is hardly surprising that many problems remain, especially in two key areas – agriculture and macroeconomic management. This paper attempts to explain these problems and to show the linkage between them. The theme of this discussion is that the problems of agricultural policy, macroeconomic management and the linkage between them exemplify the problems of transition from an economy based on socialist controls to one which is market-based.

Section 2 below provides a brief summary of the economic history of the past two and a half decades. The NEM reform package is then summarized in Section 3, with general reforms described first, followed by a more detailed account of agricultural reforms. The performance of agriculture over the past decade is described in Section 4, beginning with the immediate response to the reforms, covering the years 1990 to 1995, and then the effects of the economic crisis, since 1996. The paper then turns in Section 5 to problems of macroeconomic management, especially the problems Lao PDR has experienced in response to the Asian currency crisis of 1997. Section 6 concludes.
2. Economic overview

In the mid-1970s, at the end of the Indochina war, Laos was economically devastated. Over the following decade, the newly-established Lao Peoples’ Democratic Republic (Lao PDR) was led by Marxist guerrilla fighters and, not surprisingly, the new government experimented at first with Soviet style central planning. The central government lacked not only the information and expertise needed to implement such a policy, but even the physical means to communicate detailed instructions to the provinces, which in practice operated largely independently. Prices were controlled administratively, but the controls were not implemented consistently across the country. International trade was tightly controlled and consisted primarily of barter trade with other Communist states, especially the Soviet Union and Eastern Europe. Some parts of the agricultural sector were collectivised, especially those close to the capital, Vientiane. Even trade between the provinces of Lao PDR was tightly controlled and often prohibited, especially concerning agricultural products. Each province was expected to become self-sufficient in rice, the staple food, even though the diverse geography of the country meant that the more mountainous provinces could achieve rice self-sufficiency only at enormous cost. The outcome was a decade of economic stagnation and deprivation.

In 1986 the decision was taken to introduce a market-oriented system of reforms which were described as the New Economic Mechanism (NEM). The decision to introduce these reforms roughly coincided with similar decisions in Vietnam, but their implementation in Laos was somewhat slower. The program was not fully implemented until around 1990. Many of the reforms consisted of undoing the controls on prices and quantities introduced a decade or more previously. The removal of controls coincided with elimination of Marxist-inspired restrictions on private ownership. Restrictions on international trade were also greatly relaxed and trade with neighbouring Thailand, Vietnam and China boomed. Controls on foreign investment were relaxed and incoming investment soared, especially from Thailand, but also from Japan and China. A decade of economic growth resulted, with real growth averaging 7 per cent from 1988 (when the first national accounts were constructed) to 1996.

Thailand’s currency crisis of 1997 affected Laos as well, but its manifestation in Laos was very different from the Thai experience and that of other regional economies. Confidence in the Lao currency, the kip, collapsed, resulting in a large nominal depreciation and inflation of more than 100 per cent, but although economic growth slowed, it did not fall below 4 per cent. That is, whereas Thailand’s crisis was a severe absolute contraction of output (around 13 per cent between 1996 and 1998) with little effect on prices,
the Lao experience was only a moderate slowdown in output growth but a huge surge in prices (Table 1). It will be argued below that this inflationary outcome was largely a consequence of the incompleteness of the reform process and the reversion, under stress, to some pre-reform practices including central bank financing of public sector deficits, administrative control of prices, inadequacies in the tax system and soft budget constraints for public agencies and firms.

Table 1. Macroeconomic Indicators (1990-1999)

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<tbody>
<tr>
<td>Real GDP growth</td>
<td>6.6</td>
<td>4.0</td>
<td>7.0</td>
<td>6.5</td>
<td>8.1</td>
<td>7.1</td>
<td>6.8</td>
<td>6.5</td>
<td>4.0</td>
<td>5.2</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>19.6</td>
<td>10.4</td>
<td>8.0</td>
<td>7.0</td>
<td>6.8</td>
<td>25.7</td>
<td>7.3</td>
<td>26.4</td>
<td>141.9</td>
<td>86.7</td>
</tr>
<tr>
<td>Growth in credit</td>
<td>11.2</td>
<td>15.7</td>
<td>23.6</td>
<td>51.7</td>
<td>50.0</td>
<td>34.8</td>
<td>20.8</td>
<td>79.2</td>
<td>86.6</td>
<td>74.3</td>
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<td>Interest rate (1 year)</td>
<td>36.0</td>
<td>18.0</td>
<td>18.2</td>
<td>12.0</td>
<td>12.0</td>
<td>16.0</td>
<td>16.5</td>
<td>19.0</td>
<td>23.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Export (value $US)</td>
<td>18.2</td>
<td>22.9</td>
<td>37.3</td>
<td>57.9</td>
<td>24.9</td>
<td>4.2</td>
<td>3.1</td>
<td>-1.4</td>
<td>6.3</td>
<td>9.4</td>
</tr>
<tr>
<td>Import (value $US)</td>
<td>-9.5</td>
<td>14.3</td>
<td>7.3</td>
<td>16.8</td>
<td>30.6</td>
<td>4.4</td>
<td>17.1</td>
<td>-6.0</td>
<td>14.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Money supply (M1)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>24.5</td>
<td>48.6</td>
<td>17.4</td>
<td>9.5</td>
<td>12.5</td>
<td>5.8</td>
<td>111.4</td>
<td>28.4</td>
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<td>Monetary base</td>
<td>n.a.</td>
<td>n.a.</td>
<td>40.5</td>
<td>64.5</td>
<td>22.3</td>
<td>13.4</td>
<td>24.0</td>
<td>43.8</td>
<td>87.7</td>
<td>70.9</td>
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<tr>
<th></th>
<th>(per cent of GDP)</th>
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<tr>
<td>Government revenue</td>
<td>9.9</td>
<td>10.3</td>
<td>10.7</td>
<td>12.0</td>
<td>12.3</td>
<td>12.2</td>
<td>13.0</td>
<td>11.3</td>
<td>11.2</td>
<td>11.3</td>
</tr>
<tr>
<td>Government expend.</td>
<td>23.4</td>
<td>20.9</td>
<td>20.6</td>
<td>18.2</td>
<td>23.8</td>
<td>21.9</td>
<td>22.1</td>
<td>20.6</td>
<td>32.5</td>
<td>22.3</td>
</tr>
<tr>
<td>Current</td>
<td>11.4</td>
<td>11.3</td>
<td>10.9</td>
<td>11.2</td>
<td>11.3</td>
<td>10.6</td>
<td>10.2</td>
<td>9.5</td>
<td>8.1</td>
<td>9.1</td>
</tr>
<tr>
<td>Capital</td>
<td>12.0</td>
<td>9.6</td>
<td>9.7</td>
<td>7.0</td>
<td>10.4</td>
<td>11.1</td>
<td>11.9</td>
<td>11.8</td>
<td>18.8</td>
<td>12.6</td>
</tr>
<tr>
<td>Overall fiscal balance:</td>
<td>with grants</td>
<td>-10.7</td>
<td>-6.8</td>
<td>-5.2</td>
<td>-4.4</td>
<td>-5.2</td>
<td>-4.2</td>
<td>-5.6</td>
<td>-6.5</td>
<td>-15.5</td>
</tr>
<tr>
<td></td>
<td>Without grants</td>
<td>-14.4</td>
<td>-11.3</td>
<td>-9.9</td>
<td>-7.8</td>
<td>-11.5</td>
<td>-9.7</td>
<td>-9.1</td>
<td>-10.0</td>
<td>-21.3</td>
</tr>
<tr>
<td>Current account:</td>
<td>with transfers</td>
<td>-6.9</td>
<td>-4.3</td>
<td>-3.5</td>
<td>-0.9</td>
<td>-6.3</td>
<td>-6.9</td>
<td>-12.1</td>
<td>-10.6</td>
<td>-4.8</td>
</tr>
<tr>
<td></td>
<td>Without transfers</td>
<td>-9.6</td>
<td>-11.0</td>
<td>-8.8</td>
<td>-8.4</td>
<td>-14.4</td>
<td>-13.0</td>
<td>-16.5</td>
<td>-16.2</td>
<td>-10.6</td>
</tr>
<tr>
<td>Debt service ratio</td>
<td>10.3</td>
<td>11.2</td>
<td>6.5</td>
<td>4.7</td>
<td>3.3</td>
<td>5.7</td>
<td>5.8</td>
<td>7.3</td>
<td>8.4</td>
<td>7.7</td>
</tr>
<tr>
<td>Gross ext. reserves:</td>
<td>(SUS millions)</td>
<td>64.8</td>
<td>57.2</td>
<td>85.5</td>
<td>150.9</td>
<td>61.0</td>
<td>93.0</td>
<td>167.0</td>
<td>136.0</td>
<td>110.0</td>
</tr>
</tbody>
</table>

Source: Data from National Statistical Centre, Vientiane.
Figure 1. Lao PDR: Exchange Rates, Parallel and Official Rates, 1990 to 1999 (kip per US dollar)

Source: Data from Bank of Lao PDR, Vientiane.

Figure 2. Lao PDR: Inflation, Consumer Price Index, 1990 to 1999

Source: Data from Bank of Lao PDR, Vientiane.
3. The Reforms

Following the establishment of the Lao PDR in 1975 the Government attempted to adopt Soviet-style economic planning. In practice, the form this policy regime took was necessarily very different from the Soviet model in that active central direction of economic affairs was not possible in Laos to the extent that it had been possible in the Soviet Union and in Eastern Europe. The Lao economy remained overwhelmingly agricultural and manufacturing represented only a tiny proportion of GDP. Most importantly, the central government lacked the communications infrastructure which would be required for it to remain well informed about affairs at the local level. At the provincial level the government was even less well resourced. Comprehensive central planning was infeasible, but a highly pervasive set of controls on market activity was set in place.

In November 1986 the Fourth Party Congress resolved to reform this system of economic controls in favour of a more market-oriented set of policies. This decision mirrored policy steps also taken at around the same time by Vietnam\textsuperscript{150}, and earlier by China, where a reform process had begun in 1978. The decision to reform the economy reflected the government’s assessment that the existing policy framework, based upon tight government control of private sector activity and central planning, was not working well. Its essence was a reorientation of the economic role of the Government\textsuperscript{151}.

Rather than prohibit private sector economic activity and attempt to undertake large scale production itself, the Government would encourage private sector activity, including production based on foreign investment. The Government would permit the free operation of markets, and concentrate on providing the infrastructure required to enable the private sector to operate efficiently. The new program was implemented gradually over the next few years. The rate of implementation of this agenda of reform varied from one policy area to another and also from one province of Lao PDR to another. For this reason it is not possible to specify a single date at which the policy commenced operation. The policy was announced in 1986 and began to be implemented in 1987, in some provinces the new environment was not effectively in place until around 1990. It is therefore reasonable to consider 1990 as the first year in which the reform policy was effectively in place.

\textsuperscript{150} Vietnam’s reforms were officially announced a little later but were already under widespread discussion in 1987.

\textsuperscript{151} A comprehensive review of the NEM has been provided by Vokes and Fabella (1993).
3.1 General reforms

Pricing policies
By the mid 1980s, pervasive domestic price controls had led to development of parallel markets for most major commodities and for foreign exchange. The reform package removed the price controls, thus eliminating the parallel markets for major commodities. The official exchange rate was unified and was allowed to follow the parallel rate. Although the parallel market did not vanish, the gap between parallel and official exchange rates was greatly reduced. State owned enterprises (SOEs) were permitted to set wages and prices according to market conditions, which meant that the practice of giving the SOEs large direct subsidies, preferential access to bank credit and to foreign exchange could be discontinued. In 1990 the government decided to disengage itself from most SOEs, with the exception of public utilities. Prices of utilities continued to be controlled, adjustments were made to reflect costs more adequately. While SOEs were now permitted to set their own salaries, government salaries in general were raised but not sufficiently to match SOE or private sector salaries. The gap between government salaries and private sector salaries has continued to increase. Payment of wages of civil servants in kind was abolished, replaced by cash payments.

Liberalisation of domestic trade
The policy of provincial self-sufficiency had been disastrous and was abandoned in 1987. While previously trade between provinces was restricted to state trading companies, private traders were now permitted to engage in inter-provincial trade. Private firms were permitted to import raw materials and capital goods and were permitted to borrow from domestic banks.

Liberalisation of foreign trade
Monopolies previously accorded to government trading companies were abolished except for some ‘strategic goods’, including minerals and timber, but in those cases most of the state monopolies were gradually passed on to licensed traders. More transparent guidelines were announced for the issuance of export and import licenses, where they still applied. The link between the issuance of import licenses and retained export earnings was severed.
Export taxes were reduced and tax procedures for both exports and imports were simplified.

Stabilisation policies

In the early post-reform period neither the central government nor the state enterprises were subject to rigid budget constraints and were able to call upon unlimited credit from the government-owned banking system, which essentially printed the money required. Money creation was thus used to finance the deficits of the consolidated public sector and the result was high rates of inflation. This situation continued until 1989. Inflation of over 100 per cent resulted from the use of deficit financing to accommodate the budgetary demands arising from the replacement of payment in kind for public officials with cash payments.

Privatisation of public enterprises

The decision was taken in 1990 to privatise all of the 600 state-owned enterprises except seven considered ‘strategic’ and which were to be retained in the public sector and restructured. Progress in implementing this ambitious program has been slow. Most of the privatised enterprises have been under the jurisdiction of provincial governments. Privatisation of the larger enterprises owned by the central government has been especially slow.

Financial sector reform

Laos has made considerable progress in establishing a two-tier banking system with separate functions for the central bank and commercial banks. Relaxation of controls on foreign bank participation permitted the entry of some Thai banks and one Malaysian bank.

Foreign investment code

Revision of the foreign investment code permitted entry of foreign firms on a liberalised basis. Investment in the resources sector has been the most significant, followed by hotels and garments manufacturing.
3.2 Agricultural reforms

De-collectivisation

Since 1975, collectivisation of agriculture had been a central objective of the Government, but the 1986 Party Congress moved significantly away from this goal. The policy change was reinforced by Resolution no. 6 of the 1988 joint meeting of the Party Central Committee and the Council of Ministers which announced a de-emphasis of collectivisation in favour of encouragement of the family farm. Although in formal terms land ownership remained with the State rather than the individual, citizens were given the right to use land for their own benefit and, subject to approval, to pass that land on to their offspring or to others. All cooperative land was to be passed back to farm families.

These decisions were important but their effect was not as dramatic as they may appear because at the time of the reforms the cooperative movement had not covered a large part of the land area of the country outside the lowland paddy producing areas. Evans (1990) estimates that the area of rice producing land that was collectivised was more than 50 per cent of the total in only three provinces and that in most areas the proportion collectivised was less than 20 per cent. The proportion collectivised was highest in areas of lowland paddy production. The collective ideal was abandoned, but establishment of a workable system of land rights is a more difficult matter. Land sales do occur, but the low level of foreign direct investment in agriculture, relative to other sectors, since the reforms may be partly due to the lack of legal clarity in this area.

Marketing reforms

In 1987 private marketing of agricultural commodities was legalised. All state enterprises enjoying trading monopolies in the procurement of agricultural commodities were required to compete with any private traders who entered the market and, most significantly, the state enterprises were denied direct budgetary support of any losses incurred. Foreign investment in agricultural processing was permitted since 1990 and this has been important in the case of some cash crops such as coffee. Private sector trade in agricultural inputs such as fertiliser and farm machinery was also legalised. State rice procurement companies were dismantled in line with the abolition of the payment of civil servants’ wages partly in kind.
Control of domestic prices of agricultural commodities was gradually lifted through the late 1980s. By 1990 these controls were entirely gone, including controls over the price of rice. Production cooperatives were denied preferential treatment relative to household based production and the former virtually disappeared. State farms in the agricultural sector were disbanded.

A new agricultural tax system was introduced in March 1988, modified in 1989, which reduced the disincentive effects of the highly progressive rates previously in place. The new taxation policy was also intended to promote the reduction of shifting cultivation, seen to have undesirable environmental consequences, in favour of more sedentary forms of production.

**Infrastructure**

Under the NEM, public investment was to be directed towards improved infrastructure for agriculture. The Public Investment Plan for 1991-95 allocated over half total investment to improved public infrastructure and communications in rural areas.

**Agricultural credit**

Prior to 1988 the State Bank was the sole source of agricultural credit but only one seventh of all credit went to agriculture. Most of this was allocated to cooperatives and state farms at subsidised interest rates. The establishment of the Agricultural Promotion Bank in the early 1990s was intended to address the agricultural sector’s need for credit. The deregulation of interest rates remained a controversial area, however, and was considered politically infeasible. The supply of loanable funds to the agricultural sector thus remains a problem.

Interest rates continue to be controlled. The effect is that small farmers, lacking legal collateral, are unable to borrow through the formal banking sector and are required to borrow from informal market lenders, where interest rates are considerably higher than bank rates. The irony of this outcome is that the policy of controlling interest rates continues to be justified as a means of assisting small farmers.

**Irrigation**

While substantial public investment in irrigation schemes has occurred since the reform package was announced, a high proportion of this investment has been in large scale projects, especially in the
Vientiane plain area, which have performed poorly. Small scale systems have proved more cost-effective, both in Lao PDR and elsewhere. Government policy now favours small scale investment in irrigation but large scale projects apparently remain attractive to the Department of Agriculture and to international aid donors.

**Agricultural Trade Policy**

Prior to the NEM the Government of Lao PDR attempted to control international trade in agricultural products very tightly. For geographic reasons, this policy was only partly effective. Laos has long borders with its neighbouring countries and implementation of trade restrictions is therefore very difficult. ‘Unofficial’ trade is important even today, and especially with Thailand, but since this trade is unrecorded its magnitude can only be guessed at. With the NEM, trade policy was liberalised significantly. The exchange rate was unified and currency transactions greatly liberalised. Export taxes were officially abolished in 1989 although the rate at which this change was implemented varied from one border crossing to another. All imports are still subject to licensing and the required licences are obtained from the Ministry of Commerce. Tariff rates were not changed significantly with the introduction of the reforms\(^\text{152}\). The main change was in greater ease of access to import licences. These changes meant that domestic agricultural commodity markets were increasingly exposed to international market forces.

**Shifting Cultivation**

Evidence that the practice of shifting cultivation is inconsistent with long term sustainability of Lao agriculture has led the Government to attach a high priority to the reduction of shifting cultivation. The objective is to encourage more sedentary forms of cultivation but because of the unavailability of policy instruments which might induce shifting cultivators voluntarily to alter their farming system in the desired manner, the solution actually adopted has frequently been a policing action. Shifting cultivators have in some cases been required to relocate their entire villages from traditional areas where shifting cultivation is the preferred method of farming to areas where more sedentary means of cultivation are possible and can be

\(^{152}\) Significant tariff changes did not occur until 1995. Estimates of nominal rates of protection across major industry groups both before and after these 1995 changes suggest that the tariff changes in themselves constituted a minor liberalisation.
monitored. Shifting cultivators frequently belong to the minority Lao Theung and Lao Soung groups and the shifting cultivation of concern generally occurs at higher altitudes. Implementation of the policy has therefore often meant entirely relocating the villages concerned to lower altitudes.

Shorter fallows have been enforced to ensure that the desired sedentary forms of cultivation are practiced, rather than shifting cultivation with long fallows. But shorter fallows can accelerate the rate of land degradation, the very outcome the policy is intended to avoid.

4. The Problem of Agriculture

Table 2 shows the composition of GDP and indicates that agriculture’s share declined from around 61 per cent in 1990 to 54 per cent in 1995. This is to be expected in a growing economy, but of greater concern to the government was the decline of the crops sector, especially rice. This was a major worry to the Lao government because of its pre-occupation with issues of food security. The data implied a decline in food security, especially as regards rice.

Table 2. Share of GDP by Industrial Origin at Constant Prices, 1990-1999

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Source: Data from National Statistical Centre, Vientiane.
Growth rates of the various sectors are presented in Table 3 and Table 4 summarise growth over the entire period. Rapidly growing sectors included services such as hotels, the retail and wholesale trading industries and construction. At an aggregate level, the performance of agriculture appears impressive, with output growth around 4.8 per cent (Table 4). This compares with growth of real GDP at market prices of 6.4 per cent and growth of industrial and services output of 10.6 and 6.1 per cent, respectively. The observed rate of growth of aggregate agricultural output is high by international standards. Moreover, in comparing agricultural output growth with that of industry and services it must be recalled that in the case of agriculture this rate of output growth was achieved at the same time as resources were being released from agriculture to the other sectors of the economy, thereby contributing to their growth. From this, it appears that the rate of productivity growth in agriculture exceeded the 4.8 per cent rate of growth of output.

Table 3. GDP growth rate by industrial origin (% p.a., constant prices), 1991-1999

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<td>4.0</td>
<td>7.0</td>
<td>5.9</td>
<td>7.7</td>
<td>7.5</td>
<td>6.9</td>
<td>6.9</td>
<td>4.0</td>
<td>7.3</td>
</tr>
</tbody>
</table>

Source: Data from National Statistical Centre, Vientiane.

Table 4 shows, however, that growth has been far from uniform throughout agriculture. Forestry grew at over 21 per cent while livestock and fishery grew at over 6 per cent. ‘Growth’ of the forestry sector is simply a measure of the rate at which the stock of forest is being harvested, and to some extent this applies to livestock and fishery as well. In contrast, the
growth of the crucial crops sector, at 1.4 per cent was below population growth of 2.2 per cent over this period. That is, crops output per head of population apparently declined over the period since 1990. This was a matter of great concern to the Lao government because of its pre-occupation with issues of food security. The data implied a decline in food security, especially as regards rice.

**Table 4.** Average Growth Rates of Components of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>AGRICULTURE</td>
<td>4.75</td>
<td>5.23</td>
</tr>
<tr>
<td>Crops</td>
<td>1.43</td>
<td>9.10</td>
</tr>
<tr>
<td>Livestock &amp; Fishery</td>
<td>6.38</td>
<td>2.49</td>
</tr>
<tr>
<td>Forestry</td>
<td>21.06</td>
<td>-2.71</td>
</tr>
<tr>
<td>INDUSTRY</td>
<td>10.62</td>
<td>10.54</td>
</tr>
<tr>
<td>Mining &amp; quarrying</td>
<td>15.32</td>
<td>33.20</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>10.78</td>
<td>10.94</td>
</tr>
<tr>
<td>Construction</td>
<td>11.81</td>
<td>0.02</td>
</tr>
<tr>
<td>Electricity</td>
<td>6.33</td>
<td>22.23</td>
</tr>
<tr>
<td>SERVICES</td>
<td>6.07</td>
<td>7.10</td>
</tr>
<tr>
<td>Transport &amp; Communications</td>
<td>3.7</td>
<td>9.12</td>
</tr>
<tr>
<td>Wholesale &amp; retail trade</td>
<td>10.23</td>
<td>9.75</td>
</tr>
<tr>
<td>Banking</td>
<td>7.24</td>
<td>2.75</td>
</tr>
<tr>
<td>Ownership of dwelling</td>
<td>3.25</td>
<td>3.40</td>
</tr>
<tr>
<td>Public administration</td>
<td>4.48</td>
<td>3.08</td>
</tr>
<tr>
<td>Non-profit institutions</td>
<td>10.33</td>
<td>-6.46</td>
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<tr>
<td>Hotel &amp; restaurant</td>
<td>52.07</td>
<td>13.35</td>
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<tr>
<td>Other services</td>
<td>19.92</td>
<td>7.24</td>
</tr>
<tr>
<td>GDP at factor cost</td>
<td>6.06</td>
<td>6.78</td>
</tr>
<tr>
<td>Import duties</td>
<td>24.58</td>
<td>-25.07</td>
</tr>
<tr>
<td>GDP at market price</td>
<td>6.35</td>
<td>6.27</td>
</tr>
</tbody>
</table>

*Source:* Data from National Statistical Centre, Vientiane.

The crops sector has two major components, rice and cash crops. Rice production grew at 0.98 per cent, over the 1990 to 1995 period, compared with population growth of 2.2 per cent. That is, the data indicate that rice production per head of population declined over this period at an average annual rate of 1.2 per cent. It is possible to decompose changes in crop production into a component due to a change in area harvested and a component due to a change in yield. Because production is by definition equal to area harvested multiplied by yield, it follows that the percentage rate of change of production is equal to the percentage rate of change of area harvested plus the percentage rate of change of yield. Thus, the 0.98 per cent per annum growth rate of rice production was equal to a -1.48 per cent change in area (i.e. a decline) plus a 2.46 per cent increase in yield. Data on the irrigated and upland components of total rice production show that the decline in area was due to a decline in area devoted to upland rice produc-
tion, in line with the government’s policy of discouraging slash and burn cultivation. This fact also explains a large part of the increase in average yield, because yields on irrigated land are higher than upland yields.

In general, output of cash crops grew rapidly but staple food output - rice, corn and starchy roots - grew much more slowly. The data suggest that since the reforms agricultural producers have responded to the new market opportunities by moving significant quantities of resources out of staple food production and into production of cash crops. The cash crops where output grew rapidly include vegetables and beans, soybeans, cotton and coffee. But not all cash crops have responded in this way. Production of mung beans, peanuts, tobacco and sugar cane actually declined in absolute terms.

The growth of the cash crops and livestock sectors in the post-reform period must be seen as the consequence of four important events.

(i) The reforms reduced the barriers to domestic trade in agricultural commodities within Lao PDR. In particular, those regions with a comparative advantage in cash crop and livestock production could now more readily sell their output of cash crops and livestock in exchange for rice. Since domestic trade was no longer restricted, it was no longer necessary for a farming household to grow rice in order to be sure of having sufficient rice available for its own consumption. Improvements in domestic transportation infrastructure facilities reduced natural barriers to trade and reinforced the effects of this policy change.

(ii) The restoration of good border relations between Lao PDR and Thailand, following serious and sometimes bloody border disputes in the late 1980s, meant that cross-border trade between the two countries was no longer obstructed by political tensions.

(iii) In addition to the reduction of border tensions, the reform process in Lao PDR reduced the administrative barriers to international trade, in particular trade with Thailand and China, thus facilitating the response in Lao agriculture to the market opportunities created by rapid economic growth in these neighbouring countries.

(iv) The rapid growth of the Thai economy, with which Lao PDR shares a long and permeable border, produced greatly increased demand for cash crops and livestock, some of which could be produced efficiently in Lao PDR. A similar, but somewhat smaller, increase in demand for cash crops also occurred along the Lao PDR border with China. Thailand’s growth did not produce a demand for rice from Lao PDR, however, because Thailand is and remains a large net exporter of this commodity.

Within the rice sector, it is important to distinguish between the growth of production under irrigated and non-irrigated conditions. An average of around three fourths of total rice production in Lao PDR occurs under irrigation. The scope for substitution out of rice production and into cash crops
is much greater under non-irrigated conditions than under irrigation because
the irrigation systems in place within Lao PDR are in general specifically
designed for paddy rice production. Accordingly, the movement out of rice
production and into cash crops described above has been heavily concen-
trated in upland (non-irrigated) conditions. While rice output under irrigated
conditions has grown at 2.8 per cent (more rapidly than population) output
under upland conditions has declined at an average rate of 5.4 per cent.

The decline of rice output relative to population reflects the post-reform
economic environment of Lao PDR in three major respects:

(i) The more liberalised trading environment in place after the reforms
produced market incentives which favoured movement of resources out of
agriculture and into the non-agricultural sectors of the economy.

This phenomenon is demonstrated by examining the movement of rela-
tive prices. This is done in Figure 3. Because producer prices are unavail-
able, this figure draws upon consumer price data to show a decline in food
prices relative to services prices. These data indicate that agricultural com-
modity prices declined markedly relative to non-agricultural prices, espe-
entially those of services and construction. An economic boom followed the
more open economic environment created by the reforms, but this boom
was concentrated in the services and construction sectors of the economy,
which drew resources from elsewhere, especially from agriculture.

Figure 3. Ratio of Food Prices to Services Prices, 1988 to 1996

Source: Data from Bank of Lao PDR, Vientiane.
The inflow of foreign capital which accompanied the New Economic Mechanism had indirect macroeconomic effects on agricultural output which were in some cases negative. The increased domestic expenditure made possible by foreign aid and foreign investment produces demand-side effects which imply contraction of agriculture. Increased demand produces increases in the domestic prices of those goods and services which cannot readily be imported. These include most services and construction and the expansion of these sectors attracts resources, including labour, away from agriculture. This phenomenon has been observed in many countries experiencing large increases in capital or export revenue inflows from abroad and it is known as the ‘Dutch Disease’ or ‘booming sector’ effect. It causes the prices of agricultural and other traded commodities to decline relative to other prices, with negative effects on agricultural production.

To the extent that the New Economic Mechanism increased the exposure of agricultural commodities to international markets, this policy change indirectly increased the impact on agricultural production of these market phenomena.

(ii) Within the agricultural sector, the reforms and related improvements in market access to Thailand generated market incentives which encouraged substitution of cash crops for rice.

The particular cash crops that were suitable varied greatly from region to region. But since the liberalised market environment under the reforms meant that households’ rice requirements could be purchased and did not have to be produced, diversification into cash crops became an option that was not so readily available before the reforms.

The changes in the composition of output following economic liberalisation suggest that, in terms of economic efficiency alone, comparative advantage in Lao agriculture does not lie in expansion of rice production. Rather it seems to lie in increased high value cash crop and livestock production. The reasons for this conclusion are:

(a) The land endowment of Lao PDR. Laos is mountainous and the scope for lowland irrigation is limited. The ‘green revolution’ technology, based upon (i) irrigation, (ii) high levels of fertiliser and insecticide use, and (iii) varieties of rice adapted to these conditions, are thus less suited to Lao conditions than to those in some neighbouring countries.

(b) The poorly developed transport system within Lao PDR, which leads to high transport costs for bulky commodities. There is an advantage to producing high unit value commodities which are also storable.

(c) Continued rapid economic growth in neighbouring Thailand will produce growing export demand for high value cash crops and livestock products, rather than for staple foods.
(iii) In addition to the above, the Government has introduced *policy measures designed to reduce the incidence of slash and burn cultivation* and encourage more stable forms of land use in upland areas.

Since a high proportion of upland rice production actually occurs under slash and burn conditions, the movement out of upland rice is in part due to the reduction of slash and burn modes of production. In this respect, the reduction of upland rice production should not be interpreted as an indication of the failure of policy, but rather that the policies intended to achieve a reduction of slash and burn modes of cultivation were having their intended effect.

* * *

In summary, since the reforms aggregate rice output has grown at an average annual rate of around 1 per cent. With population growth of 2.2 per cent, these data imply a decline in the output of the rice sector per head of population since the reforms at the average rate of 1.2 per cent per year. In so far as achievement of rice self-sufficiency is a major objective of the Government of Lao PDR, these data indicate continued difficulty in the post-reform environment in moving toward that objective. Comparing the available data on the growth of rice output per head of population before and after the reforms, it is apparent that while rice output grew more rapidly than population before the reforms (the available data imply output growth per capita of just under 3 per cent per annum, 1976 to 1990), this momentum was not sustained after the reforms.

The reforms promoted the outcome of a decline in food self-sufficiency in two important ways:

(a) A large inflow of foreign exchange entered the Lao economy, both in the form of foreign aid and foreign investment.

(b) The government of Lao PDR relaxed its restrictions on international (and domestic) trade in agricultural commodities, making them more like the ‘tradeables’ and less like the ‘non-tradeables’ discussed above.

The first event, the increased inflow of foreign exchange, generated clear benefits for the domestic economy because it has permitted government services to be improved, roads to be constructed, and so forth. These are the direct effects of the spending. Some of these direct effects will have benefited agriculture, such as through road building and irrigation development. But if the ‘booming sector’ analysis is correct, the indirect effects of this increased spending will have been to raise the prices of ‘non-tradeables’, like services and construction, relative to the domestic prices of agricultural and manufactured goods. This pattern of relative price changes is precisely what the above examination of relative price movements revealed.
The second event, the liberalisation of trade in agricultural commodities, generates gains through the achievement of greater economic efficiency. But if the booming sector analysis is correct, an indirect effect will have been to accentuate the effect on agriculture of the increased spending from event (i). As agricultural commodities became more like pure traded goods, the indirect effects on them of the foreign aid/foreign investment boom became correspondingly greater.

A significant event, unrelated to the crisis, was a contraction in crop production in 1995 and only moderate recovery in 1996 (see Table 1 above). These events were attributed to poor weather conditions and it was indeed true that flooding in those years contributed to the poor harvests. However, it is argued above that the long term decline in food production, especially rice, was an indirect consequence of the reform process itself and reflected the Lao economy’s lack of comparative advantage in rice production. In 1996 and early 1997 food supply problems occurred. The government attaches very great importance to food security and responded with a huge investment program in irrigation.

In 1998 capital spending on irrigation increased dramatically. It was planned that the irrigated area would increase from 22,000 ha in 1997 to 100,000 by 2000 and to 130,000 by 2003. The government reported that in the 1998 dry season irrigated rice production increased to 53,000 ha as planned, almost doubling the output of irrigated dry season rice from 114,000 tons in 1997 to 212,000 tons in 1998. In 1999, irrigated rice area was 89,000 ha, yielding 289,000 tons. Investment in this irrigation work was huge, representing 5 per cent of GDP in 1998 alone. As Table 1 indicates, a very large increase in capital spending occurred in 1998.

5. The Problem of Macroeconomic Management

From Table 1 it is clear that over the decade ending in 1999 the growth of real output far exceeded the growth rate of population (a little over 2 per cent per annum) in every year since the reforms and did not fall below 4 per cent in any one year. Inflation of consumer prices was moderately high, reaching a maximum of 25 per cent in 1995, and then accelerating dramatically after 1997. Government expenditure exceeded revenue by an average of 12 per cent of GDP and by 1993 this deficit was financed by foreign assistance, without requiring bank finance. Discontinuation of the attempt to control the exchange rate independently of market trends led to the elimination of the gap between parallel and official exchange rates that had characterised the pre-reform period and also to a period of exchange rate stability and low inflation, lasting until 1997 (Figures 1 and 2).
Thailand’s currency crisis led to capital flight and a drastic decline in domestic private investment. The decline in output that occurred in Thailand was caused by a contraction in aggregate demand, of which the decline in private investment was the major component. In the case of Laos, private domestic investment is not a large share of aggregate demand and in this respect Laos was less vulnerable to the contagion effect of the Thai crisis as were other Southeast Asian economies. However, the decline in the value of the baht had a large effect on the Lao currency, the kip. The market value of the kip declined through 1997, as indicated in Figure 1.

At the same time as the exchange rate was depreciating, tax revenues were declining. This is most clearly shown in Table 5. The sources of the decline are shown in Figure 4, which shows the revenue from selected major tax items as a share of GDP. The decline in revenue was due, almost entirely, to a decline in taxes on foreign trade. But this was not caused by any intentional liberalisation. Export tax and tariff rates scarcely changed. It was due to rigidities in the official prices at which import and export items were valued (in kip), for the purposes of tariff and export tax collection. But this was a time of rapid depreciation in the value of the kip. The valuation prices lagged far behind market prices in kip and the revenues collected plummeted.

| Table 5. General Government Operations (1994/95-1997/98) (% of GDP) |
|------------------------|----------------|----------------|----------------|----------------|
| Revenue                | 12.2    | 13.0    | 11.3    | 11.2    |
| Tax                    | 10.2    | 10.8    | 9.3     | 8.8     |
| Nontax                 | 2.0     | 2.2     | 1.9     | 2.3     |
| Expenditure            | 21.9    | 22.1    | 21.3    | 26.9    |
| Current expenditure    | 10.8    | 10.2    | 9.5     | 8.1     |
| Of which: wages and salaries | 5.2  | 4.8     | 4.5     | 3.5     |
| Capital expenditure    | 11.1    | 11.9    | 11.8    | 18.8    |
| Current balance        | 1.4     | 2.8     | 1.8     | 3.0     |
| Overall balance        |         |         |         |         |
| Including grants       | -4.2    | -5.6    | -6.5    | -10.0   |
| Excluding grants       | -9.7    | -9.1    | -10.0   | -15.8   |
| Domestic financing     | -0.4    | -1.1    | 0.9     | 3.3     |
| Foreign financing      | 4.6     | 6.7     | 5.6     | 6.7     |

Memorandum item:

| GDP fiscal year (US billions) | 1323 | 1631 | 2029 | 3290 |

Source: Data from Bank of Lao PDR, Vientiane.

The combined effect of these two events, an increase in capital spending on irrigation and a decline in trade tax revenues, was a budget surplus well in excess of the amount that could be financed through foreign assistance. The deficit was financed through money creation. The inflationary consequences added to the rate of depreciation of the kip. It is notable that both of these events - administrative setting of the prices used for tax collection purposes and money creation as a means of financing budget deficits - were features of the pre-reform
period. The two-fold crisis - a food crisis in 1997 and the currency crisis in the same year, elicited a reversion to these practices.

Figure 4. Selected Government Revenue Components, 1992-99 (% of GDP)

5.1 1990 to 1996: Growth with stability

From 1992 to 1996 there was comparative economic stability in the Lao PDR, characterised by solid economic growth and relatively low inflation. The average annual rate of real GDP growth was 7.0 per cent and the inflation rate measured by the implicit price deflator was 11.2 per cent (the Vientiane CPI inflation measure tells a similar story). The rate of economic growth dipped below 6.0 per cent in 1993, with a recorded rate of 5.9 per cent, while the inflation rate rose to 19.6 per cent in 1995. However, both economic growth and inflation moved back towards their respective long term averages in 1996.

Fiscal Budgets and the Balance of Payments

The foundation of this period of economic stability was laid by both domestic and international factors, which together, conspired to increase the economy’s aggregate savings rate (Table 1). At the domestic level, fiscal reforms generated an increase in the share of fiscal revenue relative to GDP, rising from approx. 9 per cent in 1992 to 13 per cent in 1996. This, together with restraints on government expenditure, which averaged 21 per cent of GDP over the same period, allowed the fiscal budget deficit to be contained to an average level of slightly less than 10 per cent of GDP between 1992
and 1996. This was within the scope of international capital flows to finance, thereby limiting resort to Central Bank financing of the fiscal deficit.

Despite improvements in public savings over the period, a chronically low per capita income has meant that Laos is heavily dependent on international savings, given the size of the domestic investment program. Domestic structural reforms, expressed in the raft of policy changes known as the New Economic Mechanism (NEM), succeeded in attracting larger international private savings inflows. The surplus on capital account, expressed as a proportion of GDP increased in trend terms, rose from 4 per cent in 1992 to 8.5 per cent in 1995, then almost doubled in one year to 16.4 per cent in 1996.

**Increased Openness and Dependence**

Of great importance to the expansion of the capital account surplus was the growth in Foreign Direct Investment (FDI). From a level of less than 1 per cent in 1992 it increased over the period to 7.1 per cent of GDP in 1996. This inflow of capital allowed the economy to import at a greater rate than it exported and as a consequence both trade and current account deficits increased relative to the size of the economy. The current account deficit, which was 9 per cent of GDP in 1992, increased to 16.9 per cent in 1996.

Overall, the NEM served to increase long term rather than short-term capital inflows. There is little evidence that short-term private debt grew with increased economic openness. This reflected the nature of the domestic financial structure. The lack of an organised market in private debt or equity instruments was a major constraint as was the limited international convertibility of the domestic currency, the Kip.

Despite growing current account deficits the Central Bank, the country increased its holdings of international reserves. In 1992 total international reserves minus gold was $US 40.3m. This increased to $US 90.1m in 1995. The growing capital account surplus and the comparatively large level of international assistance ensured that the Balance of Payments was in surplus in most years prior to 1997.

**Aid and Direct Foreign Investment.**

Although the NEM encouraged private capital flows, it is clear that the economy remains aid dependent. There is no evidence of a decline in the share of official transfers, despite the increase in private sector activities. In only two years, 1996 and 1997, did FDI inflows exceed the contribution of official transfers to the balance of payments. In 1996 official transfers were $US82.0m or 4.5 per cent of GDP as opposed to FDI of $176m or 9.7 per cent of GDP. Over the period 1992-1998, official transfers averaged approx.
6 per cent of GDP compared to 5 per cent for FDI. The size and comparative stability of aid imparted some stability to the overall structure of the balance of payments.

5.2 Post-1997: Inflation and Depreciation

The Balance of Payments and Exchange Rates.

Figure 1 plots movements in the market rates for both the Baht and the Kip against the US dollar. The Baht crisis of July '97 is clearly evident. In the first phase of the Kip’s descent, the Kip ‘tracked’ the Baht closely until January '98, although the depreciation rate of the Kip was higher. The average annual depreciation rate statistic shown in Table 2 is apparent in the steepness of the Kip’s descent. In the second phase, from February '98, the two rates diverged systematically. The fall in the Baht was arrested while the descent of the Kip accelerated.

There were two important effects at work in the Kip’s depreciation in 1997:

A Balance of Payments effect. There was an international supply side shock in the form of a lower level of private international savings to Southeast Asia, including Laos. Capital flight, particularly a reduction in Thai foreign direct investment was a contributing factor. Foreign Direct Investment fell from 9.7 per cent of GDP in 1997 to 6.4 per cent in 1997. In 1998 foreign direct investment was 3.7 per cent of GDP. In two years FDI had shrunk to approx. one-third of its former size. Most of the BOP shock was felt by the Capital Account. The capital account surplus fell from 16.4 per cent of GDP in 1996 to 9.4 per cent in 1997 and then to 2.9 per cent in 1998. This was a large real shock in relation to the size of the economy. Compared to the other economies of the region most of the impact was on the long-term capital account. An overall surplus in the Balance of Payments amounting to 4 per cent of GDP in 1996 became a deficit of 1.9 per cent of GDP in 1997, and 1.5 per cent in 1998. The level of international reserves fell from $165 m. in 1996 to $112 in 1997, a fall of 32 per cent. Domestic monetary factors were not important influences on the nominal exchange rate in 1997. The domestic money stock increased by a mere 5.8 per cent and the GDP deflator inflation rate was 19.3 per cent, well below the trend rate of increase. The Vientiane CPI, an important determinant of inflationary expectations, was 15.7 per cent in 1997, a small increase on 1996.

An expectations effect was a secondary factor operating on the exchange rate was also at work in Laos. In Laos, domestic liquidity includes foreign exchange, which functions as a medium of exchange as well as a store of
value. The Baht and the $US substitute for the Kip as monetary assets in the Lao banking and domestic payments system. Any lack of confidence in the Baht easily translates into a weakening of the dollar price of the Kip as market agents shifted their currency portfolio holdings from Baht and Kip into the dollar. This had not been a problem in the past because of the remarkable stability of the Baht/Dollar exchange rate.

**Inflation**

Table 6 presents data on inflation and economic growth for the period 1989-1999. GDP growth is measured in 1990 constant prices, and the inflation rate is defined as the annual per cent change in the GDP price deflator. Economic growth over the period was satisfactory, with real GDP growing at an average annual rate of 7.03 per cent but in the same period inflation averaged 36.6 per cent per annum. The deceleration in inflation from 1989 through to 1994 reflected a priority to reduce the inflation rate. There were three successive years of single digit inflation, but the effort was not sustained. In the decade under study there was only one year in which the growth of real GDP exceeded the inflation rate (1994). The Lao authorities have been more successful in achieving economic growth than in moderating inflation.

**Table 6. Inflation, Economic Growth and Exchange Rate Performance, 1989-1998**

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth (%)</th>
<th>Inflation Rate (%) (GDP Deflator)</th>
<th>ExchangeRate K/$ (market rate) (% change)* (Average Ann.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>13.4</td>
<td>66.2</td>
<td>-52.3</td>
</tr>
<tr>
<td>1990</td>
<td>6.7</td>
<td>33.2</td>
<td>-17.2</td>
</tr>
<tr>
<td>1991</td>
<td>4.0</td>
<td>13.8</td>
<td>+1.7</td>
</tr>
<tr>
<td>1992</td>
<td>7.0</td>
<td>8.1</td>
<td>-2.3</td>
</tr>
<tr>
<td>1993</td>
<td>5.9</td>
<td>8.8</td>
<td>+0.8</td>
</tr>
<tr>
<td>1994</td>
<td>8.2</td>
<td>6.1</td>
<td>+0.4</td>
</tr>
<tr>
<td>1995</td>
<td>7.1</td>
<td>19.6</td>
<td>-18.0</td>
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<tr>
<td>1996</td>
<td>6.8</td>
<td>13.8</td>
<td>-11.2</td>
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<tr>
<td>1997</td>
<td>6.9</td>
<td>19.3</td>
<td>-41.9</td>
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<tr>
<td>1998</td>
<td>4.0</td>
<td>86.2</td>
<td>-162.7</td>
</tr>
<tr>
<td>1999</td>
<td>7.3</td>
<td>127.2</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

*Source:* Data from National Statistical Centre, Vientiane.

*Note:* * Calculated on the monthly mid value parallel market rate.

One important consequence of this pattern of inflationary economic growth is the composition of domestic liquid assets held by the community. There has been increased dollarisation of domestic liquidity. In 1995 M1 constituted 35 per cent of total liquidity, Kip time and savings deposits 23 per cent, and foreign currency deposits 42 per cent. By 1998 the share of M1 had declined to 19.5 per cent, time and saving deposits to 13.5 per cent
and foreign currency deposits increased to 67 per cent of total liquidity.\textsuperscript{153} These trends understate the true situation because of the difficulty of measuring liquidity which includes foreign bank notes, chiefly Baht and US dollars, held by the public, and circulating freely in the economy as means of exchange. From the point of view of domestic economic control this has created two difficulties. To the extent that domestic expenditure is dependent on liquidity, the BOL which can influence M1 control a declining share of liquidity. Secondly, the community has a ready means to express any shift in inflationary expectations. The first factor impacts on the supply side and the second factor affects the short run stability of the demand function for money.

Excluding the three highest inflation years, the average annual inflation rate was 15.3 per cent, which was still high compared to Laos’ trading partners. For example, Thailand is Laos’ most important trading partner in private current and capital account transactions. The average annual rate of inflation in this same period for Thailand was 5.1 per cent.

There is strong empirical evidence that the relative version of PPP applies to the determination of the dominant, bi-lateral market exchange rate, between the Kip and the Baht.\textsuperscript{154} If PPP holds the domestic inflation rate should equal the rate of depreciation of the exchange rate,\textsuperscript{155} and the scatter points should form a line with a slope equal to unity. The regression equation fitted to the scatter diagram in Figure 5, although a less rigorous test of relative PPP, is consistent with the earlier results. The slope is 0.97 and the coefficient of variation is 0.88.

\textsuperscript{153} Data from Bank of Lao PDR, \textit{Annual Report 1998}, Table 9, p. 16.
\textsuperscript{154} Joyeux and Worner (1996).
The evolution of Lao exchange rate policy has been the product of two forces. On the one hand, there has been a long-term policy reform process designed to increase economic openness with the objective of expanding the traded goods sector of the economy. On the other, growth of the economy has been at the cost of high domestic inflation. As a consequence, while Laos has a fixed exchange rate regime, in practice it had been forced to adopt a crawling peg system of official exchange rate adjustment to the parallel market exchange rate. The extensiveness of informal foreign exchange transaction outside the official foreign exchange market along a 1400 kilometre western border with Thailand, ensures the existence of a dual exchange rate system in foreign exchange (Baht and Dollars).

In September 1995 Laos formally adopted a managed floating exchange rate system. However in practice the most important agent in the domestic foreign market is the BCEL, the largest state owned commercial bank. This bank sets a commercial rate in consultation with other government authorities. Other banks follow it with a maximum margin of two per cent. Exchange rate policy therefore has a decisive influence on the exchange rate premium, the gap between the parallel market rate and the official rate.
Commitment to the New Economic Mechanism (NEM) within the province of exchange rate policy, requires variations of the official rate to keep the premium (i.e. the gap between the market and official rate) within the range consistent with a market orientated exchange rate policy. Reform to the exchange rate mechanism in 1995 was designed to give the official rate greater flexibility.

There are two other important characteristics of the Lao exchange rate mechanism. The official exchange rate is expressed in terms of US dollars, but the dominant trading partner of Laos is Thailand. The Baht is the key currency in both private trade and capital transactions. This fact, together with the widespread use of Baht and US dollars as a medium of exchange and store of value in Laos means that arbitrage readily establishes a spot market Kip/Baht exchange rate given the high substitutability between Baht and Dollars. Secondly, the Kip/Baht parallel market rate is determined by relative purchasing power parity.

Figure 1 above suggests that the BOL maintained a policy of keeping the official exchange rate ‘in touch’ with the market rate through frequent small adjustments in the official rate. Volatility in the average monthly exchange rate premium reflected the consequences of a normally lagged adjustment of the official rate to unexpected changes in the market rate. A rapid rate of depreciation in the market rate tended, under this system of ‘leaning against the wind’, to large short term increases and greater volatility of the premium. Sharp increases in the market premium occurred in July 1995 (16%), August and September 1997 (17%), and September ’98 (16%).

Following the Baht crisis of July 1997, there was a large jump in the market premium for the dollar, fully registered in August and September. This was the highest the premium reached over the period. It reflected the foreign exchange market effect of the balance of payments crisis that hit the economy. The market exchange rate depreciated at the monthly rates of 10.8, 13.05 and 10.9 per cent in July, August and September, respectively. Failure to adjust the official rate resulted in a premium of 17 per cent in August and September. An official devaluation of 18.9 per cent in October 1997 brought the premium back to 5 per cent. A market depreciation of 19 per cent in January 1998 was matched by a devaluation of 20 per cent that same month. The premium reached the level of 2 per cent. This was the lowest rate achieved in 1998.

The relationship between market exchange rate variations, the average size of the monthly premium and the volatility of the premium over the year (measured by the standard deviation) for the five years between 1994 and 1998 is presented in Table 7 and confirms the positive relationship between the three variables from 1994 to 1997. Between 1994 and 1997 greater economic pressure on the market exchange rate was associated with an in-
creasing premium and greater volatility in the average monthly setting for the premium over the year. The surprising exception is 1998, which was marked by far greater pressure on the exchange rate mechanism, an annual depreciation rate of 163 per cent, almost a four-fold increase on 1997. Despite this the average size of the premium was smaller at 6.95 per cent and volatility was less in 1998 than in both 1995 and 1997. It can be concluded that official exchange rate policy proved remarkably successful in terms of maintaining a market orientated approach to exchange rate setting in the face of much greater economic pressures in the foreign exchange market in 1997 and 1998.

Table 7. Market Premium (%), 1994-1998

<table>
<thead>
<tr>
<th>Year</th>
<th>Market FX Rate (K/SUS) (Av. Ann.% change)</th>
<th>Market Premium 12 month Average monthly Value (%)</th>
<th>Standard Deviation on average Market Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>+0.35</td>
<td>1.12</td>
<td>0.41</td>
</tr>
<tr>
<td>1995</td>
<td>-18.02</td>
<td>4.74</td>
<td>4.36</td>
</tr>
<tr>
<td>1996</td>
<td>-11.16</td>
<td>2.77</td>
<td>1.04</td>
</tr>
<tr>
<td>1997</td>
<td>-41.85</td>
<td>7.47</td>
<td>5.22</td>
</tr>
<tr>
<td>1998</td>
<td>-162.68</td>
<td>6.95</td>
<td>4.10</td>
</tr>
</tbody>
</table>

Source: Monthly data on market and official exchange rates provided by Bank of Lao PDR, Research Dept., Vientiane.

Inflation, macroeconomic policies and the money supply

The fact that the inflation rate and the level of output increased in 1998 and 1999 is strongly suggestive of dominant Demand-Pull inflationary forces in the economy. The source of the increase was expansionary fiscal and monetary policies beginning in 1997, and intensifying in 1998. The acceleration of the inflation rate in 1999, despite the evidence of tighter monetary policy, reflected the rise of inflationary expectations as market transactors engaged in currency substitution. This had the effect of reducing domestic currency demand, thereby raising the M1 income velocity of circulation and aggregate monetary expenditure.

The motives for this policy shift in 1997-98 together with the effects of the policy are indicated in the statement of the BOL Governor in the Annual Report 1998156.

In 1998 the Lao PDR continued to suffer from the economic and financial crisis in the ASEAN region and domestic difficulties due to flooding in central and southern of Lao PDR in the last year. This caused a slow down in the economic growth of the Lao PDR compared to 1997.

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Faced with such difficult situation, the Lao Government decided to invest in constructing an irrigation system in order to solve the problem of food and foodstuff in the future and to overcome the effects of natural disasters in the long-term. Due to the decreased proceeds from the export of timber and wooden products and the slow down of foreign investment in Lao PDR because of regional crisis, and the high expansion of domestic credit to invest in irrigation system caused the high inflation and great fluctuation in the exchange rate. (p. 1)

There are three broad conclusions to be drawn from this statement:

The objective of government macroeconomic policies was to restore economic growth in the face of an economic slow down.

The government initiated, or rather brought forward, a public investment program in agriculture infrastructure to deal with the twin problems of slow growth and sectoral difficulties in agriculture.

The possible short-run inflationary effects, given the method of financing, were implicitly given lower priority.

**Domestic Credit, the Monetary Base and the Money Supply**

In the absence of expenditure estimates of GDP and its components, the effects of macro-economic policy actions on domestic credit, the money base and the stock of money is shown in Table 8. There was a large expansion in domestic credit by the banking system in 1997 and 1998. Total credit extended increased 142 and 94 per cent respectively. This was a consequence of loans extended by the banking system to government enterprises and the private sector. Net claims on central government, which records the net effect of financing the budget deficit on total credit outstanding, actually fell by 2 and 4 per cent respectively for the two years, despite the rise in the fiscal deficit in 1997 and 1998 (Table 1). This result was due to increased government deposits in the banking system, which offset the gross extension of credit to central government. Despite this fiscal policy, measured by its impact on credit growth, was far less contractionary in 1997 and 1998 than in 1996, where central government contributed to a fall in total credit of 5 per cent. This ‘less tightening effect’ of the budget could thus be interpreted as an easing of fiscal policy in relative terms compared to 1996 and 1999. From private discussions with BOL officials the apparent reduction in credit to government reflected borrowing by the State ‘off-budget’ (i.e. outside formal government accounts).
Table 8. Monetary Survey, 1995-1999 (annual % change)

<table>
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<tbody>
<tr>
<td></td>
<td>% chg.</td>
<td>% chg.</td>
<td>% chg.</td>
<td>% chg.</td>
<td>% chg.</td>
</tr>
<tr>
<td>Domestic Credit (mill. KIP)</td>
<td>21.90</td>
<td>-4.88</td>
<td>142.20</td>
<td>94.41</td>
<td>48.71</td>
</tr>
<tr>
<td>Claims on central government.(net)</td>
<td>-93.92</td>
<td>-5640.72</td>
<td>-1.70</td>
<td>-4.13</td>
<td>-494.16</td>
</tr>
<tr>
<td>Claims on non-fin. govt. enterprises</td>
<td>58.73</td>
<td>33.49</td>
<td>226.07</td>
<td>85.64</td>
<td>99.19</td>
</tr>
<tr>
<td>Claims on private sector</td>
<td>30.42</td>
<td>20.82</td>
<td>83.43</td>
<td>87.98</td>
<td>62.62</td>
</tr>
<tr>
<td>Net foreign assets (mill. KIP)</td>
<td>33.39</td>
<td>100.99</td>
<td>64.93</td>
<td>93.38</td>
<td>153.26</td>
</tr>
<tr>
<td>Monetary base (reserve money)</td>
<td>13.39</td>
<td>24.00</td>
<td>43.81</td>
<td>87.71</td>
<td>70.99</td>
</tr>
<tr>
<td>Money stock (M1)</td>
<td>9.51</td>
<td>12.48</td>
<td>5.79</td>
<td>111.40</td>
<td>28.35</td>
</tr>
<tr>
<td>Total reserves minus gold ($US mill.)</td>
<td>51.17</td>
<td>79.13</td>
<td>-32.01</td>
<td>4.14</td>
<td>-13.38</td>
</tr>
</tbody>
</table>

*Source: Bank of Lao PDR, Research Dept., Monetary Survey, Vientiane.*

Monetary and credit policies were expansionary in 1997 measured by the large increase in the monetary base by 44 per cent. Despite this the money stock increased by only 6 per cent. In 1998 monetary policy was highly expansionary. The monetary base increased by 88 per cent and the money stock (M1) by 111 per cent. The weak link between the monetary base and money supply increases indicates significant instability in the money multiplier.

**Monetary Base and Money Supply changes: Instability of the M1 Money Multiplier.**

The relationship between changes in the monetary base and changes in the money supply is depicted in Figure 6. Despite there being a loosely positive relationship between the two variables, it is by no means stable. If 1989 and 1999 are compared, the two years of highest money supply increase, with 108 and 111 per cent respectively, the money base increase in 1989 was 327 per cent compared to 88 per cent in 1998. Clearly, the different money multipliers implied indicate large shifts in portfolio decisions by the banking system and the non-bank public. If 1997 is compared to 1998 there is a clear indication of a large increase in the money multiplier in 1998 as a 44 per cent increase in the monetary base was required to support a 6 per cent increase in the money stock in 1997. In 1998 a 111 per cent increase in the money stock was supported by an 87 per cent increase in the money stock. The implied increase in the money multiplier in 1998 reinforced the expansionary impact of credit policy on the money base.
Inflation, the Money Supply and Income Velocity

The underlying structure of the Lao economy supports a flexible Quantity Theory of Money approach to the determination of the domestic inflation rate:

- Domestic output and expenditure is dominated by Food for which short-run domestic supply elasticities is low.
- Domestic expenditure change is dominated by the public sector, which looms large in the monetary sector of the economy.
- The domestic capital market is highly underdeveloped lacking an organised market in equities and a weak banking system which severely circumscribes the monetary portfolio choice of asset holders.
- The demand for money is dominated by current transaction requirements.
- There is a high degree of dollarisation of domestic liquidity. The high substitutability between domestic money and foreign exchange as a monetary asset creates the possibility of an inflation hedge against anticipated movements in the domestic price level and the exchange rate.

In these circumstances money supply changes in excess of transactions requirements will be quickly reflected in expenditure changes. The inflation effect of any increase in the money supply is complicated by shifts in the demand for domestic currency given the high substitutability between do-
mestic money and foreign exchange. A change in the inflation rate or ex-
change rate depreciation rate impacts on the income velocity of circulation
of domestic money, aggregate expenditure and the inflation rate via the cur-
rency substitution effect. Figure 7 indicates that between 1986 and 1999
there is a reasonably close relationship between the inflation rate, money
supply growth (left axis) and changes in the M1 income velocity of circula-
tion. As expected the years of high inflation are associated with large money
supply increases.

Figure 7. Money, Prices and Income Velocity, 1986-1999 (% change).

6. Conclusions

By 1996 Laos had enjoyed an extended period of economic boom. The lib-
eralizing effects of a market-oriented program of economic reform, the New
Economic Mechanism, as well as the demand effects of the massive boom
occurring in neighbouring Thailand led this boom. But Laos’ boom had led
to an unexpected and unwelcome consequence. High levels of capital inflow
produced a pronounced ‘Dutch disease’ – a decline in traded goods prices
relative to those of non-tradeables – which in turn led the relative contrac-
tion of the agricultural sector and declining levels of food self-sufficiency.
The latter, in particular, was considered unacceptable. To counteract it, the
Lao authorities responded with a massive programme of public investment
in agriculture, beginning in 1997 and reaching its highest level in 1998.
The Asian currency crisis occurred on top of these developments. The depreciation of the Lao currency, combined with rigidities in the way the Lao government collected tariff revenues, meant that revenues actually declined at the same time as expenditures were increasing. The large budget deficits implied by these events were financed by monetary creation, producing a rapid inflation. Thus, while most other governments in the region responded to the Asian currency crisis with contractionary monetary and fiscal policies, partly under the misguided direction of the International Monetary Fund, Laos responded with an expansionary policy.

The outcome was that although the crisis produced severe recessions but little or no inflation in most other Asian economies, in Laos there was a rapid inflation and no recession. It would be absurd to suggest that the Lao response was entirely intentional, but it is not at all obvious that the outcome was inferior to that observed in neighbouring Thailand, for example.

The rapid inflation in Laos did have serious negative consequences. One relates to the salaries of civil servants. In Laos, as in many socialist and post-socialist societies, government salaries are squeezed during periods of rapid inflation. Table 9 shows average civil servant salaries adjusted for inflation of consumer prices. The implication of these data is that salaries with a real value of 100 in 1994/95 had a value of 45 in 1998/99. The real value of salaries had declined by fully 55 per cent in only four years.

Table 9. Average salaries of civil servants, real and nominal, 1995 to 1999

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Monthly salary of civil servants*</td>
<td>68,108</td>
<td>69,013</td>
<td>72,000</td>
<td>74,504</td>
</tr>
<tr>
<td>Growth rate of nominal salary</td>
<td>-1.5</td>
<td>1.3</td>
<td>4.3</td>
<td>3.5</td>
</tr>
<tr>
<td>CPI(1995=100)</td>
<td>100</td>
<td>107.3</td>
<td>135.6</td>
<td>192.6</td>
</tr>
<tr>
<td>Growth Rate of CPI</td>
<td>19.4</td>
<td>7.3</td>
<td>26.4</td>
<td>42</td>
</tr>
<tr>
<td>Real salary of civil servants</td>
<td>100</td>
<td>94.44</td>
<td>77.96</td>
<td>56.80</td>
</tr>
<tr>
<td>Growth rate of real salary</td>
<td>-20.5</td>
<td>-5.6</td>
<td>-17.4</td>
<td>-27.1</td>
</tr>
</tbody>
</table>

Source: Data from National Statistical Centre, Vientiane.
Note: *Simple average salary. Units: kip per month, current prices.

A feature of Laos' transition is that the reform process has been directed from high levels of government. Civil servants, many of whom were educated during the pre-reform period in the Soviet Union, Eastern Europe or even Cuba, did not necessarily favour the reforms but were required to implement them. Corruption is now a serious problem, much more so than in the pre-reform period. The drastic decline in the real value of civil servant salaries can only worsen this problem of economic transition.
References


Adopting the Acquis Communautaire in countries in transition: the case of company law in the Slovak Republic

1. Introduction

Transition issues have gained prominence in economic literature during the past decade, as economic and societal transformations in the former communist bloc gathered pace. They offer social scientists a previously unmatched opportunity to study radical societal change firsthand. It has come to be understood that one of the more important aspects of these transitions is legal transformation. In the early 1990s, however, this was an area overshadowed by the economic reforms per se; extensive economic liberalisation, macro-economic stabilisation programmes and especially privatisation schemes. Gradually, institution-building in general and legal reforms in particular have begun to receive policy-attention; developments which may be attributed to the fact that earlier economic reforms have often not yielded the promised results and that negotiations about membership in the European Union (EU) are now well advanced.

The role of formal institutions (i.e. laws and regulations) is an area receiving greater attention within the fields of institutional economics and law and economics. Often legal change has been assumed to be something that can be effected ‘overnight’ by the legislature. More recent literature, however, has begun to understand the dynamics of legal change, pointing to the possibility (among other things) that there might be strong components of path dependence in the ways in which a regulatory framework devel-

* Please note that although minor alterations to the text have been made the paper as such reflects the situation as it was perceived by the authors at the time of the initial presentation of the paper in 2001.


158 This is not to say that the literature suggests that such legal changes may be effective overnight, rather there has been much discussion of the need for these formal rules to be in somewhat harmony with the ruling informal institutions; for a brief overview of the literature, cf. Olsson (1999), Ch. 11.
The experiences of central and eastern Europe pose very interesting examples since the changes have: (i) been rapid, not least due to the loss of legitimacy of the communist regulatory framework; (ii) been all-encompassing, touching most areas of societal life; and (iii) we can detect not one but at least two waves of change, the first being the immediate response to the downfall of communism and the second being in response to the demands by the European Union.

This paper looks at a particular area of legislative change, that of company law, focusing on the branches of law of direct relevance for the ‘Company Law Acquis’ – and thus of relevance for the development of corporate governance structures. The area of company law could be expected to belong to the more dysfunctional areas of transition following the fall of communism (eradicating private property and capitalist firms had been a priority of most revolutionary regimes).

It also provides a study of how a regulatory framework developing over more than forty years in the confine of the European Community is being incorporated into former soviet economies in a much shorter time period. Indeed harmonising a national regulatory framework with an established supra-national framework is proving as difficult as the transition from a planned to market-oriented economy. The Slovak Republic helps to highlight some of the important dynamics of legal change. That country from 1989 onwards has experienced no less than three phases of legal change: the immediate post-1989 period, the division of the federation in 1993, and the period of adoption of the Acquis Communautaire.

The paper proceeds as follows. The first section provides a brief overview of the legislative developments in Slovakia post-1989. The section covers the period from 1989 to approximately 1993 – a period characterised by the changes connected to a move from federal socialism to national capitalism. Section two begins with an overview of the provisions for company law contained in the Acquis Communautaire and discusses how the EU Acquis gradually became an important factor for institutional change in


160 Acquis Communautaire is the term used for the body of European Union law, i.e. what has been acquired by the three European communities so far. It includes Treaties (primary law) as well as Directives, Regulations, Recommendations and Decisions etc (i.e. secondary law). “The phrase Acquis Communautaire, sometimes translated as the ‘Community patrimony’, denotes the whole range of principles, policies, laws, practices, obligations and objectives that have been agreed or that have developed within the EU”, see Bainbridge (2002).

161 With regard to company law there has for example, during much struggle, been adopted a mere nine directives and one regulation during a period of more than 30 years. For a discussion of the main points of disagreement in this process, see Acts of the Conference on Company Law and the Internal Market (1997).
Slovakia as well as in the central and eastern European applicant countries in general. This section covers the period from approximately 1993, a period characterised by the move from national to forms that approximates ‘supra-national’ capitalism in its focus on the adoption of the Acquis. Section three identifies some aspects of transposition and implementation of Slovak company law with the Acquis and confronts the harmonisation requirements with reality, especially those provisions in the Acquis with direct implications for corporate governance. Section four provides an assessment of the current status of harmonisation as well as difficulties associated with legal transposition. Section five concludes with some tentative conclusions.

2. Law in Slovakia 1989-1993: from federal socialism to national capitalism

Legal changes have been at the core of economic and democratic transformation. Following the resignation of the Czechoslovak communist leadership on 24 November 1989 the provisional federal government of Marián Čalfa set out to fulfil some of the demands that triggered the so-called Velvet Revolution. In early 1990 many laws were adopted, establishing democratic freedoms such as free elections, free press, freedom of assembly and freedom of religion. A critical document in this respect was the Bill of Fundamental Rights and Freedoms, adopted on 9 January 1991 as the Constitutional Act no. 23/1991. The importance of this act was that it required that all acts and other legal norms henceforth should be adjusted to be in conformity with it, with these changes effected no later than 31 December 1991 or the act in question would become ineffective. This provision of the bill may be interpreted both as a ‘carrot’ and a ‘stick’, aiming to bring the Czechoslovak legal system back to the tradition/family of continental law based on Roman law. It can also be thought of as a judicial version of the economic ‘shock therapy’.

Despite differences over the pace and extent of economic reform, the problem of establishing the legal foundations of a market-oriented economy were tackled during the first months of the democratic Czechoslovakia. In April 1990 a package of four laws was adopted, aimed at enabling competition and foreign investment. Perhaps the most important of these acts was the Law on Entrepreneurship by Individuals (Act no. 105/1990) giving all individuals the right to establish and run a company engaged in trade or production. Significantly, the law removed the ban on the private hiring of

162 On some of these differences, both within the federal government and between the Czech and Slovak politicians, cf. Olsson (1999), pp. 69-70.
labour. The other important act was the Law on Public Limited Companies, replacing its predecessor from 1949 (whose objective had been to nationalise all joint-stock companies).\(^{163}\) Taken together these acts were the beginning of company law as an independent legal area of *ius privatum* in Slovakia, within the framework of the former Czech and Slovak Federation.\(^{164}\) The pressing economic need for change was also significant; by unleashing the latent entrepreneurial spirit the number of registered entrepreneurs in former Czechoslovakia rose from 80,000 in 1989 to 1.1 million in early 1992 – business activities could now be undertaken in any area not expressly forbidden.\(^{165}\)

In terms of company law the most important step was the adoption of the new *Commercial Code* (Act. no. 513/1991 of the Collection), which came into force on 1 January 1992. The new code was modelled on the German code, but has a rather specific character in that it not only regulates the establishment, conduct and dissolution of legal entities but also covers business contractual relations. This rather unusual state of affairs may be interpreted as a compromise by the legislators in which they wanted to cater for the needs of the new business environment in adopting a more homogenous *Commercial Code* (the act was *de facto* approved without much discussion) at the same time as providing a framework for contractual relations that were already occurring. The natural place to solve the latter would of course have been in the old *Civil Code* of 1964 (Act no. 40/1964). However, having to re-codify the Civil Code would have taken a lot longer – and thus the solution was to include some provisions in the new Commercial Code. The result was that some types of contracts, e.g. contract of sale, contract for work and contract on lease, appeared in both the Commercial Code and the Civil Code. In terms of legal hierarchy it meant that the latter turned into a so-called *lex generalis* to the Commercial Code, which in these instances automatically becomes a *lex specialis*.\(^{166}\) The Commercial Code quickly be-

\(^{163}\) The other two laws were the Law on Enterprises with Foreign Capital Participation and the Law on Economic Relations with Foreign Companies; the former amended a already previously adopted joint-venture law, doing away with any limits on foreign participation and the latter removing the remnants of the foreign trade monopoly by allowing all firms to engage in foreign trade, see Olsson (1999), pp. 70-71.

\(^{164}\) Private law (*ius privatum*) can in Slovakia be divided into three categories: (i) *general private law*, i.e. civil law based on the Civil Code (Act no. 40/1964); (ii) *special private law*, i.e. commercial law based on the Commercial Code (Act no. 513/1991), family law based on the Law on Family (Act no. 94/1963) and labour law based on the Labour Code (Act no. 311/2001 that recently replaced the Act no. 65/1965); and (iii) *international private law* based on the International Private and Procedural Law (Act no. 97/1963).


\(^{166}\) The mutual relation is expressed in the beginning of the Commercial Code (Art. 1, para. 2), stating that “The matters referred to the status of entrepreneurs, the obligations between
Adopting the Acquis Communautaire in countries in transition: company law in the Slovak Republic

came one of the most used laws in the country – a development supported by the quick ‘transformation’ of lawyers (often from state-owned enterprises) into private commercial lawyers.

At the same time as the new Commercial Code came into effect (1 January 1992) the Law on Entrepreneurship by Individuals from 1990 was replaced by the Small Traders’ Act (Act no. 455/1991). This act complemented the Commercial Code in that it regulated the behaviour of individual entrepreneurs/tradesmen who undertook profit-making activities independently, in their own name and with full personal liability. Compared to its rather short-lived predecessor, the act amongst other things made more precise the conditions for undertaking economic activity and formalised the licensing procedure. The act also abolished certain provisions of the acts on nationalisation – thus paving the way for the processes of privatisation and restitution begun in 1990.

The main thrust of legal changes came as a response to the changing economic and political environment. The new economic environment confronted the legislature with the need to quickly establish a legal framework suitable for capitalist economic relations. Naturally there were also many cases where the causality was somewhat altered – the legislature not only had to cater for private ownership – it also had to foster (and in some ways create) it by means of adopting the legal framework which was to regulate the processes of restitution, small-scale privatisation and large-scale privatisation. Nevertheless, legislators in Slovakia as other transition countries mostly responded to radically changing circumstances rather than leading it.

The rapidity of change was bound to have some detrimental effects on the quality of the laws passed – and this may be one of the reasons for frequent changes in laws adopted after the fall of communism. The same rate of frequent changes has characterised the majority of acts adopted in the very early 1990s – the Commercial Code has experienced 17 amendments from 1992 onwards, the Securities Act (Act no 600/1992; recently replaced by the Act no. 566/2001) was amended 15 times and the Small Traders’ Act

business parties as well as some other relations inherent to business, shall be governed by the provisions of the Commercial Code. If some matters may not be resolved under the provisions of the Commercial Code, then the provisions of the Civil Code shall be applied. If such matters may not be resolved neither under the provisions of the Civil Code, then they shall be assessed according to commonly-observed business usage, and in the event of its absence - under the principles on which the Commercial Code is based on”.

167 A minor part of the Law on Entrepreneurship by Individuals remained in force, namely those provisions regulating self-employed persons engaged in farming/agriculture business who were not incorporated into the Commercial Register.

(Act 455/1991) has been amended 40 times in just ten years. The Civil Code was between its adoption in 1964 and the beginning of economic and societal transition in 1989 amended only 5 times, after that 20 times so far. Thus, the quantity of laws often took its toll on quality – and courts and lawyers gradually became aware of these shortcomings – leading to the process of more or less constant amendments.

At the same time as changes to the institutional set-up were sweeping and radical, a characteristic shared with other countries in transition, the specific way in which they manifested themselves in Slovakia was affected by previous laws. The way the Commercial Code was developed and linked with the already existing Civil Code is just one case in point. Examples of path dependence are also evident in many other areas. There was, for example, a package of ‘private’ legislation adopted in the mid 1960s which still serves as the legal base for much of current law; including the Act on Family (Act no. 94/1963), the International Private and Procedural Law (Act no. 97/1963), the aforementioned Civil Code (Act no. 40/1964) and the Economic Code (Act no. 109/1964) and in 1965 the Labour Code (Act no. 35/1965; recently replaced by Act. no. 311/2001). All these acts, (with the exception of the Economic Code), are valid in Slovakia.

One may question why important parts of the former legal order were retained from socialism? Why didn’t all of this old legislation get re-codified? One explanation relates to the ‘external’ pressures of the general haste with which the change was demanded. There was a perception there was not time to go through a complicated and time-consuming process of full re-codification – time and effort perhaps better devoted to the restoration of principles of rule of law per se. Another possible explanation for the ‘durability’ of the socialist legal order is that (with the exception of the Economic Code) it was built on Roman law – albeit with significant emphasis on the public interest (defined by the party elite) rather than on individual rights and private ownership.

3. Law in Slovakia 1995-2004: from national to supra-national capitalism

Following the June 1992 parliamentary elections a political deadlock developed on the federal level, which led to the decision to divide Czechoslovakia into its two constituent republics. By 1 January 1993 – the so-called ‘Velvet Divorce’ was a fact. Independence posed a number of challenges for the Slovak Republic – having to establish the institutions and organisations connected to statehood. The first year(s) of independence were thus not a time of significant corporate law reform, partly because many of the
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more important reforms to support and foster a market-oriented economy had already been undertaken in the framework of the federation. Additionally, the focus was on the development of Slovakia’s constitutional and administrative law, and major formal changes were needed so that federal laws could be incorporated into new national. The first act adopted by the newly independent Slovak Republic was consequently Act no. 1/1993 on the Collection of Laws which formally made a distinction between the legal measures adopted before 1 January 1993 (Zb.) and after this date (Z.z.) by a simple abbreviation stated in the brackets. Legal continuity was to be ensured by interim and final provisions stated in Article 152 of the Slovak Constitution (Act no. 460/1992), according to which all acts and other binding legal rules of the federation were to remain valid and effective in the Slovak Republic provided they were not contrary to the Slovak Constitution, subject to confirmation by the Constitutional Court.

At this time, the possibility of eventual membership in the EU emerged; a phenomenon which came to influence a large part of the subsequent legal reforms. An Association Agreement with the European Communities had already been successfully negotiated and signed by the former Czech and Slovak Federation on 16 of December 1991.\(^{169}\) This agreement never came into force due to the split of the federation and its rejection by the European Parliament, as well as the rejection by the national parliaments of the Member States. After the dissolution of the federation, new negotiations were undertaken by both republics and the European Commission, resulting in the signing of agreements in Luxembourg on 4 October 1993.\(^{170}\) The Europe Agreement, came into force in Slovakia as of 1 February 1995.

The agreement set up the guidelines for the gradual integration of Slovakia into the internal market of the Communities on the basis of a free trade area between Slovakia and the EU Member States during a maximum 10-year transition period. This period was divided into two successive stages, each in principle lasting five years, beginning on 1 February 1995. The agreement covers all spheres of economic life, including political (so-called structured) dialogue, economic, financial and cultural co-operation. Article 69 of the agreement, commits Slovakia to making all existing and future legislative measures consistent with the Community legislation, beginning in the area of the internal market but promising an extension to the whole of the Acquis Communautaire.

\(^{169}\) According to article 310 (formerly 238) of the Treaty establishing the European Community (the Treaty of Roma) the Community is allowed to conclude association agreements with a third party (i.e. states or international organisations). With regard to Central and Eastern European countries wishing to join the EU these treaties have come to be called ‘Europe Agreements’.

\(^{170}\) Adamis (1994).
The agreement also created special institutional structures to supervise the fulfilment of the content of the agreement in form of the Association Council between Slovakia and the EU, the Association Committee and sub-committees, and the Joint-Parliamentary Committee. At the same time, the organisational framework in the Slovak administration was established to handle the increasing communication and cooperation between Slovakia and Brussels. By Governmental resolution no. 137/1995, all 20 ministries and 5 governmental offices were obliged to establish European Integration Units to co-ordinate and guide all the activities of the ministry with the EU, with a direct subordination link to the state secretary of the ministry, responsible for this agenda. However, short afterwards the government by resolution 90/1997 strengthened the organisational capacity of these units in terms of personnel and finance reflecting the growing integration agenda. In 1999, further organisational changes were undertaken due to concern about the flexibility and efficiency of the European Integration Units, which had become marginalized from other ministerial departments that were now also working with the EU agenda. Thus, by government resolution 52/1999, units dealing with European integration were merged. The real document that considerably contributed to meet the requirements for developing administrative capacities and new institutions with a view to implement the Acquis, however, was the “Analyses of the Strengthening of Administrative Capacities and Building New Institutions Necessary for the Implementation of the Acquis in Slovakia”, adopted by the Government on 18 July 2001 (Resolution no. 702/2001). The Government by this document decided to create 833 new job positions; the aim with the new was to strengthen legislative and integration departments connected with the legal approximation, structural funds, financial control, protection of the external border of the EU, etc.

The application of Slovakia for full membership of the EU was approved by the Slovak government on 20 June 1995. Seven days later the application was submitted to the European Council Summit in Cannes. This summit was also important as the site where so-called White Paper on Enlargement was presented.171 If the Europe Agreements might in a simple way be considered to represent the goal, the White Paper was to become the road map to achieve those goals. For the first time, there was a clear distinction between the transposition of the community legislation in the area of the internal market on the one hand and its implementation in practice on the other. The White Paper clearly stated that the main challenge for any applicant

171 The official name of the White Paper is the White paper on preparation of the association countries of Central and Eastern Europe for the integration into the internal market of the Union.
country was not technical adjustment of legal texts (i.e. transposition) but the enforcement of harmonised law. The Commission continued to monitor stages legislative reform, but only the final stage was taken into account when assessing real ‘progress’.

This became apparent in the Commission’s Opinion on Slovakia’s Application for EU Membership, published in July 1997, within the Agenda 2000 (known also as AVIS). The Opinion represented the first comprehensive evaluation report on the deficiencies of applicant countries in adopting the Acquis. The Opinion stated that Slovakia did not meet the accession criteria, while there had been greater progress in some other applicant countries. The Opinion became a base on which the Commission decided at the next summit of the Council in Luxembourg in December 1997 to divide the 10 applicant countries of Central and Eastern Europe into the two groups; the first being the so-called Luxembourg group (where the decision to start accession negotiations was taken): the Czech Republic, Estonia, Hungary, Poland and Slovenia, and the second group, the so-called Helsinki group, consisting of Latvia, Lithuania, Bulgaria, Romania and Slovakia. While the Luxembourg group began accession negotiations together with the Acquis screening process already in March 1998, the Helsinki group were limited only to the Acquis screening exercise.

Agenda 2000 also brought new aspects into the enlargement process by reinforcing the pre-accession strategy requiring countries draft their own national strategies to define the short-term and long-term priorities according to the Accession Partnerships. These strategies are known as the National Programmes for the Adoption of the Acquis Communautaire (NPAA). Once Slovakia was requested to submit its national strategy to Brussels by the end of March 1998 questions arose about the nature of the Acquis – it was unclear how far the National Programme should go. Slovakia accepted as the main structure for the NPAA the structure of the negotiation groups adopted by the European Council for General Affairs in December 1997, which defined 31 different negotiation groups, of which 29 covered the scope of the Acquis. The other two chapters relate to the institutions and other questions not involved in previous chapters. Company law is the official title for chapter no. 5. Given the fact, that the Acquis screening process had started in March 1998, i.e. after the deadline when all the na-

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172 The Copenhagen summit in June 1993 formulated the so-called Copenhagen (accession) criteria. These consisted of: (i) political criteria, e.g. the stability of institutions guaranteeing the democracy, rule of law, fundamental rights and freedoms, especially minority rights; (ii) economic criteria, e.g. the existence of a functioning market oriented economy and the ability to compete with the economies in the Union; and (iii) general criteria, e.g. the ability to assume the obligations of the membership, to participate in the political union, monetary union and others.
tional programmes had to be submitted – the first Slovak NPAA had contained oblique references to the White Paper. After the multilateral and bilateral phase of Acquis screening, it became clearer to Slovak officials what the Acquis was about. The Commission also obtained more knowledge about the implementation of individual Directives and Regulations in the Slovak legal order. The work of the Slovak government eventually proved fruitful – in October 1999 the Commission stated that Slovakia now met the criteria. Within a year the Slovak Republic had submitted all the 29 position papers, which declared a commitment to adopt and implement the acquis communautaire, with a reference date to join the EU as of 1 January 2004.

4. The Acquis and company law: what progress in Slovakia?

The Europe Agreement contains 9 titles (chapters), 124 articles, 17 annexes and 8 Protocols. Of specific importance for company law and various aspects of corporate governance are Chapters II and III, Establishment and Supply of Services, respectively. With regard to Chapter II, Slovakia has committed itself to facilitate the setting up of operations on its territory by Community companies and its nationals during the transitional period, i.e. before 2005. In practice, this means equal treatment for Slovak and European Communities’ citizens/companies operating in Slovakia.173

For Community nationals establishing businesses in Slovakia as self-employed persons, there was time left to apply the national treatment provisions as of the sixth year after the date of entry into force of the Europe Agreement, i.e. 2001. In Slovakia this area is legally covered by the Small Traders’ Act No. 455/1991 which in turn refers to Article 21 of the Com-

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173 For the purposes of the Agreement establishment shall mean (Art. 45, para. 4): “a) as regards nationals, the right to take up and pursue economic activities as self-employed persons and to set up and manage undertakings, in particular companies, which they effectively control. Self-employed and business undertakings by nationals shall not extend to seeking or taking employment in the labour market of another Party. b) as regards companies, the right to take up and pursue economic activities by means of setting up and management of subsidiaries, branches and agencies; subsidiary of a company shall mean a company which is effectively controlled by the first company; economic activities shall in particular include activities of an industrial character, activities of a commercial character, activities of craftsmen and activities of professions.” There were, however, exceptions to this general rule of free establishment pertaining to e.g. the establishment of financial services and sectors related to the end of the transitional period, like armament and defence production, steel production, acquisition of state-owned assets under privatisation process, ownership, use, sale and rent of real property, dealing and agency activities in real property and natural resources.”
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Commercial Code, according to which non-residents\textsuperscript{174} can conduct business activities\textsuperscript{175} on the territory of Slovakia under the same conditions and to the same extent as Slovak persons, unless the law stipulates otherwise. However, the law conditioned the undertaking of foreign persons upon gaining permanent or long-term residence permit according to the Act no. 73/1995 on the Stay of Aliens in the Territory of Slovakia,\textsuperscript{176} i.e. only individuals granted permanent or long-term residence permits could enjoy the same treatments as Slovak nationals. The Alien Act further set another condition to obtain these permits and that was to submit the valid labour permit according to the Labour Code. Thus there was a circle of conditions causing a non-transparent bureaucratic process that was not very attractive for foreign persons. The amendment to the Commercial Code adopted as Act no. 500/2001 exempted EU Member States and OECD nationals (self-employed persons that undertake business in Slovakia as the natural persons) from signing the Business Register (Art. 21, para. 4 and 5). To obtain a business licence it is thus enough to notify the residence, putting foreigners on an equal footing with Slovak nationals. This provision will come into force as of the day of the accession of Slovakia into the EU, i.e. 1 May 2004. The new provision (Art. 30, para. 3) extended the equal treatment also to non-resident representatives authorised to act on behalf of the foreign companies. All other persons shall submit the residence permit to be signed into the Commercial Register.

The Europe Agreement contains in principle the general legislative framework to regulate free movement of companies. It sets up also the definition of the ‘Community company’ and ‘Slovak Republic company’ relevant to the transposition of the respective directives on company law of the EU into the Slovak legal order. A ‘Community company’ and a ‘Slovak Republic company’ are defined as a company or a firm set up in accordance with the laws of a Member State or of the Slovak Republic, respectively, and having its registered office, central administration, or principal place of business in the territory of the Community, or the Slovak Republic, respectively. In the case that a company or firm set up in accordance with the laws of a Member State or of the Slovak Republic, respectively, has only its reg-

\textsuperscript{174} For the purposes of this Act the term "non-resident" shall mean an individual with domicile (and a legal entity with its registered office) outside the territory of the Slovak Republic. For the purposes of this Act a legal entity with its registered office in the Slovak Republic shall be regarded as a Slovak legal entity.

\textsuperscript{175} For the purposes of this Act the term “business activities of a non-resident in the territory of the Slovak Republic” shall mean business plied by such non-resident if its enterprise or an organizational part thereof are located in the Slovak Republic.

\textsuperscript{176} The Act was in 2002 replaced by the new Law no. 48/2002 on the Residence of Foreigners.
istered office in the territory of the Community or Slovakia, respectively, its operations must possess a real and continuous link with the economy of one of the Member States or the Slovak Republic.

The White Paper defines the key measures needed for approximation and harmonisation of company law. The two most important directives are the first and the second company law directive from 1968 and 1976, respectively.\(^\text{177}\) The implication of the first directive is to define a system of public disclosure which applies to all incorporated companies – making available to the public through the commercial registers, accurate and up to date information on, for example, instruments of constitution of a company, the identity of those empowered to represent it, the financial situation of the company and any change of its status etc. The second company law directive targets public limited companies, focusing on the raising, maintenance and alteration of their capital.

In the opinion of the European Commission they should, “guarantee the necessary protection for creditors and investors, both local and foreign who want to enter into contact with companies incorporated in the associated countries” and are thus both defined as first-stage measures to be implemented within the 5-year period.\(^\text{178}\) As second-stage key measures the White Paper define three additional directives and one regulation – all to be implemented no later than 2005 in accordance with the Europe Agreement, or no later than at the time of accession - whichever comes first.\(^\text{179}\)

The current paper does not have the ambition to provide a full and detailed account of current Slovak company law and its harmonisation with

\(^{177}\) The full name of the two directives are, respectively, the First Council directive of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community, in short 1st Company Law Directive (68/151/EEC) and the Second Council Directive of 13 December 1976 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, in short 2nd Company Law Directive (77/91/EEC).

\(^{178}\) White Paper, p. 312.

\(^{179}\) The three directives are the following: (i) the Third Council Directive of 9 October 1978 based on Article 54(3)(g) of the Treaty concerning mergers of public limited liability companies (78/885/EEC); (ii) the Eleventh Council Directive of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of companies governed by the law of another Member State (89/666/EEC); and (iii) the Twelfth Council directive of 21 December 1989 concerning single member private limited companies (89/667/EEC).
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the company law directives. As of February 2001 the official status according to the TAIEX database was that none of the directives were fully implemented.\(^{180}\) Moreover, the Slovak Government in its negotiation position of 31 October 2000 committed itself to achieve “full compatibility” with the amended Commercial Code to be “effective from 1 June 2001”.\(^{181}\) Formally this full compatibility was also reached, albeit with a short delay, as of 1 January 2002 with the adoption of an extensive amendment to the Commercial Code (Act no. 500/2001). According to the Government this amendment solved previous harmonisation delays and fully implemented all the unimplemented or partially implemented Directives.\(^{182}\)

In the light of the governmental proclamation on the full compliance with the Acquis, it is interesting to look at whether and how some of the key features of the first and second company law directives have been implemented.

Regarding the First company law directive, we have chosen to focus on the provisions that seek to make available information of interest through public commercial registers. With respect to this it was necessary to adopt provisions on the publication and provision of copies of documents referred to in the First company law directive (articles 2-3) to anybody applying for a copy of the documents relating to registered companies. In the Slovak Republic a company register (Business Register, in Slovak terminology) is provided for and regulated in the Commercial Code, paragraphs 27-34. Currently, however, the problem is that the register is not centralised. The register is operated by the eight so-called register courts in the seat of regional courts. Substantive progress has been reached by a project carried out by the Ministry of Justice (responsible for the company law in Slovakia) which aim is to link the existing commercial registers into one information network. In January 2001 the electronic version of the Commercial Register was launched on a web site (http://www.orsk.sk). Here data on registered companies is publicly available free of charge. Despite this progress there still remains problems to be solved with regard to the legal validity of printouts.

\(^{180}\) In this context it can be noticed that one of the few directives concerning enterprise behaviour – albeit falling under the chapter of freedom to provide services – is the so-called Large Holdings Directive (88/627/EEC) – a directive that is discussed in detail in the following chapter.


Regarding the Second company law directive, we chose to focus on the provisions that limit public companies with regard to purchasing their own shares. In the reading of Commercial Code as of January 2001 not much of the directive was implemented. It is therefore positive that in the amendment of the Commercial Code all aspects regarding the purchase of a company’s own shares are implemented in the text. However, one important amendment to the directive, which was made in 1992, i.e. paragraph 24a that was amended in order to avoid a loophole whereby companies could use their subsidiaries to buy their own shares, does not seem to be fully covered in the amendment to the Commercial Code.

The amendment to the Commercial Code (no. 500/2001) also introduced the collection of deeds and enforcement fines for the violation of obligations in register proceedings; addressed the issue of invalidity of a company; made a reference to the Civil Procedure Code which excluded the possibility to submit an appeal against the decision of the register court if the court accepts the petitioner’s proposal to the full extent and made the decision of the registering court enforceable from the date when the data entered, i.e. were signed in the Business Register. All in all this helped to smoothen and speed up the procedures relating to the registering of companies in the commercial register.

5. Tentative conclusions

Some of our conclusions and thoughts derived from the process of writing the paper will now be outlined. It should be stressed that these ‘conclusions’ are very tentative in nature – much of the empirical studies need to be deepened and/or complemented. Hopefully, these brief notes may serve as a ground for further discussion.

It is possible to discern two distinct waves of legal reform in the Slovak Republic – the first consisting of changes in the regulatory framework in the immediate post-1989 period – the second consisting of the gradually intensified efforts at adopting the Acquis communautaire.

There are similarities and differences between these two waves. One similarity is that the impetus for change in both was ‘external’ to the existing regulatory framework. For example, in 1989 political changes sweeping across the soviet bloc countries led to the collapse of the centrally administered economy. In the adoption of the Acquis, a similar situation arose – it became painfully clear that the process that started with the ambition to join the EU required another wave of legal and administrative reform.
The changes have been complicated by the fact that very few involved in the process had any *a priori* knowledge either of the structure or the aims and underlying rationale. This is also something applying to both waves of legal change – i.e. post-1989 and during the enlargement negotiations in the 1990s.

Laws adopted in the 1990s have been subject to frequent change - indicating that the legal framework has been unstable. We suggest that this is a consequence both of the speed with which legal reforms have been carried out and of the fact that the ‘need’ for change is not one that has grown from ‘inside’ the system. It may, for example, be speculated that if the need for change had grown more gradually, it would have been possible for the system to resolve the problems in a more ‘orderly manner’.

The preferred method to cope with the apparent shortcomings of the laws has been to amend existing laws rather than re-codify the act in question. Re-codification is of course a more difficult and long-term process, involving many organisations and interest groups. The consequence of this is a ‘patch-work’ of laws not fully congruent with each brought about by specific ministries and interest groups.

Although legal change has been relatively radical and swift, it is possible to point to clear tendencies of continuity and path dependence – both in 1989 and 1993. For example, the durability of the laws adopted in the 1960s and the way the legal order affected the drafting of Commercial Code.

The ‘third wave’ of change that took place in the Slovak Republic, connected to the division of the federation in 1993 lacked the characteristics of the other two waves of change in that it was more of an administrative adjustment. However, the changes meant that administrative capacity was strained and that priorities other than company law reform were put on the agenda; the struggle for national identity became equally important as entrepreneurship reforms.

Shortcomings remain in the transposition of EU company law. One may only speculate whether the remaining loophole allowing subsidiaries to buy shares in the controlling company is a consequence of bad work/lack of time, or a failure to understand the economic importance of the directive.

In 1993-1998 the main problem for the lawyers was to understand the functioning of the principles of the community law in the Slovak legal order that had to respond to the transposition of the *Aquis*. There existed a group of lawyers with a rigid perception of the legal
order that found it difficult to allow the supremacy of the Acquis during the time of association. For them the Acquis was a part of the international law that had to respect the traditional principles of the international legal order.

The legal relationship between the EU and Slovakia as with the other candidate countries have not been clearly defined in the pre-accession period. Much could e.g. have been solved if the Slovak Constitution had included a so-called general reception clause about the supremacy of the international treaties above the internal legal order.

The lack of knowledge of the meaning of the Acquis that was for the candidate countries a completely new legal order contributed to the delays and errors in implementation.

Some non-transparent institutional structures in the area of the European Integration and overlapping competencies of the ministerial departments was also an aspect of the process of adaptation to the functioning of the administrative structures.

Last, but not least, constant requirements from the European Commission and other EU institutions to elaborate and send expert information on short notice often overwhelmed the bureaucracy with not very important issues, that, however, had to be sent to Brussels.

There has been a strong tendency towards convergence of formal legal rules in Central and Eastern European Countries, a phenomenon arising out of the new greater exposure of individual countries to external influences, economic globalisation, and the dynamics of the EU-membership application process.

A quite strong domestic lawyers group have emerged attempting to establish Roman law as the basis for the legal system of continental Europe.

Much legislation has been imported from various Codes within the continental European tradition (e.g. influence of German law on the Commercial Code, influence of Swiss and Austria law on the Civil Code), rather than drawing upon a pure pre-socialist heritage. The results suggest that law reform has been primarily responsive to economic change rather than initiating or leading it.

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Adamis, Miroslav (1994), Europska dohoda o pridružení uzatvorená medzi Európskymi spolocenstvami a ich členskými štátmi na jednej strane a Slovenskou republikou na strane druhej. Slovenska obchodna a priemyselná komora (The
Europe Agreement establishing an association between the European Communities and their member states on the one hand and the Slovak Republic on the other, Bratislava.


Market transparency, ownership concentration and harmonisation of law in some East European accession countries: a critical note

“Publicity is justly commended for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. [...] But the disclosure must be real. And it must be a disclosure to the investor. It will not suffice to require merely filing a statement of facts with the Commissioner of Corporations or with a score of other officials, federal and state. That would be almost as ineffective as if the Pure Food Law required a manufacturer merely to deposit with the Department a statement of ingredients, instead of requiring the label to tell the story.”
Brandeis (1914), Chapter V.

1. Introduction

In the early 1990s economic reform efforts in the Baltic and Central and East European countries was directed towards what was then seen as the three main pillars of economic reform, i.e. macroeconomic stabilisation, rapid and extensive economic liberalisation, and privatisation of the means of production. Today, however, it is more or less conventional wisdom that these reform programmes to some extent were flawed in that they failed to sufficiently stress a fourth pillar of reform, namely institution-building.\(^{183}\)

This ‘renewed’ interest in the role of institutions is partly a result of the general upswing in the field of ‘law and economics’ and the revival of institutional economics connected to the works of North and others. It is also partly a consequence of the fact that in many countries the initial reform efforts failed in delivering the desired results. For example, privatisation often did not result in promised dramatic increases in productivity, nor even in the imposition of hard budget constraints. Another reason for the recent

\(^{183}\) Cf. EBRD (1999).
focus on institution-building is the European Union’s membership negotiations with a number of former soviet countries, the imposition and enforcement of its regulatory and institutional framework (Acquis Communautaire) has become a policy-issue of top priority for accession.

An area of particular interest with regard to institution-building has become the capital market. It is apparent that the capital market in many of the emerging market economies functions at such a low level of efficiency that it is doubtful as to whether they perform any of the four functions commonly associated with a functioning capital market, namely: (i) to establish share prices, and thereby an evaluation of company performance; (ii) to provide risk capital for companies; (iii) to encourage risk-taking and investment by spreading the risk; and also, (iv), to correct managerial failure through a market for corporate control. 184 This failure of the capital market to attract and generate new funds for the companies is particularly worrying as many of the formerly state-owned enterprises (SOE’s) are in dire need of restructuring and funds for modernisation.

Stock markets were relatively quickly established in most transition economies, and often seen as important symbols of the transition to capitalism. The exact timing and structure, however, varied and was closely connected to the scheme chosen for privatisation of the large enterprises. Mass privatisation with vouchers has, for example, in many cases been connected to the development of wide but thin markets.185 Among the countries studied in this paper, Slovakia and Lithuania illustrate the former development. In the Slovak case voucher privatisation resulted in more than 500 tradable equity issues being put on the market overnight in early 1993, resulting in a high demand for organisations and institutions to co-ordinate trade. However, the actual regulation of the work at these organised markets lagged seriously behind.

In 1991, the Bratislava Stock Exchange (Burza cennych papierov v Bratislave, BCPB) was established, and trading commenced on 6 April 1993. In September 1993, trading began at the Lithuanian stock exchange (National Stock Exchange of Lithuania, NSEL), although in a more modest 22 issues from 19 different issuers. In Riga and Tallinn it took longer before exchanges started operating. At the Riga Stock Exchange (RSE) trading commenced in July 1995,186 and in Estonia, finally, trading at the Tallinn Stock Exchange (TSE) began on 31 May 1996, with 11 securities then listed.

185 Cf. discussion in Olsson (1999), Chs. V and VII.
186 It should be noted that during 1995 trade was only conducted in 17 equity issues (end-year) and with a minuscule total equity turnover of below 20,000 USD.
Looking at the development at the exchanges through three key indicators of capital market development, however, it becomes apparent that all markets have a long way to go (see Table 1). With regard to market capitalisation as a per cent of GDP, a measure which in transforming economies also indicate the extent of privatisation (in more mature economies would indicate to what extent equity historically has been used to mobilise capital), relatively high levels were reached early on, although even there it depended on the type of privatisation adopted.

Table 1. Key indicators with regard to market performance 1993-1999

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<td>Slovakia (nominal)</td>
<td>25.4</td>
<td>22.1</td>
<td>30.6</td>
<td>32.0</td>
<td>28.1</td>
<td>20.2</td>
<td>18.5</td>
<td>17.5</td>
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<tr>
<td>adj. figure (excl. non-traded issues)</td>
<td>5.8</td>
<td>6.6</td>
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<tr>
<td>Estonia</td>
<td>16.7</td>
<td>24.6</td>
<td>9.4</td>
<td>37.1</td>
<td>358</td>
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<td>Latvia</td>
<td>0.2</td>
<td>3.0</td>
<td>6.1</td>
<td>10.9</td>
<td>13.2</td>
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<td>Lithuania</td>
<td>0.6</td>
<td>2.5</td>
<td>6.3</td>
<td>15.9</td>
<td>22.7</td>
<td>27.5</td>
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<td><strong>Turnover ratio, % of mkt. cap.</strong></td>
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<td>Slovakia (nominal)</td>
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<td>adj. figure (excl. non-traded issues)</td>
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<td>Estonia</td>
<td>26.0</td>
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<td>11.0</td>
<td>7.5</td>
<td>9.7</td>
<td>6.6</td>
</tr>
<tr>
<td><strong>Value traded, % of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.02</td>
<td>1.2</td>
<td>4.8</td>
<td>14.4</td>
<td>12.6</td>
<td>5.0</td>
<td>2.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Estonia</td>
<td>4.3</td>
<td>33.9</td>
<td>17.8</td>
<td>5.5</td>
<td>6.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>.0004</td>
<td>0.2</td>
<td>1.5</td>
<td>1.4</td>
<td>0.6</td>
<td>3.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.01</td>
<td>0.4</td>
<td>0.6</td>
<td>0.6</td>
<td>2.5</td>
<td>2.1</td>
<td>2.9</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Sources: National securities markets statistics; national statistics; own computations

As for two other indicators, developments in the four countries in question is more worrisome. Looking at the turnover ratio (market turnover as a percentage of total market capitalisation), an indicator of market liquidity, it is apparent that the markets remain thin. As can be seen in Table 1, turnover equals only a small fraction of the total market capitalisation of the public issues; in 1999 there was none of the markets market had a higher turnover ratio than 16 per cent. The only market that came to show an acceptable liquidity is the Estonian market in 1997 and 1998; although the market still

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188 Corresponding figures for some of the other transforming economies in the region were in 1996 35.2, 6.6 and 12.4 per cent for the Czech Republic, Poland and Hungary, respectively. The figure for the Swedish market in the same year was 96.9 per cent. See, Olsson (1999), Table 16, p. 153.
has not recovered after the crash and the consecutive restructuring of portfolios. A second indicator of liquidity, namely the value of shares traded as a per cent of GDP, which gives an indication of the extent to which liquidity is available on an economy-wide basis, gives no reason for comfort. Here only the Estonian market that has reached any significant levels of liquidity.

We pose the question as to why these markets do not function. A working hypothesis here is that these markets must gain public confidence before liquidity can grow in any significant manner. A key issue in this respect, then, concerns market transparency; currently a majority of observers and analysts agree that much is to be hoped for. It is thus important to gain deeper insight into the actual structure of markets, the information generated and the general status of corporate governance – both with regard to the formal rules and regulations and the actual pattern of ownership and control that has developed. It can, for example, be assumed that improvements in the information generated and dispersed as well as the protection of minority shareholders may serve to increase investor confidence in these markets. This would probably serve to increase the funds available both for companies already on the market and those wishing to enter. The lack of generally and publicly available information is also something that helps to explain why many of these emerging markets are characterised by very high transaction costs, often only mitigated by various types of insider knowledge.

A similar consideration lay at the core of a 1985 European Commission’s report that proposed a new directive on information to be published when major holdings in the capital of a listed company are acquired or disposed of, (see Section 2). For policy-makers in emerging markets the ongoing transposition of the Acquis Communautaire presents a good opportunity to at least partly improve market transparency by means of adopting and enforcing the Large Holdings Directive. In many of the emerging markets such information is even more important considering that many of the issuers have been recently privatised. There is thus not the kind of tacit knowledge about the issues and issuers that in more mature markets is accumulated over time. The nature of the directive, and the data generated by it, thus lies at the core of this paper.

This rest of this paper proceeds as follows. Section two introduces the implications of the European Union directive 88/627/EEC (the so-called Large Holdings Directive). Section 3 provides an analysis of the extent to which this directive has been implemented in the various countries. In connection with this, the general state of disclosure is also discussed, i.e. what alternative sources and mechanisms for information distribution regarding ownership and control exist. Section 4 summarises and presents some of the data on ownership concentration that has been gathered in a comparative analysis. Section 5 concludes with a discussion of the implications of the
preliminary findings, both in terms of the possible causes for the current state-of-affairs and the possible implications for the research and policy community.

2. The Large Holdings Directive: an overview

The European Union directive of 12 December 1988 On the information to be published when a major holding in a listed company is acquired or disposed of (88/627/EEC, henceforth the Large Holdings Directive), in short, obliges all individuals and corporations (irrespective of their legal form) to notify the issuer and a supervisory body when acquisition or disposal of securities leads to the proportion of voting rights held by that person or entity to cross any of the thresholds set out by the directive (10, 20, 33.3, 50 and 66.7 per cent).\(^\text{189}\) The intention with the Large Holdings Directive was to provide adequate information for investors, and it was for example explicitly stated that it was adopted with an aim to “strengthen public confidence in securities” by means of improving “the quantity and quality of the information made available to the public”.\(^\text{190}\) This task was seen as increasingly necessary with the further integration of national capital markets within the European Union. The particularities of the market and forms of control might be relatively transparent to the investors and market participants in the individual country in question, but still provide a cumbersome task for foreigners and other would-be investors. This argument is particularly relevant for the Baltic States and Slovakia where the small size of the market implies that domestic corporate investors may have quite clear information over who controls a particular business but the market still remains opaque for foreign investors and other ‘outsiders’. The directive was supposed to solve this problem by forcing owners (and the issuers) to disclose information on the ultimate blockholdings, thus giving a picture of corporate control. Also, given the small size of the markets in question it is likely that some type of integration/co-operation will be necessary to maintain competitiveness and attractiveness – making it even more crucial that some type of harmonisation takes place. For example, the markets in the Baltic States are already partners in the Norex alliance on co-operation which in includes Sweden, Denmark, Norway, and Iceland.\(^\text{191}\)

\(^{189}\) Alternatively, the directive also allows for thresholds of 10, 25, 50 and 75 per cent of the votes, see Article 4, para. 1, 88/627/EEC.

\(^{190}\) On the argumentation for adopting the directive, see Commission of the European Communities (1985).

The large holding directive refers to two aspects of corporate control. Firstly, the directive focuses on the voting power commanded over a listed company, as opposed to the percentage of its capital that is controlled by a person or corporation. This allows us to make a distinction between ownership (capital) and control (votes). Secondly, the directive aims to make transparent the blocks of votes that are controlled, as opposed to the direct stakes controlled. This, in turn, allows for investors and potential investors to be informed about whom (and how) ultimate control (or, at least, how much of the control) of a listed company is exerted. It also deserves to be noted that an advantage of the reporting chain established by the directive is that it obliges the party that actually has the correct information to disclose it. For example, it is only the ultimate controller of a block that knows how he/she commands the various votes, it is thus required that it is this party that reports to the issuer and a supervisory authority. Furthermore, since the issuer is the one that actually knows how many votes that are outstanding in the corporation in question it is on him that the requirement to report to the market rests.\textsuperscript{192}

An example of which data should be available from the Large Holdings Directive is presented in Figure 1 below where Company D is the listed company in question. In the example Company A holds a direct stake of 20 per cent of the votes (V), albeit only 10 per cent of the capital (C). Holding company C, in turn, holds a direct stake of 35 per cent of the votes and 17.5 per cent of the capital. In addition three individual investors, Mr. E, Mr. F and Mrs. F, holds direct stakes of 10.1, 6 and 5 per cent of the votes, respectively. Their corresponding stakes in the capital of the company are 5.05, 6 and 5 per cent, respectively. Prior to the introduction of the Large Holdings Directive the information visible to investors in general (depending on national regulations) would be of the direct stakes of capital exceeding the national reporting limit, for example 10 per cent. In this case, potential and actual investors would be aware only of Company A and Holding company C, holding 10 and 17.5 per cent of the equity, respectively. In total this would add up to 27.5 per cent of the capital subscribed to two different investors; the largest individual ‘stake’ being 27.5 per cent.

The implications of the Large Holdings Directive is nevertheless that it would be the voting power that would be disclosed (it is optional for coun-

\textsuperscript{192} Article 10 (para. 1) of the Large Holdings Directive (88/627/EEC) states that “[a] company which has received a declaration referred to in the first subparagraph of Article 4 (1) must in turn disclose it to the public in each of the Member States in which its shares are officially listed on a stock exchange as soon as possible but not more than nine calendar days after the receipt of that declaration. A Member State may provide for the disclosure to the public, referred to in the first subparagraph, to be made not by the company concerned but by the competent authority, possibly in co-operation with that company.”
tries to make also the disclosure of capital stakes mandatory). Disclosure of voting power rather than capital stakes would thus increase the ‘ownership concentration’ in the sense that 65.1 per cent of the votes are held by the two aforementioned investors in addition to the one individual investor exceeding the supposed reporting threshold of 10 per cent. In this ‘first step’ of improved disclosure, the market gets to see that ownership concentration is more than double pre-directive levels – with the same basic situation with regard to ownership; now the largest stake is 35 per cent.

However, perhaps the most important aspect of the Large Holdings Directive is that it requires owners to disclose the total voting power in their control. In our example, this means that combined voting blocks of different investors should be reported. One such block would be the one controlled by Bank B (which previously did not report any ownership at all). The bank apparently controls Holding Company C together with Company B (through a voting pact); the total extent of their votes in Company D is 55 per cent. In addition the bank controls the block held by investor Mr. E who has not given any specific instructions for how his/her 10.1 per cent of the votes should be used. Thus, the total voting block in Company D controlled by the bank reaches 65.1 per cent. This, however, is not the only voting block that would have to be reported. Given that Mr. and Mrs. F have an agreement to act in concert they also exceed the reporting threshold of 10 per cent with their 11 per cent voting block. Thus, with the introduction (and enforcement) of the Large Holdings Directive the picture of Company D changes from being one where there are only two significant owners, the largest holding 17.5 per cent of the capital, to one where it is apparent that more than 75 per cent of the votes are held by two groups.193 This is indeed important information for a potential investor.

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193 It should be noted that the picture would change somewhat if Mr. E either did not deposit his shares with Bank B, or if he (like Mr. and Mrs. F) retained the voting rights and/or gave instructions to the bank on how to vote on his behalf – in all of these alternative scenarios it would be Mr. E directly that would have to submit a notification.
Figure 1. Direct capital/voting stakes vs. voting blocks according to the Large Holdings Directive


The reporting procedure that follows is illustrated in Figure 2, where we retain the same agents as in the example above. Here once any of the two blockholders either acquire or dispose of shares so that they cross one of the thresholds laid down by the directive (time A) they are obliged to inform both the relevant Supervisory Authority and the issuer within seven days (time B). The purpose of putting the information obligation on the blockholders is of course that only they can have the relevant information on how large a portion of the shares they control; they also have first-hand information on when this transaction takes place. An advantage of reporting both to the authorities and the issuer is that it may (as mentioned above) be that only the issuer has full insight into the structure of the capital and votes issued by the company. They thus have the possibility to correct any misunderstanding on behalf of the blockholder with regard to how large a portion of the votes his shares actually command. After receiving the notification (time C) it is the obligation of either the issuer or the Supervisory Authority to inform the public within 9 calendar days (time D); the directive allows for national legislators which of the two that the information obligation should rest on. While some discretion is left to the national authorities to set the exact rules; the main point is that it should be distributed widely.194

194 The directive states that disclosure 'must be made by publication in one or more newspapers distributed throughout or widely in the Member State or States concerned or be made available to the public either in writing in places indicated by announcements to be published in one or more newspapers distributed throughout or widely in the Member State
Thus, ideally, once the directive has been implemented by member states of the European Union, as well as the accession countries, it will be possible to trace various types of control structures (e.g. pyramidal holdings; blocks held through proxy voting etc.) which otherwise would have remained hidden from the normal investor. In terms of research, the adoption and implementation of the directive would also allow for the construction of a comparative dataset that could be used to study both the concentration of control (votes) and the degree of separation of ownership (capital) and control.

3. National transpositions of the directive in the Baltic States and Slovakia

The implementation of the directive has met with resistance and delays. In the four countries in question only one has so far implemented the Directive in the way intended, namely Lithuania. In Lithuania the directive was adopted through the *Rules on Disclosure of acquisition of a block of shares*. Referral to these rules appears in Article 9 of the Securities Act. Because it is in their securities act the rules apply to all Joint-Stock Companies whose securities are publicly listed, currently more than one thousand companies. The rules outline the types of joint action targeted by the rules and include a standardised form that needs to be filled out in case of crossing one of the thresholds, either in the process of acquisition or disposal of shares directly

or States concerned or by other equivalent means approved the by the competent authorities.’ See, 88/627/EEC, Article 10, para. 2 [emphasis added].
by a shareholder or by means of concerted action. The sanctions for non-disclosure include suspension of the voting rights for two years[^195].

The information on blockholdings is available to the public free of charge via three means: (i) the official gazette, where an abridged version of the notification is published; (ii) the NSEL newsletter/website; and (iii) in the reading room of the Securities Market Commission (SMC) in paper files organised by company. Apart from the size of the block, the type of the concert action is disclosed according to the seven definitions of reportable concert action under these rules[^196]. One shortcoming in comparison with the directive is that there was no initial date at which all blockholdings had to be reported, hence there is no blockholding data available on companies where no significant acquisitions/disposals of shares have yet occurred[^197]. This problem is to some extent alleviated by the fact that data available on direct ownership of capital.

The central data source for such information on direct ownership of capital is the annual (semi-annual for listed companies) reports submitted to the NSEL and the SMC. NSEL provides cumulative data on capital stakes for a fee. In addition to cumulative reports, changes in direct ownership of capital are also reported to the SMC and the NSEL in accordance with the regulations on disclosure of material events; data is then made public within 24 hours[^198].

In Latvia the directive has been implemented, at least formally. Latvian Joint Stock Companies are regulated by two laws with regard to governance and ownership disclosure, the laws “On Joint Stock Companies” and “On Securities”. The Large Holdings Directive is nominally transposed as part of these laws, and thus applies to all shares in public circulation, currently some 120 companies[^199]. While the first transposition of the law was entirely nominal, amendments in June 2000 to the law “On Securities” alleviated some of the problems with transposition. The text of the directive is now transposed correctly, although with a lower level of detail in the reporting procedure than in Lithuania[^200]. The initially very vague definition of concert action to be stated when reporting.

[^195]: These sanctions are not applicable in case of disposal. Also, the route to avoiding the sanctions is by disposing of the shares that cannot be voted under sanctions and buying them back reporting the purchase accordingly.
[^196]: In addition to this, data on blockholdings is available in cumulative form from the SMC in computer readable format (Excel-files).
[^197]: Another potential shortcoming is that it is not the issuer (being the one with full information on the outstanding shares/votes) who is obliged to inform the public.
[^198]: Companies also may disclose stock information via press releases, news agencies.
[^199]: In Latvia the law “On Joint Stock Companies” permits for JSCs to choose either a closed or open form; the latter has been chosen by approximately 120 public joint stock companies.
[^200]: There is no set notification form, nor any clear classification of the type of the concert action to be stated when reporting.
action is replaced with a listing of different possible types of concert action that need to be reported. The list also states that when adding up the voting rights to be reported, “voting rights acquired in any other indirect way” must be added.\(^{201}\) However, the reality is quite different. Firstly, it seems that in the way the law is interpreted, only written contracts between parties is considered a basis for concerted action.\(^{202}\) Secondly, actual voting stakes reported are not given by the ultimate controller of these voting rights, but either by the issuer or owner of the direct stake (capital or voting), not the blockholder.

The reason for this state of affairs, according to the Securities Markets Commission (SMC), is the difficulty in enforcing the law upon shareholders rather than the issuers. According to our observations, the SMC does monitor and does identify the most obvious cases of unreported concert action and demands clarification on part of the shareholders. However, this is something that happens on a case-by-case basis and is not systematic and thus cannot possibly cover all instances of concert action.

In practice this means that a very popular off-shore holding company mechanism allows concealing the actual owner of the company. The reported owner is the offshore entity, which is often wholly owned by a Latvian investor. However, the only stake reported is that of an anonymous holding company and not of the person or entity with whom the ultimate voting rights rest. A number of similar off-shore holdings can be established, thus avoiding any mandatory take-over bids (see Appendix A).

The ensuing public information thus differs from Lithuania. Firstly, no blockholdings data is available on a regular basis. Secondly, information on direct stakes is not available in cumulative form, nor is there any electronic storage of the information.\(^{203}\) The only data on capital stakes available in

\(^{201}\) Wording from the law “On securities”: “When calculating voting rights provided for in Articles 64 and 65 of this Law, the following voting rights are added: (i) voting rights acquired by third persons in their name but acting as investor’s agents; (ii) voting rights acquired by investor’s subsidiaries; (iii) voting rights acquired by third persons under a written agreement, concluded with the investor on lasting or systematic joint activities with regard to management of the Issuer; (iv) voting rights acquired by third persons under a written agreement, concluded with the investor on temporary transfer of voting rights for a remuneration; (v) voting rights which are arising from shares transferred to a person and which the person is authorised to use at its own discretion without need to receive a specific order from the investor; (vi) voting rights ensured by shares owned by the investor which serve as a security for the benefit of a third person. If this third person controls voting rights attaching to the pledged shares and announces a wish to exercise these rights, these voting rights shall be looked upon as voting rights of this third person; and (vii) voting rights acquired in any other indirect way.”


\(^{203}\) The changes in ownership are reported in paper format and are kept in paper files. The only source from which ownership information is available in cumulative form is the Latvian
cumulative form can be obtained from the Depository and only for the most recent GSM for each Joint Stock Company.

In Slovakia, there is a great deal of confusion about the directive. There is, however, a general awareness of the problems, best exemplified by the following harsh albeit correct judgement of the country’s capital market: “[t]he capital market in the Slovak Republic, which is only in the initial development stage, is marked by a relatively low liquidity, a lack of high-quality issues, a lack of transparency, the misuse of privileged information and the insufficient protection of minority shareholders.”\(^{204}\) It also stated that “[t]he main objectives of the Slovak capital market reform is to revitalise the capital market, regain the confidence of investors, and to adapt the capital market in the Slovak Republic to the EU and OECD accession requirements.”\(^{205}\) However, not much has been done on the Large Holding Directive, it is not mentioned specifically in the NPAA. The same lack of explicit mentioning characterises the *Conception of the Capital Market Development in the Slovak Republic*, which was an ambitious attempt from the Ministry of Finance to outline the necessary steps to reform and revitalise the Slovak capital market.\(^{206}\) Despite numerous references to other EU directives (and deadlines for their implementation) the only indirect mention given to the issue of transparency with regard to ownership and control is that the “[r]eporting duty of all entities should therefore be stipulated clearly...”, and that issuers “should give to a supervisory body, at least annually, any information on important transactions with persons owning over 5 per cent of interest in their registered capital or with persons acting in ac-

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Central Depository (LCD). The reason is that LCD compiles lists of shareholders who have blocked their shares for the shareholder meeting. These need to be approved by the SMC and made public 3 days before the general shareholder meeting. This information is available for all public JSCs and is released to the company shareholders free of charge. However, only the most current information is available and the LCD does not keep a backlog of the previous shareholder lists. For the potential investor and/or analyst this means that the only source of information is through the commercial data-provider Lursoft which through agreements both with the Enterprise Register and the LCD is the sole provider both of data from both. With regard to ownership information they provide the most current lists of shareholders at a cost of 1.75 LVL (2.85 USD) per 10 shareholders.

\(^{204}\) National Programme for the Adoption of the Acquis Communautaire 2000, Section 3.1.2.2.

\(^{205}\) National Programme for the Adoption of the Acquis Communautaire 2000, Section 3.1.2.2.

\(^{206}\) See, Ministry of Finance of the Slovak Republic (1999); the document was prepared by the Ministry of Finance as a background material for a Slovak Government session where it was presented by Minister of Finance, Brigita Schmögnerová. As mentioned the document is interesting and ambitious and sets deadlines for which directives should be implemented at what time and what other reform measures that should be initiated. However, as time has shown many of the ambitions have proven less successful than intended.
cordance with them. The Bratislava Stock Exchange even states that the directive “is embedded in §79a of the Act no. 600/1992 Coll. on Securities [which] is principally in compliance with the requirements of the aforementioned Directive.” This is patently not true.

The current reading of the Securities Act states that if anyone acquires or disposes of shares “in connection with voting rights that represent more than 5, 10, 20, 30, 50 or 65 per cent share [...] the person is obliged to notify in writing the centre [SCP] and the issuer [...] on the first working day following the day when these shares were acquired [or disposed of].” Also, regarding information to the public the paragraph states that the SCP “shall arrange for an immediate publishing of these facts in the national periodical press that publishes stock information [i.e. Hospodarske Noviny].” However, in practice the Slovak market remains as non-transparent. Direct holdings have been monitored by the central depository (SCP) for a longer time and the first (small) step towards implementation was taken in 1995 when changes in the Securities Act obliged owners of securities to inform the SCP when surpassing one of the thresholds set out. These changes, however, fell far short of the requirements set out in the Large Holdings Directive on most, if not all counts, especially that it did nothing about reporting voting rights, it did not apply to controlled undertakings, and it did not require that the issuer be informed etc. In the summer of 1999, however, a minor step towards compliance was taken in that reporting as of 1 July was required for voting rights as opposed to the capital owned. There were however no changes with regard to who – in terms of e.g. pyramidal holdings – the reporting requirement applied to, i.e. voting blocks were (and are still) not reported. The current law is thus not only ‘not in accord’ with the Large Holdings Directive, it is in fact ‘superfluous’ in that the information submitted to the SCP (and ‘checked’ by them) is information already in possession of the SCP – and thus information that could be made public regardless of any paragraph in the Securities Act and the reporting mecha-

207 Ministry of Finance of the Slovak Republic (1999), Section 3.5.
208 See, Bratislava Stock Exchange (2000), p. 1. The one objection voiced about the compliance of the paragraph was that it referred to the stake of the capital held rather than to the per cent of voting rights – this objection, however, was taken away with the amendment to the Act on Securities which changed this fact (see below).
210 See Securities Act (Act No. 600/1992 Coll. of laws) para. 79a. The amendment was in the National Programme for the Adoption of the Acquis Communautaire 2000, Section 3.1.2.2, described as intending to ‘improve the transparency of relations between securities holders, to enhance the protection of minority shareholders and to establish conditions for the operation of foreign securities traders in the Slovak Republic.’
211 Unluckily there is no mentioning of any changes in the new Securities Act, which is due to come into effect on 1 January 2001.
nism. The only way of currently making this information public by the SCP is through regular advertisements in the business daily *Hospodarske Noviny*. Data on voting power is thus not available in cumulative form.

Estonia is yet another of the Accession Countries where the adoption of the Large Holdings Directive seems to have met with resistance and been assigned a relatively low priority. In the current Securities Markets Act, initially adopted in 1993, (as amended up to and including February 2000) there are no provisions that cater for the generation of such information on the concentration of voting rights. However, for a long time there has been work carried out on a totally revised Securities Market Act. In the National Programme for the Adoption of the Acquis in 1999 it was stated that a new Securities Market Act “would harmonise all EU legal acts in the field of securities analysis” would be drafted and submitted to Parliament in the second quarter of 1999.  

212 Estonian NPAA 1999.

213 Interview July in Estonia, Finance Ministry.

214 The new law on the Central Register of Securities has already been passed by Parliament and will enter into force as of 1 January 2001; according to the law all public limited companies have to register their stock books with the ECDS no later than 1 January 2003; those not willing to do that should reorganise themselves into a private limited company. The changes have been provoked by the fact that the current situation is confusing in that many companies, which are by name public, are actually *private* (i.e. their shares are not publicly
On the negative side, it can be noted that the draft fails to include some types of concerted action mentioned in the directive and,\textsuperscript{215} above all, people involved in developing the new regulatory framework are pessimistic about getting/enforcing notifications that would reveal either the true extent of the voting-block or the identity of the actual blockholder. Part of the reason for this is that the working group drafting the new Act yielding to the pressure of some interest groups will allow nominee accounts – shielded from insight from the central authorities like the ECDS – something which will serve to reduce transparency.

The current state of disclosure is such that some minor parts of the Large Holdings Directive are reflected in the TSE Requirements for issuers, which with regard to the reporting of major holdings states that “[w]here a natural person or legal entity acquires or disposes of a holding in an issuer, and where, following that acquisition or disposal, the proportion of the voting rights of shares reaches, exceeds or falls below one of the thresholds of 5, 10, 20, 33, 50 and 66 per cent, the issuer is required to notify the Exchange immediately once aware of such an occurrence.”\textsuperscript{216} The problem with this disclosure regime is that the rules and regulations of the exchange are only binding between those two contracting parties, there is thus no legally binding requirement for any third party to abide by these rules. For these rules to become effective the TSE would need the backup of national legislation to give it enforcement power; the current TSE rules and regulations are not an adequate basis for legal disputes. The sanctions currently in place

\textsuperscript{215} The responsibility for developing the detailed disclosure regulation will however rest either with the Ministry of Finance or the future unified supervisory authority. The law on the new unified capital market supervisory authority, incorporating the current Securities Market Supervision, the Insurance Supervision and the Banking Supervision of the National Bank, is due to go to Parliament by October 15. However, according to sources working with the matters this date sounds unlikely. According to their estimates a more realistic timeframe is that the act may be brought to Parliament and passed sometime in the first half of 2001, and perhaps the new authority may begin work later during the year. See, Kessler (2000) [interview].

\textsuperscript{216} Requirements for issuers, Tallinn Stock Exchange, para. 6.11.1; emphasis added. In addition issuers are to report significant holdings in other undertakings in their listing particulars which are filed with the TSE; as such are e.g. included all undertakings in which the issuer holds at least 10 per cent of the equity.
for non-reporting include fines to the issuer; however, the TSE has not yet punished anyone for the breaching ownership information disclosure rules.

To summarise it can be stated that the adoption of the Large Holdings Directive indeed has met with resistance and/or delays in the majority of countries studied. The extent and degree of implementation is summarised in Table 2.

Table 2. The national transposition of the Large Holdings Directive (88/627) in four countries

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Slovakia</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transposition Date</td>
<td>Not transposed</td>
<td>Currently not transposed</td>
<td>30/10/1997, latest amendment 01/06/2000</td>
<td>31.01.1997, amended 01.05.1998</td>
</tr>
<tr>
<td>Through which national law was (will) the directive (be) transposed? (in case future plans are known)</td>
<td>N/A.</td>
<td>N/A.; will be transposed with the (eventual) adoption of the new Securities Market Act</td>
<td>Law “On Securities”, articles 64, 65, 65.1</td>
<td>“Rules on Disclosure of acquisition of a block of shares”, referred to in the law “On Securities”, article 9</td>
</tr>
<tr>
<td>What are the reporting thresholds?</td>
<td>N/A.</td>
<td>5, 10, 20, 33.3, 50, 66.7 per cent</td>
<td>10, 25, 50, 75 per cent</td>
<td>10, 20, 25, 33.3, 50, 66.7, 75 per cent</td>
</tr>
<tr>
<td>Voting power or capital power?</td>
<td>N/A.</td>
<td>Voting</td>
<td>Voting</td>
<td>Voting</td>
</tr>
<tr>
<td>How much time may pass between crossing a threshold and reporting to the company?</td>
<td>N/A.</td>
<td>“Immediately”</td>
<td>7 days</td>
<td>7 days</td>
</tr>
<tr>
<td>Who notifies (will notify) the public: Article 10 (1)?</td>
<td>N/A.</td>
<td>Market organiser, e.g. the TSE</td>
<td>Securities Markets Commission</td>
<td>SMC and the NSEL if the Company is listed</td>
</tr>
<tr>
<td>Does the national law prescribe that “a company must also be informed in respect of the proportion of the capital held by a natural person or legal entity”; Article 4 (1)(3)?</td>
<td>N/A.</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>Is the data currently collected according to the directive as transposed? If not, what are the deviations?</td>
<td>N/A.</td>
<td>N/A.</td>
<td>No. Data is collected from company, not the holder of the voting rights; blocks are not reported, reporting is done “on demand from the SMC”, not on regular basis.</td>
<td>Yes.</td>
</tr>
<tr>
<td>In addition to the immediate dis-</td>
<td>N/A.</td>
<td>Not yet decided.</td>
<td>No.</td>
<td>Yes.</td>
</tr>
</tbody>
</table>

292
What are the sanctions for non-reporting mentioned in Article 15?  

| What are the sanctions for non-reporting mentioned in Article 15? | N/A. | Not yet decided. | Fines. On a legal entity in the amount of up to 200 minimum monthly salaries; on a natural person a fine in accordance with the Latvian Code of Administrative Violations. In case of repeated violations the SMC may prohibit the person from engaging in transactions with securities in public circulation for a time period of up to 3 years, or apply other sanctions provided for in legislative acts. (Article 67.3) | Loss of all votes attaching to the shares that were acquired in excess of the limit subject to declaration for two years from the moment the correct data is announced. Also, all decision adopted between the acquisition of the block of shares and disclosure of correct information may be annulled in court in the event that the issuers managing bodies have been changed or property or non-property rights were violated by the decision(s). (Chapter 3, Article 9.6 of the Securities Law). |

How are these sanctions applied?  

| How are these sanctions applied? | N/A. | N/A. | Upon decision of the SMC. | As decided by court. |

Source: Database compiled from national sources, interviews etc.

It is apparent that the quantity, quality and type of data that is available differs widely among the four countries in question. The one common denominator is that data on direct ownership of capital is, in various forms, available. It should be noted that the research has not advanced far enough to be able to plot the equivalent of the capital stakes in terms of voting power (issuers may have issued dual class shares, have voting caps in their statutes, have latent voting power issued in the form of stock options or convertible bonds etc.). Despite these problems it is this kind of data that has been used for this initial survey. The characteristics of the data are summarised in Table 3.
### Table 3. Data availability and sources

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Slovakia</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>What kind of data is available?</td>
<td>Direct Capital stakes</td>
<td>Direct Capital stakes</td>
<td>Direct Capital Stakes</td>
<td>Direct Capital Stakes/Voting Stakes</td>
</tr>
<tr>
<td>Are the blockholdings reported/available?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Is data available cumulatively?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>For which time period?</td>
<td>End-year data</td>
<td>End-year data</td>
<td>General Shareholder Meeting registry</td>
<td>General Shareholder meeting/Data on changes in voting stakes</td>
</tr>
<tr>
<td>Data Source</td>
<td>Issuer</td>
<td>Depository</td>
<td>Depository</td>
<td>NSEL/Depository</td>
</tr>
<tr>
<td>Who distributes the data?</td>
<td>RM-Systém</td>
<td>ECDS</td>
<td>Lursoft</td>
<td>NSEL/Depository</td>
</tr>
<tr>
<td>Is the data free of charge?</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No/Yes</td>
</tr>
<tr>
<td>Is the data available on the website?</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No/No</td>
</tr>
</tbody>
</table>

Source: Database compiled from national sources, interviews etc.

Note: In Estonia the ownership data is free of charge and available on the website only for the listed companies, for all other companies whose shares are registered at the ECDS only persons with a so-called “legitimate interest” may access the ownership data (e.g. issuers can get the full list of the owners of the securities issued by them). In case that data about a specific company is made public, prior agreement with the investors has to be made. However, for investors holding more than the stipulated limit of ten per cent the information can be obtained from the list of shareholders that the company has to attach to the annual financial report submitted to the Commercial Register.

It is apparent that a critical issue in disclosing information on direct stakes is what kind of securities accounting system that has been developed in the respective markets. In all of the countries studied the securities accounting system differs to varying degrees. One can, for example, distinguish between countries that have adopted a one-tier or a two-tier accounting system, respectively. Another distinction can be made between those that have opted for full dematerialisation of securities and those that have not.217 Together these are factors that are influential in determining what kind of ownership data that is made available. The differences between these markets in securities accounting are summarised in Table 4.

In Slovakia the Central Securities Register (Stredisko cennych papierov, SCP) is ideally set to provide such information. For example, there is a one-

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217 A third relevant distinction with regard to share issues concerns to what extent different classes and types of shares have been allowed; this, however, is a field where comparison and analysis is yet to be undertaken by our group of researchers.
Market transparency, ownership concentration and harmonisation of law in accession countries

tier accounting system, allowing the SCP to see the ultimate owner of the respective stakes; there are bearer shares, i.e. all securities are dematerialised and kept in the books of the SCP; all issues must be registered with the SCP which has a monopoly with regard to the registration of ISIN-codes and the book-keeping of securities; the SCP is a state-controlled entity etc.\textsuperscript{218} Taken together this means that the depository has the possibility to publish all relevant information on the ownership of direct stakes of capital, cumulatively as well as dynamically. This, however, is not done. Rather, the only data disclosed by the SCP is that ensuing from owners reporting their direct voting stakes in accordance with paragraph 79a of the Securities Act. The one alternative data source for cumulative data is the commercial database released by the RM-Systém (one of the two organised markets in Bratislava). However, the data on capital ownership in this database is not based on primary sources, but rather on the reporting of the issuers themselves (something which is not fully enforced, resulting in missing data for a number of issues).

A different approach has been taken by the Estonian Central Depostitory for Securities (ECDS), established in 1994. There available data on ownership of all registered issues is made available free of charge, both cumulatively and for individual firms. Data is available from 1996 onwards. The data-problems in Estonia thus do not concern the willingness to disclose data but rather the limitations imposed by the current securities accounting system. Unlike in Slovakia the ECDS does not have a monopoly on registering securities – issuers have the choice of issuing bearer shares or registered shares – thus restricting data availability to the issues actually registered with the ECDS. Also, despite also having a one-tier model of registration, the use of nominee accounts (and foreign off-shore holdings) is more common in Estonia than in Slovakia. In addition, the use of such accounts is set to increase from 2001 when the regulations for ECDS are changing – thus further reducing transparency and data availability. However, the same changes in regulations will at the same time increase transparency as more issues will be registered and bearer shares will be banned.\textsuperscript{219}

\textsuperscript{218} There have however been some changes over time with regard to some of these factors. During the third Meciar government bearer shares were for example introduced (1995), a practice which was abolished with an amendment to the Securities Act in 1999. Also, there is currently a discussion concerning the need for establishing a two-tier system, albeit with provisions which make it possible to identify the individual owners – not least for tax purposes, cf. Ministry of Finance of the Slovak Republic (1999).

\textsuperscript{219} According to the current legislation, every Estonian investor has to open the securities account at the ECDS in his own name. This means that the ECDS has the direct access to every security account. The right to open nominee accounts, which exists, is currently limited to non-residents holding a respective license. However, according to the new law on the
In Latvia the two-tier nominee account system which is operated by the Latvian Central Depository (LCD) does not allow the LCD to see or have access to the information on individual securities accounts of either legal or physical entities. Hence, the only information on the securities holdings LCD has is on total bank nominee accounts. However, as the LCD also performs the function of drawing up the shareholder lists for public Joint Stock Companies, some data on ownership of direct stakes is available. Prior to the General Shareholder’s Meetings (GSM) all shares that are to be voted on have to be ‘frozen’ at the LCD by the shareholder. The LCD thus lists all these holdings into one list which then serves as a basis for the GSM in the sense that the ones listed have the right to vote with the number of shares/votes indicated in the list. LCD then stores the most recent lists for each company – data which is then made available to the public for a fee through the private company Lursoft which not only provides LCD-data but also Enterprise Register data.

In Lithuania, finally, the Central Depository has no role at all in ownership data collection and/or dissemination. The only role of the Lithuanian Central Depository, in contrast to the other countries, is in transaction set-

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220 The only exception is the Initial Register – a system of initial accounts where the voucher privatisation stakes are held. These accounts must be activated by transferring the shares to the bank accounts and remain “frozen” at the LCD before the owner of the securities makes the transfer. Currently around 30 per cent of all shares realised through privatisation remain in the Initial Register.

221 Therefore, the main data source for direct stakes in Latvia is the LCD, which has the most recent GSM lists for all companies in Excel format. Other possible alternatives would be, for example, the Securities Markets Commission which is set to approve each list made by LCD; it checks whether the shareholders have the right to vote (have not violated any regulations, including those on reporting) and it may also ask the banks to disclose the names of the holders of the accounts in case it suspects concert action and/or unreported sales/acquisitions of shares. SMC also stores these lists in per company files, although only in paper format. The Riga Stock Exchange also receives the information on the direct stakes via (semi) annual reports, although neither they accumulate data on stakes. It does, however, report the direct stakes for the listed companies on their website. Finally, regarding voting blocks, the only source of information is the SMC, which stores the data in paper files sorted by company. However, this data is very fragmentary.
tlement. Rather the National Stock Exchange of Lithuania (NSEL) is the organisation more involved in ownership information dissemination. NSEL collects data for direct stakes for all companies from their (semi-) annual reports and makes it public in cumulative form (for a fee) or in per company form through the website (free).222

Table 4. Securities depository systems in Slovakia and the Baltic States

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Slovakia</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>One- or two-tier accounting system?</td>
<td>One-tier</td>
<td>One-tier</td>
<td>Two-tier</td>
<td>One-tier</td>
</tr>
<tr>
<td>Only dematerialised securities?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Monopoly-position for the depository?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>OTC-trading through the depository?</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>N.A.</td>
</tr>
</tbody>
</table>

Source: Database compiled from national sources, interviews etc.

4. Ownership and control in the Baltic States and Slovakia

In this section we present some very preliminary results from the analysis of the data on ownership that has been gathered within the framework of the ECGN survey of ownership and control in accession countries. The purpose of the presentation is not to lay the ground for any far-reaching conclusions; rather to point to the areas where further research is warranted. The data used for the analysis consisted of the listed issues in the respective country. In Estonia the share issues traded on the Main List and Secondary List at the Tallinn Stock Exchange (TSE) have been included, a total of 22 issues.223 For Slovakia the issues included are those traded on the official list (13 issues) and the list of registered securities (31 issues) at end-1999, a total of 44 issues. For Latvia a total of 60 issues were targeted; the eight issues from the Official list, the 13 from the Second list and the 39 issues on the Free

222 The Securities Markets Commission (SMC), however, functions in the same way as in Latvia, although with two important exceptions: (i) it gets full data on voting blocks and stakes which in Latvia is reported only by selected shareholders/issuers; and (ii) it has this data in a cumulative format from the moment the Large Holdings Directive was transposed (1997). Thus there are two sources of cumulative data, NSEL for direct stakes, and the SMC for voting blocks.

223 The two lists differ mainly with regard to requirements for capitalisation, diversification and track-record. With regard to market capitalisation the requirement is for 300 and 10 mn EEK for the Main List and Secondary List companies, respectively. With regard to diversification and track record the corresponding limits are 1000 (or 300 with min. 10,000 EEK worth of equity) and 100 investors and three and two years of audited financial reports, respectively. A basic requirement for both lists is that the issue is registered with the Central Depository, the Securities Commission and that one-quarter of the issue should be in public circulation.
list. For Lithuania, finally, six issues from the Official list and 41 issues from the Current list i.e. a total of 47 issues, were targeted.

For the four countries in total this means that 173 issues were targeted. However, varying data availability among countries has resulted in the fact that the total amount of issues included in the actual statistical analysis was only 144. As can be seen in Table 5, data for the listed issues has been most readily available in Estonia where only one issue was missing and the least available was in Latvia where only 72 per cent of the targeted issues were included in the final analysis. Further work will be required to fill these gaps.

Table 5. Ownership data availability (direct stakes) among listed issues, end-1999

<table>
<thead>
<tr>
<th>Country</th>
<th>Targeted issues (no.)</th>
<th>Included issues (no.)</th>
<th>Included issues (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>44</td>
<td>34</td>
<td>77.3%</td>
</tr>
<tr>
<td>Estonia</td>
<td>22</td>
<td>21</td>
<td>95.5%</td>
</tr>
<tr>
<td>Latvia</td>
<td>60</td>
<td>43</td>
<td>71.7%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>47</td>
<td>46</td>
<td>97.9%</td>
</tr>
<tr>
<td>Total</td>
<td>173</td>
<td>144</td>
<td>83.2%</td>
</tr>
</tbody>
</table>

Source: Database based on national sources; own calculations

These preliminary analyses have focused on a narrow range of issues. Firstly, we wanted to get an idea about the degree of ownership concentration that prevails. Secondly we wanted to find out whether there are any significant differences between countries and market segment in this respect. Thirdly we wished to see if it was possible to find any significant trends over time; which has only been possible (so far) with regard to Slovakia and Estonia. Finally, we wanted to get an idea about what type of owners that dominate in the respective countries.

Ownership concentration. As can be seen from the data, the level of ownership concentration is indeed very high. Looking at the direct stakes held by the largest, second largest and third largest individual owner at end-1999/early 2000 (Table 6), and comparing it with data on blockholdings in a number of European Union member states (Table 7), we can see the degree of ownership concentration. Beginning with the most extreme example, Estonia, even the median largest direct stake is larger than any of the reported voting blocks among the countries in Table 7. As for the other countries, the degree of ownership concentration is also apparently very high.
Table 6. Size of the largest, 2nd largest, 3rd largest direct capital stake for the listed companies

<table>
<thead>
<tr>
<th>Country</th>
<th>No of Co.’s</th>
<th>Median Largest</th>
<th>Median 2nd</th>
<th>Median 3rd</th>
<th>Cum. 1st-3rd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>34</td>
<td>39.4</td>
<td>18.84</td>
<td>10.29</td>
<td>68.53</td>
</tr>
<tr>
<td>Latvia</td>
<td>43</td>
<td>51.26</td>
<td>7.68</td>
<td>4.8</td>
<td>63.74</td>
</tr>
<tr>
<td>Estonia</td>
<td>21</td>
<td>52.64</td>
<td>12.57</td>
<td>6.28</td>
<td>71.49</td>
</tr>
<tr>
<td>Lithuania</td>
<td>46</td>
<td>42.24</td>
<td>11.36</td>
<td>8.24</td>
<td>61.84</td>
</tr>
</tbody>
</table>

Source: Database compiled from national sources; own computations

Furthermore, if one looks at the median size of the second largest direct stake we find that these owners are on average considerably stronger than would be the holder of the second largest voting block in the European Union member countries listed in Table 7. In this context, it should once again be stressed that the data on the Baltic countries and Slovakia do not give a picture of the real control of firms – it is indeed possible that there in many cases is some types of implicit or explicit collusion between the holders of the larger stakes in a company. By way of illustration, we have therefore calculated the cumulative stakes held by the three largest owners and compare that with the size of the voting blocks. Although imprecise and certainly in many cases inappropiate it still gives an idea of the potential ownership concentration that could be found were case data on blockholdings available. To draw any conclusions in that direction, however, further data collection is needed; but even if figure on blockholdings cannot be found it is likely that our understanding of the real meaning of the reported direct stakes could be enhanced by means of case studies of individual companies and groups of companies.

Table 7. Size of the largest, 2nd largest, 3rd largest ultimate voting block for non-financial companies on an official market

<table>
<thead>
<tr>
<th>Country</th>
<th>No of Co.’s</th>
<th>Median Largest</th>
<th>Median 2nd</th>
<th>Median 3rd</th>
<th>Cum. 1st-3rd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>50</td>
<td>52</td>
<td>2.5</td>
<td>N/A.</td>
<td>54.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>121</td>
<td>50.6</td>
<td>N/A.</td>
<td>N/A.</td>
<td>50.6</td>
</tr>
<tr>
<td>Germany</td>
<td>374</td>
<td>52.1</td>
<td>N/A.</td>
<td>N/A.</td>
<td>52.1</td>
</tr>
<tr>
<td>Spain</td>
<td>193</td>
<td>34.2</td>
<td>8.9</td>
<td>5.2</td>
<td>48.3</td>
</tr>
<tr>
<td>France</td>
<td>40</td>
<td>20</td>
<td>5.9</td>
<td>3.4</td>
<td>29.3</td>
</tr>
<tr>
<td>Italy</td>
<td>214</td>
<td>51</td>
<td>7.6</td>
<td>3</td>
<td>61.6</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>137</td>
<td>43.5</td>
<td>N/A.</td>
<td>N/A.</td>
<td>43.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>250</td>
<td>9.9</td>
<td>6.6</td>
<td>5.2</td>
<td>21.7</td>
</tr>
</tbody>
</table>


Differences among countries and/or market segment. As regards differences among countries this preliminary statistical analysis by means of analysis of variance (ANOVA) have shown no such statistically significant
differences at the 5 per cent level; at the 10 per cent level we can see a tendency that ownership is indeed more concentrated to the largest individual owner in Estonia as compared to Slovakia. As for the second largest owner, those owners in Slovakia (.05), Lithuania (.05) and Estonia (.10) have larger stakes than their Latvian counterparts. The same pattern repeats itself for the third and fourth largest owner. With regard to the fifth largest owner this type of analysis of variance has not been possible due to too small samples.

As for differences depending on upon which tier a specific company is listed we find no general pattern that is valid across all four countries. Looking at the individual countries, the one country where significant differences are traced is Latvia. For example, we found that the largest owner among companies on the Official List (1st tier) has a significantly (.05) smaller stake than the largest owner in a company listed on the Free list (3rd tier). Also, looking at the cumulative stake held by the two and three largest owners of direct stakes the same pattern repeats itself.

Ownership over time. Looking at the developments over time it is interesting to find that there has actually been a statistically significant trend towards increased ownership concentration over the period in question in both Estonia and Slovakia when looking at the stakes held by the largest and second largest owners (see Figure 3). In both countries there is initially a slight decrease in the level of ownership concentration in the first period following privatisation and the listing of the companies, after that however the trend is for a steady increase.

Figure 3. Ownership concentration over time: the per cent of capital held by the one and two largest owners in Estonia (EST) and Slovakia (SR), 1993-2000.
Type of owners. An analysis of the type of owner shows that in the region as a whole domestic owners dominate. However, it is clear that foreign ownership of listed issues is far more frequent in Lithuania and, above all, Estonia. In the latter foreign legal subjects dominate among the five largest owners, with the exception of the third largest direct stake holder where there is an equal number of domestic legal entities. In Lithuania foreign legal entities are approximately as frequent as domestic legal entities among the largest and second largest owners; among the third and fifth largest they dominate, only as the fourth largest owner does the count for domestic legal entities outnumber the foreign. In Slovakia and Latvia, though, domestic owners outnumber foreign owners by a wide margin. It can also be noted that only in Latvia do real persons constitute a significant presence among owners, by far outnumbering legal entities among the fourth and fifth largest owners (and almost equal among the third largest owner).

Table 8. Relative frequency (%) of foreign legal owners in four countries

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Slovakia</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Largest</td>
<td>11.8</td>
<td>57.1</td>
<td>15.0</td>
<td>40.4</td>
</tr>
<tr>
<td>Second largest</td>
<td>6.9</td>
<td>61.1</td>
<td>11.9</td>
<td>40.0</td>
</tr>
<tr>
<td>Third largest</td>
<td>26.1</td>
<td>46.2</td>
<td>8.1</td>
<td>42.3</td>
</tr>
<tr>
<td>Fourth largest</td>
<td>6.7</td>
<td>50.0</td>
<td>15.1</td>
<td>33.3</td>
</tr>
<tr>
<td>Fifth largest</td>
<td>0.0</td>
<td>66.7</td>
<td>3.4</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Source: Database compiled from national sources; own computations

5. Conclusions

An interesting question is why there has been such a reluctance to fully implement the Large Holdings Directive (88/627/EEC) when it apparently holds the promise of at least partially improving the situation on the capital market – an issue which policy makers at least officially put high on the agenda in all the countries concerned? We are not in any position to give any definite answer to this question – we may, however, speculate about some of the possible reasons.

One reason that has been voiced by representatives of the supervisory authorities in Estonia, Slovakia and to some extent Latvia, is the problems of actually obtaining and verifying such data on control-structures. Enforcement will indeed always be a problem, although it should not be used as an argument of not even trying to implement the adequate regulations. As the experience of Lithuania shows it is no reason not to even try. In Lithuania there are in fact indications that the implementation and effectiveness of
the directive is gradually improving; in 1997 only 554 block-holdings were reported, while in the figure doubled in 1998 to 1,005 and in 1999 increased to 1,294 notifications.

Another reason, perhaps more plausible, has been aired by officials in Slovakia and Estonia during more informal conversations, that the reluctance is due to the fact that nobody (with an influence) is really interested in finding out/making public who controls what. In the case of Slovakia this latter argument has to be understood in the light of the privatisation policy pursued which was very corrupt and gave rise to complicated cross-holdings and industrial conglomerates controlled by individuals with close ties to the (Meciar) government(s). In Estonia officials have offered similar possible explanations, pointing out that during the drafting of the new Securities Act it was the dominant market actors (i.e. banks) which pushed for allowing nominee-accounts to be set up also in the country – an effective way of making ownership and control more non-transparent. Thus, given that privatisation generally was a very politically sensitive process – leading to the build-up of pyramidal industrial holding structures (often with political connections) and off-shore ownership – there is little surprise that one finds serious resistance against real disclosure to the public.

To conclude it should be pointed out that legal reforms are very difficult. In fact, one reason for the non-implementation could well be that there is a lack of understanding of the implications of the directive. Also, the process is made more difficult by the fact that changing regulations often entails consecutive rounds of changes and involves many different agencies. The problems, however, are magnified when legal tradition requires that much of the regulations are formalised in primary law. In this context it would be beneficial – at least with regard to capital market regulation, which aims to regulate a quickly changing environment – if the primary laws were revised with an ambition to make them more general (and thus perhaps more long-lasting), instead leaving more of the detailed regulation either to secondary legislation (e.g. government decrees) or to appointed supervisory authorities (e.g. as in the case of Lithuania).

However, a number of reasons support the continued work toward regulatory harmonisation. In addition to the obvious, and rather instrumental, reason that lies with meeting the European Union requirement of full adoption of the Acquis Communautaire the need for regulatory harmonisation in the field of capital market regulation is a very real one, namely to tackle the acute problems relating to the lack of transparency. In this context it may be noted that it is not so much a question about developing the ‘perfect’ regulations – it is more important that regulations are somewhat in conformity

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with other countries if these markets are to attract foreign investors. Or, as stated in a report presented at the Baltic Development Forum Summit in September, “what matters is not so much what the rules are but more that they are the same” and therefore “legislators should as a minimum implement existing EU regulation.”\(^{225}\)

At the same time, however, one has to recognise the fact that at some markets, as a consequence of the privatisation schemes chosen, a large number of issues that currently are at least nominally public either ‘do not belong’ on the market since they are too small and illiquid and/or ‘do not belong’ on the market because the issuer in question has not put this issue on the market of his free will. The latter is for example reflected in the very low adherence to reporting requirements that is exhibited in the Slovak Republic where in 1997 only one-third (33%) of issuers of publicly tradable securities fulfilled their reporting obligations to the Ministry of Finance, half of them (50.8%) to the BCPB and some nine-tenths (90.3%) of them fulfilled it with regard to the alternative organised market, RM-Systém.\(^{226}\)

Thus, in combination with more stringent reporting standards it may be advisable to devise mechanisms for the orderly ‘delisting’ of those issues that do not belong on the market. Such provisions, however, must clearly take into account the fact that many small shareholders from mass-privatisation still remain – it is thus important that these shareholders do not get disenfranchised with the capital market again – the latter would be counterproductive to enhancing the public confidence in capital markets.

As for the quantitative results provided in this paper there is little surprise to find that ownership is highly concentrated. The concentration of ownership was often a direct consequence of the privatisation policies deployed – and the vast majority of firms listed on the stock exchanges are direct/indirect heirs of formerly state-owned enterprises. In most countries a majority of the firms were indeed sold to strategic investors, and also in countries which used mass privatisation by means of vouchers (Slovakia and Lithuania) it was rather rule than exception to see a quick restructuring and concentration of ownership following privatisation.

What perhaps is somewhat surprising is the high level of ownership concentration and even more the increase in ownership concentration in recent years. The high level of ownership concentration could in itself probably be explained in terms of insecure property rights and high transaction costs. However, if this proposition is accepted one would also expect to see that the level may decrease as the legal environment improves – yet this has apparently not been the case. Thus, either the legal environment has not im-

\(^{225}\) Clausen et al. (2000), p. 6.

\(^{226}\) See, Ministry of Finance of the Slovak Republic (1999), Section 3.1.
proved in the same way with regard to capital market regulation as has previously been thought or there are other mechanisms at work. In this context it is interesting that the available data point to the fact that the division between ownership (equity) and control (votes) in these four countries is smaller than in some of the EU ones. Having developed company laws only recently, the transition countries have avoided the complexity of developing a variety of corporate forms and legal devices. Our speculation is that the difference between ownership and control does exist, not through traditional legal mechanisms, but through pyramidal structures with varying legal forms, offshore ownership, with informal co-operation between owners and directors.

References


Interviews

Below are listed all those interviewed persons who have contributed to increase our understanding of the issues relating to transparency and the functioning of the securities markets and its regulations, irrespective if directly cited or not.


Appendix A. Off-shore holdings: the current structure of the Ave Lat Grupa

The very recent example is that of the restructuring of one of the largest holding companies in the food processing sector -Ave Lat Grupa. This holding company has been of a significant interest to the journalists, who often perform the function of what the SMC should do – informing the public of the ultimate control of the enterprises. Ave Lat Grupa has gone through several ownership changes – being under control of former Prime Minister Andris Skele, Prime minister at the time. Apparently, Skele’s shares were transferred to Bolster Management under a trust arrangement. The company itself was renamed into New Technology and Business Development Corporation (NTBDC).

In August this year, the company announced the following change: the company sold three of its holdings Ave Lat Sargs, Riga Milk Factory and Laima. The new owners of these three companies are three new unlisted companies NTBDC S, NTBDC P, and NTDBC L respectively. The owner of these new companies is the same (Bolster Management Limited) as the former Ave Lat Grupa – currently named NTBDC as mentioned above. Hence, through this sale, the ownership of the companies which previously were under control of Ave Lat (NTBDC) are now at the same ‘level’ as the former holding company. It will now remain unclear who will own these companies, plus they need not file consolidated accounts and adjust their market behaviour (pricing policy). The current structure of the Ave Lat looks the following:

Ave Lat Grupa is a private Joint Stock Company. Hence, although governed by the law on “Joint Stock Companies”, it does not have to comply with the Transparency Directive. Hence, the presented here ownership information is the only picture the public can get.
However, with introduction of the new Commercial Code (arguably on January 1), the law “on securities” will be applicable to all JSC companies. In other words, the distinction between private and public companies will disappear. However, the reporting burden will still lie with the Bolster Management in case it has the voting power (as the current trust arrangement suggests).
## Appendix B. Ownership concentration in four countries among the five largest owners of listed companies

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>n</th>
<th>Min</th>
<th>Max.</th>
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<td>Largest owner, average for the four countries</td>
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<td>6.2</td>
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<td>18.8</td>
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<td>98.2</td>
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<td>2nd largest owner, average for the four countries</td>
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<td>1.0</td>
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<td>15.5</td>
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*Source:* Database compiled from national sources; own computations
Efficiency and technical trading profitability: evidence from US and Chinese equity markets

1. Introduction

Technical analysis uses past prices in an attempt to predict future prices. Although the vast majority of the professional traders use technical analysis, most academics, until recently, did not recognize the validity of these methods. They prefer the much more theoretical fundamental analysis. However, since the article of Brock, Lakonishok and LeBaron (1992), showing that simple forms of technical analysis contain significant predictive power for US equity index returns, many studies in the finance literature have investigated technical analysis to determine its validity as an investment tool. Among others, based on the same universe of 26 trading rules, however, Bessembinder and Chan (1998) argued that although the technical trading rules do have predictive ability in US data, their use would not allow investors to make excess returns in the presence of costly trading.

Technical trading rules, while many and varied, aim in general to identify the initiation of new trends. Some of the simple rules include filter rules (buy when the price rises by a given proportion above a recent trough), trading range breaks (buy when the price rises by a given proportion above a recently established trading range) and moving average crossovers (buy when a shorter moving average penetrates a longer moving average from below). For each rule, the analyst chooses the time horizon over which troughs and peaks are to be identified and moving averages calculated, as well as the threshold before a decision is made (Beechey et al., 2000).

Most of these technical trading rules are simple and fairly inexpensive to implement. One would therefore not expect such rules to generate excess profits in an efficient market. Most academic studies of technical analysis, including Fama and Blume (1966) and Jensen and Benington (1970), conclude that technical analysis is not useful. In the last few years, increasing evidence that a relatively simple set of technical trading rules possess significant forecast power for equity returns has renewed interest in technical analysis (Brock et al., 1992; Hudson et al., 1996). Bessembinder and Chan (1998) further investigate and provide interpretation for the intriguing Brock
et al. finding. Undertaking additional empirical analysis of the same technical rules examined by Brock et al., Bessembinder and Chan (1998) document that the forecast ability is partially, but not solely, attributable to return measurement errors arising from nonsynchronous trading. They argue that the evidence supporting technical forecast power need not be inconsistent with market efficiency. ‘Break-even’ one-way trading costs are computed to be 0.39 per cent for the full sample and 0.22 per cent since 1975, which are small compared to recent estimates of actual trading costs.

However, these methods of testing for successful technical trading rules were considered to suffer from the potential problem of data mining because the rules are imposed ex post by the testers. The possibility that bias in choice of rule remains. Skouras argues that Brock’s ‘single’ arbitrarily selected rule found to be effective lacks justification given that real technical analysts use different rules in different times and in different markets (2001, p. 214). He further argues that these limited rules are chosen according to non-rigorous and often implicit criteria makes results drawn from them subject to standard data-mining criticisms, which diminish their forcefulness. Theoretically this could be a problem that would be avoided if the rules considered are the choices of an Artificial technical Analyst which are by construction explicit and can be expected to be robust with respect to reasonable variations in the agent’s design. The preferred strategy to test technical trading rules is to formulate the rules ex ante, thus eliminating potential bias (Fyfe et al., 1999) through the introduction of artificial intelligence techniques such as genetic algorithms. However, a degree of arbitrariness still remains in the selection of the rule class to be tested. In addition, the arbitrariness involved in the specification of learning schemes is an additional problem. Recently, Sullivan, Timmermann and White (1997) utilize White’s reality check bootstrap methodology to evaluate simple technical trading rules while quantifying the data-snooping bias and fully adjusting for its effect in the context of the full universe from which the trading rules were drawn (Sullivan et al., 1997).

Our paper focuses on different issues mainly the relationship between market efficiency and returns on simple trading rules and the relationship between different efficient equity markets with richer background, while we have run the bootstrap tests to largely fix the data-snooping problem. While there is no perfect solution to arbitrariness of selection of rules or rule class, this paper focuses on simple technical trading rules which are fairly inexpensive to implement. The paper tests the hypothesis that these simple rules should not generate excess profits in an efficient market. Therefore, moving averages and trading breakout rules should be a good selection for the test. A solution to the problems of too few rules which are arbitrarily selected and tested by Brock et al. and Bessembinder and Chan is offered by in-
including most rules which are possibly implemented by traders. We actually exhausted all rules until that the rule generates few trades. We realize that our list of 412 trading rules does not completely exhaust the set of rules that were considered historically, such as channel break-outs, on-balance volume averages etc. However, our list of rules is vastly larger than those compiled in previous studies and we actually focused on these simple rules, which can be implemented by normal investors without additional costs.

We also evaluate the possibility that the return forecastability documented by Brock et al. could simply reflect measurement errors in portfolio returns arising due to nonsynchronous reporting of prices which induces spurious positive autocorrelation in index price change (Scholes and Williams, 1977). The technical trading rules we evaluate exploit positive serial dependence. Typically, the technical rules initially emit a buy (sell) signal on a day characterised by an unusually large upward (downward) market movement. The partial adjustment of index values resulting from nonsynchronous trading of the component securities implies that the measured next day return will tend to be biased in the same direction as the prior day price change. This bias implies that profits from the technical rules will tend to be overstated. As a simple control for the effects of nonsynchronous trading, we compare buy and sell day returns while implementing a one-day lag between the initial emission of a signal and the resulting trade.

2. The technical rules and measurement of returns

We first describe the technical rules evaluated by Brock et al. and Bessembinder and Chan and address some issues related to these rules chosen by these authors.

2.1 Technical rules

Two of the simplest and most popular classes of technical trading rules, moving average crossover rules and trading-range breakout rules, are examined by both Brock et al. (1992) and Bessembinder and Chan (1998). These 26 trading rules include ten variable-length-moving-average (VMA) rules, ten fixed-length-moving-average (FMA) rules, and six trading-range-break (TRB) rules. The moving average rules involve comparison of a short-term moving average of prices to a long-term moving average. Buy (sell) signals are emitted when the short-term average exceeds (is less than) the long term average by at least a pre-specified percentage band. The most popular moving average rule is considered to be 1-200, where the short average is one day (today’s price) and the long average is 200 days. Other
variations that they evaluate include 1-50, 1-150, 5-150, and 2-200. Each rule is evaluated with bands of 0 and 1 per cent, making for ten moving average combinations in total. Once a single is emitted, VMA rules call for the position to be maintained until the short and long moving averages cross again, while FMA rules hold the position for a fixed number of days. Bessembinder and Chan evaluate FMA strategies with fixed holding periods of ten and thirty days.

Trading range break rules involve comparing the current price to the recent minimum and maximum. TRB rules emit buy singles when the current price exceeds the recent maximum by at least a pre-specified band, and emit sell signals when the current price falls below the recent minimum by at least the pre-specified band. Bessembinder and Chan and Brock et al. both evaluate separate TRB rules over the period 50, 150 and 200 days, respectively. They use bands of 0 and 1 per cent, making for a total of six TRB combinations.

Skouras argued that these arbitrarily selected rules found to be effective lack justification given that real Technical Analysts use different rules in different times and in different markets (Skouras, 2001, p. 214). Based on the literature of charting, we found simple trading rules implemented by traders and practitioners are much more than only these 10 VMA and 10 FMA rules, including variations and modifications of moving average crossover rules. For example, usually more than one moving average is used to emit trading signals instead of only one moving average (cross-over with a current stock closing price [such as 1-50, 1-150 and 1-200]). Buy and sell signals can be generated by cross-overs of a slow moving average by a fast moving average, where a slow MA is calculated over a greater number of days than the fast MA.

There are two types of filters we will impose on the moving average rules and trading break. The filters are said to assist in filtering out false trading signals (i.e. Those signals that would result in losses). The fixed percentage band filter requires that the buy or sell signal exceed the moving average by a fixed multiplicative amount, b. Traders may not only use bands of 0 and 1 per cent but also use some higher bands, such as 2 per cent. More importantly, arbitrarily determined fixed 10-day holding period for FMA is most unreal. We consider holding a given long or short position for a pre-specified number of days, c, which are based on previous academic studies and the technical analysis literate.

Among the eighty-four VMA rules that we evaluated, we find that the rule with the highest break-even costs (1.52%) is (short mv=13, long mv=200, band=0%), which is much higher than the eighty-four-VMA rule portfolio’s average break-even costs (0.514%) (see Table 1). The FMA rule with the highest break-even cost actually is (short mv=7, long mv=20,
band=1%, holding period=50 days). Its break-even cost is 5.6 per cent compared with 0.13 per cent of the one for the average 288-FMA-rule portfolio. It is important to note that neither of these rules are the ones selected by Bessembinder and Chan and Brock et al. To avoid any arbitrary selection of these simple rules, we include most of the rules, which generate at least few trades during the period concerned.

In this paper, for VMA rules, short-term moving averages include 1, 4, 7, 10, 13, 16 and 19 days, while long-term moving averages consist of 50, 100, 150 and 200 days. Each rule is evaluated with bands of 0, 1 and 2 per cent, making for eighty-four variable-moving average combinations in total. For FMA rules, much more rules were included in our selection to reflect more realistically the situation in a trader’s world. Short-term moving averages include 1, 3, 5 and 7 days, while long-term moving averages include 50, 100, 150 and 200 days. We also include different holding days including 10, 15, 20, 25, 30, 35, 40, 45 and 50 days. Each rule is evaluated with bands of 0 and 1 per cent, making for 288 fixed moving average combinations in total. For Trading Range Break (TRB) rules, while the short term moving average is always only 1, the TRB range includes 50, 100, 150 and 200 days. We also include different holding days including 10, 20, 30, 40, and 50 days. Each rule is evaluated with bands of 0 and 1 per cent, making for 40 fixed moving average combinations in total.

2.2 Methodology

To evaluate the effect of transaction costs on the profitability of trading rules, we simulate a ‘double-or-out’ strategy. Under this strategy, an investor borrows to double the stock investment upon buy signals, sells stock to hold cash on sell signals, but holds a standard long stock position in the absence of a signal. Let $R_t$ denote the index return on day $t$ and $i_t$ is the daily risk-free interest rate and $r_t = R_t - i_t$ denote the index return excess of the interest rate. Let $\pi$ denote the additional (pre-trading cost) day $t$ return earned by a trader relying on technical rule $j$ as compared to that earned by an investor who passively holds the index. Under this strategy, a trader reacts to buy signals by borrowing money to double their equity investment. This gives a pre-transactions cost trading return on buy days of $TR_t = 2R_t - i_t$, which exceeds the buy and hold return by $r_t (= \pi^B)$. During sell signals, the trader reacts to sell signals by liquidating any equity holdings and purchasing interest bearing instruments, leading to sell day trading returns of $TR_t = i_t$, which exceeds the return from passively holding the index by $-r_t (=-\pi^S)$. On days where no signal is emitted the trader simply holds a long equity position, giving a trading return of $TR_t = R_t$, so $\pi = 0$. In the absence of
transaction costs, the additional return ($\pi$) earned by technical trading relative to a buy-and-hold strategy is given as:

$$\pi = _{-} TR_T - _{-} R_t = \pi^B + \pi^S = N_B \cdot r_B - N_S \cdot r_S$$

where $N_B$ is the number of days the double (buy) position is held, $N_S$ is the number of days the out (sell) position is held. Daily interest rate for these markets is not available to us. We approximate $\pi$ as:

$$N_B \cdot R_B - N_S \cdot R_S$$

where $R_B$ and $R_S$ are mean raw returns on buy and sell days, respectively. If $N_B$ differs from $N_S$, our excess profit measure will typically be biased. However Bessembinder and Chan (1998) noticed that for typical interest rates this bias is small relative to the magnitude of buy versus sell day returns.

Of course, a trader would incur transaction costs. Let $C$ denote the percentage one-way round-trip cost of buying and selling. For new signals that shift the position from ‘double’ to ‘out’ or vice versa, 200 per cent of the portfolio much be traded immediately. New trading signals that arrive while the trader is holding a standard long position generate a trading most of $c\%$, plus another $c\%$ when the position is eventually reversed. Let $N_i$ denote the number of position taken in response to newly emitted rule $j$ buy and sell signals during the sample interval. Accumulated trading costs exactly consume the excess return to using technical rule $j$ instead of buy-and-hold if $\pi = 2 \cdot N_i \cdot C$, so the break-even one-way trading cost for rule $j$ is $C_i = \pi_i / N_i$.

3. Empirical results

Brock et al. emphasize the danger of obtaining spurious empirical results if trading rules are both discovered and tested in the same data set. They note that there is no complete remedy for ‘data-snooping’ biases, but attempt to mitigate the problem by using long data series and by reporting results for all rules evaluated. We therefore report results for all rules tested as follows. Meanwhile, we use bootstrap methodologies to assess the statistical significance of our various point estimates. We have run a hypothesis that $\pi^B + \pi^S = 0$, which states that the technical rules in the aggregate have no predictive power for returns. If the hypothesis that the technical rule as a group possesses no forecast power cannot be rejected statistically based on our extended rules, then the conclusion made by previous authors that technical trading rules possess forecast power for US markets should be rejected at first place.

In Table 1, we report returns to technical trading, numbers of trades and break-even costs for 84 VMA rules and 84 VMA portfolio. The results for 288 FMA rules and 40 TRB rules will be provided upon request. Outcomes
of hypothesis tests for the full sample and for each individual rule and for portfolios is reported besides. P-values for the ‘Buy-Sell = 0’ hypothesis report the proportion of outcomes in 500 simulations where the buy-sell differential is as large as or larger than observed in the actual data. Technically we find annually excess return of buy or sell position by converting its relevant daily buy or sell return as follows:

Annual excess buy (sell) return = \exp(\text{mean daily buy (sell) return} \times 250 \times \text{proportion of buy (sell) position in a year}) – 1

This procedure should result in more accurate outcome than ones obtained by Bessembinder and Chan (1998) in which each total buy (sell) return has been annualised by dividing by the number of years in the sample. We find percentage break-even costs by dividing annual buy-sell return by trades per year for rule j. The columns labelled ‘Buy’, ‘Sell’ and ‘Buy-sell’ reflect the quantities the annual excess buy return, annual excess sell return and the difference between annual excess buy and sell return and break-even costs.

In Table 2, we report results for each of four sub-periods of approximately equal length (exactly the same as Bessembinder and Chan), 1926-1943, 1944-59, 1960-1975 and 1976-1991, the last of which is chosen to represent the period of reduced transaction costs following the deregulation of brokerage commissions in the US in May 1975. To economise on space, sub-period results are reported for portfolio but not individual rules. Table 1 and 2 report results obtained when trading returns are measured beginning with the closing index value that initially generate a signal, while in Table 3 we report portfolio results obtained when a one-day lag is imposed to allow for the effects of nonsynchronous trading. In both Table 2 and 3 we report returns to technical trading, number of trades and break-even costs from our test and ones from Bessembinder and Chan.

For the full sample, aggregation across all rules gives a buy-sell differential of 1.50 per cent per year, and \textit{ex post} break-even one-way transactions costs of 0.29 per cent, which is smaller than that (0.39%) of Bessembinder and Chan. \textit{Ex post} profitability and break-even costs vary across rules. As a group, the VMA rules provided the largest buy-sell return differential (5.12% p.a.), allowing the highest break-even costs (0.51% p.a.). The FMA

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\textsuperscript{227} Note that the reported returns are those that accumulated during periods when buy and sell signals were in effect, and that they do not represent annualised returns. As such, they reflect the relative scarcity of FMA signals. On average the FMA rules generated 1.72 signals per year, accompanied by an average 30-day holding period. Thus, no FMA signal is in effect during most of the 269 actual trading days per year. TRB has a similar situation with FMA. A trader relying on VMA rules would take a position most days; the only days a position is not taken are those where the short moving average differs from the long moving average by less than the pre-specified band.
and TRB rules generated buy-sell differentials of only 0.46 and 1.37 per cent per year, respectively, allowing break-even costs of 0.13 and 0.19 per cent, respectively. However, in the absence of ex ante reasons to prefer some rules, we view the break-even cost computed across all evaluated rules as providing the most appropriate benchmark. Imposition of a one-day lag reduces break-even costs aggregated across all rules from 0.29 to 0.22 per cent.

Break-even costs have declined over time substantially. Aggregated across all rules, the buy-sell differential for the 1926 to 1943 subsample was 3.3 per cent, which allowed break-even cost of 0.58 per cent. The annual buy-sell differential has declined to 0.80 per cent in the 1944 to 1959 interval, 0.94 per cent in the period between 1960 and 1975 and 0.45 per cent in the most recent 1976 to 1991 period. As a consequence, break-even costs declined continuously to 0.09 per cent for the most recent subsample. With a one-day lag imposed, break-even costs for the post-1975 sample become negligible, only 0.01 per cent. This number is substantially smaller than that (0.11%) obtained by Bessembinder and Chan. This result suggests that forecast ability is partially attributed to return measurement errors arising from nonsynchronous trading before 1975, and solely attributable to the return measurement errors for the post-1975 period.

Combining the estimates of effective bid-ask spreads and commissions give estimated one-way equity trading costs of 0.25 per cent plus market impact for institutional traders (Bessembinder and Chan) for the post-1975 period. This estimated trading cost is much higher than the ex post break-even costs for the most recent subperiod. The estimated one-way transaction cost of 1.35 per cent for the period between 1960 and 1975 is also higher than the ex post break-even costs for the same period, which are 0.20 per cent without any trading lag or 0.10 per cent if a one-day lag is imposed. There is no reason to believe that trading costs prior to 1960 were lower than earlier decades. We conclude that it is unlikely that traders could have used our extensive simple trading rules to improve returns net of trading costs comparing with those rules originally evaluated by Brock et al. and Bessembinder and Chan.

Table 4 and 5 reports mean break-even cost for the double-and-out strategies between US and Chinese stock markets. Despite the substantial recent growth of Chinese stock markets, as one of the most important emerging markets, their institutional structure has led some to question whether they are as informationally efficient as their US counterparts. The ownership of the majority of Chinese listed companies is concentrated in the hands of a small number of investors (legal person ownership), and the incidence of insider trading is relatively high. Also, requirements for financial disclosure are less stringent, leading to a scarcity of publicly available in-
formation. If Chinese stock markets are in fact relatively inefficient, technical analysis may be able to exploit the inefficiencies. We found that the rules are quite successful in predicting stock price movements in Chinese markets with excess annual return of 5.92 per cent, which allowed break-even costs of 1.31 per cent. However, this break-even costs is higher than the estimated actual trading costs of about 1.5 per cent during the 1990s. Nevertheless, aggregated across all rules, the buy-sell differential in Dow Jones Industrial Average for the same period was -0.33 per cent, which allowed break-even cost of -0.12 per cent.

4. Conclusions

Overall, for the period prior to 1975, we find that simple forms of technical analysis contain significant forecast power for US equity index. However, as Bailey et al. (1990) discuss, mis-pricings that are smaller than transactions costs need not be immediately eliminated even in an efficiency market. We argue that the evidence of technical forecast power need not be inconsistent with market efficiency. For the post-1975 period, we find no evidence at all supporting technical forecast power by these popular trading rules in the US market. In comparison, we find that these simple trading rules are quite successful in predicting stock price movements in Chinese markets and allowed traders to make possible excess profits in the 1990s, but it did not allow the average investors to make profits from it. Compared with Chinese markets, trading systems based on these simple trading rules does not work at all to beat the US index during 1990s. There are a number of reasons these trading systems fail.

A large part of the failure of such approaches likely has to do with increasing market efficiency in US markets. The 1990s witnessed the growth of two important forces: personal computers and discount brokerage commissions. The personal computer lets individuals learn about and act quickly upon statistical patterns in price and volume data. Cheap trading, particularly online, has allowed investors to exploit technical strategies far more easily. Of course, as more investors try their hands at technical analysis, trying to take advantage of pricing anomalies, the anomalies evaporate and the strategy loses its advantage. That is market efficiency at work. One example of this is the classic moving average crossover systems. The premise is that the system is a trend-following system and you buy when the short-term average crosses above the long-term average and sell when the short-term average crosses below the long-term average. The problem with this premise is that the market only trends about 10 to 20 per cent of the time and spends the rest of the time in narrow ranges. If we look more
closely at cycle theory, the moving average crossover system will be 180 degrees out of phase with the market if we use a half-cycle and full-cycle length moving averages. This means the system will be buying when it should be selling and vice versa. When the half-cycle average crosses the full cycle average, the market is topping, and the opposite is true at bottoms (Ruggiero, 2001).

References


Table 1: Annual Returns, Break-Even Trading Costs: Technical Trading Rules (84 Variable moving average rules) Implemented on DJIA Stocks from 1926-1991, No Trade Lag

<table>
<thead>
<tr>
<th>(Item1, Item2, factor)</th>
<th>Buy</th>
<th>Sell</th>
<th>Buy-Sell</th>
<th>Trades per year</th>
<th>Breakeven Costs</th>
<th>Bootstrap P-Values</th>
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| 288 FMA Rules         | 0.47| -1.05| 1.53    | 1.95            | 0.39                | 0.008             | 0.29            |
| 40 TRB Rules          | 1.72| -1.47| 3.18    | 4.15            | 0.38                | 0.006             | 0.43            |
| All 412 Rules         | 1.43| -1.89| 3.32    | 2.88            | 0.58                | 0.000             | 0.54            |
| 1944-1959             |
| 84 VMA Rules          | 6.51| 1.82 | 4.69    | 4.79            | 0.49                | 0.018             | 0.59            |
| 288 FMA Rules         | 0.70| 1.08 | -0.38   | 1.59            | -0.12               | 0.004             | 0.14            |
| 40 TRB Rules          | 2.66| 1.50 | 1.16    | 3.11            | 0.19                | 0.000             | 0.18            |
| All 412 Rules         | 2.07| 1.27 | 0.80    | 2.39            | 0.17                | 0.000             | 0.39            |
| 1960-1975             |
| 84 VMA Rules          | 2.44| -0.80| 3.23    | 4.68            | 0.35                | 0.004             | 0.52            |
| 288 FMA Rules         | 0.20| -0.05| 0.25    | 1.58            | 0.08                | 0.658             | 0.30            |
| 40 TRB Rules          | 0.75| -0.39| 1.14    | 3.20            | 0.18                | 0.021             | 0.10            |
| All 412 Rules         | 0.71| -0.23| 0.94    | 2.37            | 0.20                | 0.000             | 0.36            |
| 1976-1991             |
| 84 VMA Rules          | 3.79| 2.66 | 1.13    | 5.15            | 0.11                | 0.018             | 0.40            |
| 288 FMA Rules         | 0.95| 0.56 | 0.39    | 1.72            | 0.11                | 0.008             | 0.28            |
| 40 TRB Rules          | 0.73| 1.29 | -0.57   | 3.70            | -0.08               | 0.654             | -0.20           |
| All 412 Rules         | 1.51| 1.06 | 0.45    | 2.61            | 0.09                | 0.000             | 0.22            |
### Table 3. Annual Returns, Break-Even Trading Costs: Technical Trading Rules Implemented on DJIA Stocks from 1926-1991, One-day Trade Lag

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<th>Break-Even Costs(%)</th>
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Table 4. Annual Returns, Break-Even Trading Costs: Technical trading rules implemented on DJIA Stocks compared with Chinese stocks during 1991-2000, No Trade Lag

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Table 5. Annual Returns, Break-Even Trading Costs: Technical trading rules implemented on DJIA Stocks compared with Chinese stocks during 1991-2000, one-day Lag

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<tr>
<td>84 VMA</td>
<td>15.27</td>
<td>-2.67</td>
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<td>-0.37</td>
<td>1.84</td>
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<tr>
<td>40 TRB</td>
<td>12.87</td>
<td>1.73</td>
<td>11.14</td>
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<tr>
<td>Total 412 Rules</td>
<td>5.40</td>
<td>-0.63</td>
<td>6.03</td>
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<td>ShenZhen B</td>
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<tr>
<td>40 TRB</td>
<td>7.61</td>
<td>-11.37</td>
<td>18.98</td>
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<tr>
<td>Total 412 Rules</td>
<td>6.81</td>
<td>-7.26</td>
<td>14.08</td>
</tr>
<tr>
<td>China Portfolio</td>
<td>7.05</td>
<td>-3.27</td>
<td>10.32</td>
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Appendix: Trading Rule Parameters

This appendix describes the parameterisations of the 412 trading rules used to generate the full universe of rules under consideration.

<table>
<thead>
<tr>
<th>A. Variable Moving Averages</th>
<th>B. Fixed Moving Averages</th>
<th>C. Trend Range Band (TRB) support and resistance</th>
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<tr>
<td>N = fast moving average</td>
<td>N = fast moving average</td>
<td>n = number of days in the support and resistance range</td>
</tr>
<tr>
<td>M = slow moving average</td>
<td>M = slow moving average</td>
<td>b = fixed band multiplicative value</td>
</tr>
<tr>
<td>B = fixed band multiplicative value</td>
<td>C = number of days a position is held, ignoring all other signals during that time</td>
<td>c = number of days a position is held, ignoring all other signals during that time</td>
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</tbody>
</table>

N = 1, 4, 7, 10, 13, 16, 19 [7 values]  
M = 50, 100, 150, 200 [4 values]  
B = 0, 0.01, 0.02 [3 values]  
There will be a combined VMA 84 rules

N = 1, 3, 5, 7 [4 values]  
M = 50, 100, 150, 200 [4 values]  
B = 0, 0.01 [2 values]  
C = 10, 15, 20, 25, 30, 35, 40, 45, 50 [9 values]  
There will be a combined FMA 288 rules

N = 50, 100, 150, 200 [4 values]  
b = 0, 0.01 [2 values]  
c = 10, 20, 30, 40, 50 [5 values]  
There will be a combined 40 TRB rules
Money and Finance in Transition
Research in contemporary and historical finance

Economics is today undergoing important shifts in focus and theoretical orientation. In part, this has been a response to the need to address changing economic circumstances, including the collapse of communism and transition to market, globalisation and financial volatility. In addressing these problems, economists have also been forced to re-open many long held principles and approaches. This book is a collection of essays addressing themes that are part of that process of critical re-evaluation: exchange rate regimes, internationalisation of investment, and the economics of transition. The book brings these issues together in a way that draws out some of the common themes and issues as well as the current frontier of research in each area. It will be of interest to economists as well as those interested in the way economics as a discipline has been addressing important questions about the world we are living in as well as how history can help us to understand it.

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