Volume 44

Progress in Economics Research

Albert Tavidze
Editor

NOVA

PROGRESS IN ECONOMICS RESEARCH

VOLUME 44

PROGRESS IN ECONOMICS RESEARCH

Additional books and e-books in this series can be found on Nova's website under the Series tab.

PROGRESS IN ECONOMICS RESEARCH

VOLUME 44

ALBERT TAVIDZE
EDITOR

nova science publishers
New York

Library of Congress Cataloging-in-Publication Data

ISBN: 978-1-53618-282-8 (eBook)
ISSN: 1549-1552

Published by Nova Science Publishers, Inc. † New York

CONTENTS

PREFACE

Progress in Economics Research. Volume 44 begins with an analysis of the influence of the economic crisis of the year 2008 on the consumption of “affordable luxuries” through an examination of the sales and market performance of different product categories.

Following this, the authors assess an approach for reshaping the institutional basis for regional economic progress inspired by ongoing national economic reforms in present-day Ukraine. The theoretical basis for conclusions is drawn from the modern theory of new institutionalism.

An in-depth analysis of energy efficiency in the South Caucasus region is provided, identifying two basic problems: incompatible legislation and incompatible consumer tariffs.

Continuing, this compilation reviews the de-risking experience of several Caribbean countries. Some considered solutions include utilizing the correspondent banking relationship of domestic Central Banks, strengthening domestic regulatory and legislative framework to reduce risk perception, and lobbying at the regional level to raise awareness.

The authors also address the importance of public procurement in spending public funds, which has a high impact on the development of the private sector.

The conclusion raises questions regarding whose GDP should be optimized in a global economy, whose employment level should be addressed, and how this new stage in world development will look.

Chapter 1 - During economic downturns marketers challenge new consumption behavior patterns, since consumers shift their purchasing habits during recessions, reduce their expenditure and look for cheaper products. In other words, in hard times, consumers may spend less on holidays, home appliances or electronic devices. From a rational economic perspective, such changes in purchasing patterns are quite logical, since consumers are engaging in a behavior to conserve resources in an environment of scarcity. However, a deeper examination of consumer spending behavior indicates that not all spending behavior in economic downturns is consistent with rational behavior. Even though spending on the majority of consumer goods during the recent economic recession declined, one specific product category experienced surprising growth: beauty products. This trend is known as the "lipstick effect" suggesting that lipstick sales were inversely correlated to the economy performance. The "lipstick effect" can be traced back to the Great Depression of the 1930s, when the US industrial production halved, but sales of cosmetics rose. Further, there is some evidence of the increase of sales of some product categories during the recent economic crisis, as substitutes for more expensive items. Interestingly, a number of product categories emerged as "affordable luxuries" since the economic crisis of the year 2008 such as beauty and personal care products like nail enamel, eye mascara or hair dyes. This fact indicates that the "lipstick effect" term may no longer be applicable to the lipstick itself, but to a wider range of product categories over time, that today includes some food items such as confectionery, chocolate, premium ice-cream or even smoothies. In this context, the main goal of the present study is to analyze the influence of the economic crisis of the year 2008 in the consumption of "affordable luxuries"; and for this purpose the sales and market performance of different product categories is examined. Findings show that in times of economic downturn, marketers should focus on products and services that consumers can afford ant that provide them positive emotions, pleasure and hedonism, improving their quality of life and well-being in a recessionary context. That is, the psychological nurturing provided by these “affordable luxuries” that increase consumers’ feelings of pleasure and happiness may the main explanatory factor for the “lipstick effect.” The emotional gratification and affordable prices of these “affordable *luxuries*” may be the key factor underlying the recession-proof items.

Chapter 2 - Problem statement. In the last 3-4 years, Ukraine has demonstrated its impressive pace of reforms and social modernization. This country has accumulated a gigantic public demand for a significant modernization of public administration methods: from people in power to numerous institutions of governance and economic liberalization in virtually everything. As a consequence, being in a volatile external environment heated by active national reforms, such as decentralization, the Ukrainian regions are forced to constantly adapt their economic policies, institutional structures and competencies. Chapter objective is to design and justify the authentic approach to reshaping the institutional basis for regional economic progress inspired by the ongoing national economic reforms to further implement it in the present-day Ukraine. Methods applied and chronology. An empirical part of the chapter was compiled by the results of the author’s all-Ukrainian expert survey on the issues of the economic policies of the Ukrainian regions in 2017-2018. The theoretical basis for conclusions obtained is drawn from the modern theory of new institutionalism, as well as the complex approach and synthesis and induction as scientific methods. Structure. The chapter consists of 8 parts: Introduction, Definition of key notions, Description of the empirical background, “Ukrainian decentralization and the “new normal” for regional economic growth,” “Decentralization prioritizes the individual. Will the Ukrainian regions be able to cope with their problems and to upgrade?”, “Institutional renewal of the basis for economic policy modernization: proposals for Ukraine and ideas for other emerging democratic countries,” Conclusions, and References. Connection with previous studies. The chapter is logically linked to the author’s methodology for renewal of the Ukrainian regional economic policy, already published in Volume No 41 (2018), and develops it, expanding its institutional structure and frame as an essential element. The resulting methodology is believed to be universal, and findings can be relevant for many developing countries. Chapter general characteristics. The chapter is generally methodological in its nature with a clear link to modern processes of reforms at the national and sub-national levels. In the authors' opinion, they often allow conclusions to be drawn far beyond an individual country or region and may be useful to different countries as an analogy.

Chapter 3 - The South Caucasus Region is one of the most interesting and, at the same time, one of the most vulnerable regions in the world. In addition, strategic interests of the USA, the EU, Russia, China, Turkey, and Iran conflictingly intersect here. After the collapse of the USSR the South Caucasus states displayed intense social & economic development in several years. Among the South Caucasus states electricity market is deficient only in Georgia. However, the liberalization of the market provides a flexible possibility to distribution companies for signing futures contracts on electricity purchase, which allows the Operator to perform seasonal electricity export, import and transit. In-depth analysis of energy efficiency in these countries identifies two basic problems as follows: (i) Incompatible legislations according to which the electricity market is entirely liberalized in Georgia and rigidly controlled by governments in Armenia and Azerbaijan; (ii) Incompatible consumer tariffs, which are diversified on wholesale and retail tariffs in Georgia and imposed by governments in Armenia and Azerbaijan. Experience of the last decade has shown that the liberal energy market with competition of private distribution companies is a precondition for the development of the electricity sector. From this point of view perspectives of Georgia are optimistic whereas in Armenia and Azerbaijan at a certain stage and in near future farther growth is doomed to fail. Picturesque GDP growth in Azerbaijan in 2005-2008 with the sniper accuracy coincides with the period when Baku-Tbilisi-Ceyhan (BTC) oil pipeline became operational. This peculiarity outlines volatility of the Azerbaijani economy, lion's shear of which is governed by the hydrocarbon sector. Correspondingly, decrease of the world oil prices in recent years at the background of diminished oil production determined not only deterioration of economic indicators but also devaluation of the Azeri Manat in the beginning of 2015. Azerbaijan is exporting basically hydrocarbons, Armenia – commodities and clothing, export structure of Georgia is much more complex: in 2019 the country exported 778 kinds of commodities & goods including Hi-tech products. In 2019 the exports volume from the South Caucasus roughly equaled US$ 26.5 billion or 32.63% of the bulk regional GDP. In case of Initial Public Offering (IPO) and capitalization of commodities, the added value derived from financial instruments would be, at least, three times more. Correspondingly, the authors are proposing foundation of the Caucasus Commodity and Stock Exchanges, which may be launched only in Georgia due to the geopolitical framework. Today, the Southern Gas Corridor consists of three pipelines: (i) South Caucasus Pipeline (SCP), which started gas transportation in 2006; (ii) Trans-Anatolian Pipeline (TANAP), which pumped the first gas in autumn 2018, and (iii) Trans-Adriatic Pipeline (TAP), which is under construction phase. When all the system of the Southern Gas Corridor becomes entirely operational, it will be able to diminish the European energy dependence on Russia only by 10-15%. Huge increase of the capacity seems to be impossible due to limited gas reserves of Azerbaijan. Correspondingly, the authors have launched an idea to include Iranian gas reserves in the pipeline system. The project has the following important positive features: (i) Its execution will destroy the Russia-Iran partnership in gas sector and create their severe competition in gas supply to Europe; (ii) European energy dependence on Russia will be diminished at least twice; (iii) Added value of the Southern Gas Corridor will be tripled; (iv) The project will significantly improve the economic and, therefore, the social background of Iran, create hope for the better future and this way promote democratic changes in the country; (v) The project will merge Iran with the civilized world and this way decisively mitigate influence of Iran on terroristic organizations.

Chapter 4 - In the aftermath of the 2008 global financial and the 2010-2011 Eurozone crises, several regulatory jurisdictions have strengthened their financial sector regulation, supervision, and risk management to increase the resiliency of financial institutions. More specifically, regulators are seeking to curb money laundering and the financing of terrorism with stricter anti-money laundering (AML), countering the financing of terrorism (CFT) and know-your-customer (KYC) regulations. The compliance with AML and the CFT regulations is expensive, particularly due to the regulations differing across jurisdictions. Furthermore, the high penalties that banks face for financial infractions decrease their profitability. Several global banks have responded to this new compliance risk challenge by de-risking. Although the term “de-risking” refers to the strategies adopted by a bank to reduce its risk exposure to the assets in its portfolio, in the context of this new challenge, the de-risking refers to the intentional termination of financial relationships with clients or groups of clients which may be categorized as “high risk”. Caribbean banks and financial institutions are being affected by the changing financial regulatory environment. In fact, large banks are terminating their corresponding banking relationships (CBRs) with Caribbean banks. CBRs refers to financial services in which a financial institution provides on behalf of another financial institution. CBRs includes services such as: international wire transfers; accepting of deposits on the behalf of other financial institutions; and the facilitating of payments. The recent phenomenon raises two important research questions: 1) What is the impact of de-risking upon the Caribbean? 2) What policy measures may be adopted to address the de-risking challenge? This chapter reviews the de-risking experience of several Caribbean countries. Several approaches have been adopted to address the de-risking challenge. In most instances, Caribbean banks have sought to find replacement correspondent banks. Other considered solutions include the utilizing of the correspondent banking relationship of domestic Central Banks, strengthening domestic regulatory and legislative framework to reduce the risk perception, and lobbying at the regional level to raise awareness of the issue.

Chapter 5 - The importance of public procurement in spending public funds is very high in every state and society. Therefore, these procedures have a high impact not only on spending public funds but also on the development of the private sector in general. Therefore, to achieve these goals, one of the prerequisites for sustainable procurement is a clear technical specification, whereby the public authority clarifies its needs whether for goods, works or services, and the business has a clear view of its offers including liabilities, costs and profit. Therefore studying and analyzing technical specification is of the utmost importance for sustainable procurement. In the course of what has been said above, this chapter is constructed as a modest contribution to this issue.

Chapter 6 - The world is changing rapidly. Many distinguished economists were convinced that the international Pareto optimum, particularly relevant for the enlargement of the European Union (EU), was quite a realistic achievement only if EU follows the dictate of a strong radical free market reform. “Laissez-faire” was considered as a magic solution for every economic issue within the EU. However, the authors believe that the EU is becoming a perfect case in point to illustrate the labyrinth of transition from a “territorial” (nation) state into a “market” state on the basis of profound globalization process and functional integration of the global economy. Dialectic of globalization suggests that the extant economic theory becomes virtual and unsuitable for the process of globalization. The authors raise the following questions which they are not able to answer just by using the existent (neoclassical) economic theory and policy: whose GDP should be optimized in a global economy? Whose employment level should be addressed: that of territorial or the market state? Who is the main economic subject in the upcoming market state: (multi/transnational) corporations or individual (non-sovereign) states deprived of their economic resources during privatization? How this new stage in the world (capitalist) development is going to look like? Since the authors have (partly) stepped in the next stage of capitalist development, the authors propose the term “mega-capitalism” which totally differs from Friedman’s and neoliberal understanding of economic processes and Fukuyama’s end of history. Should the EU join mega-capitalism as a unique state or as bunch of (currently 28) integrated national states? Should the EU maximize its own GDP or GDP of individual member states? The same question is pertinent for the level of employment, social justice etc. Is the EU becoming or should it become (only) a region within the unified global state? These are the questions that need to be answered as soon as possible for the sake of the citizens of the EU and the authors will try to tackle these questions within this chapter.

In: Progress in Economics Research … ISBN: 978-1-53618-248-4
Editor: Albert Tavidze

Chapter 1

MARKETING CHALLENGES IN ECONOMIC DOWNTURNS: FROM THE LIPSTICK TO THE SMOOTHIE-BAR EFFECT

Cristina Calvo-Porral*
University of A Coruña, A Coruña, Spain

ABSTRACT

During economic downturns marketers challenge new consumption behavior patterns, since consumers shift their purchasing habits during recessions, reduce their expenditure and look for cheaper products. In other words, in hard times, consumers may spend less on holidays, home appliances or electronic devices. From a rational economic perspective, such changes in purchasing patterns are quite logical, since consumers are engaging in a behavior to conserve resources in an environment of scarcity.

However, a deeper examination of consumer spending behavior indicates that not all spending behavior in economic downturns is consistent with rational behavior. Even though spending on the majority

* Corresponding Author's E-mail: ccalvo@udc.es.

of consumer goods during the recent economic recession declined, one specific product category experienced surprising growth: beauty products.

This trend is known as the "lipstick effect" suggesting that lipstick sales were inversely correlated to the economy performance. The "lipstick effect" can be traced back to the Great Depression of the 1930s, when the US industrial production halved, but sales of cosmetics rose. Further, there is some evidence of the increase of sales of some product categories during the recent economic crisis, as substitutes for more expensive items.

Interestingly, a number of product categories emerged as "affordable luxuries" since the economic crisis of the year 2008 such as beauty and personal care products like nail enamel, eye mascara or hair dyes. This fact indicates that the "lipstick effect" term may no longer be applicable to the lipstick itself, but to a wider range of product categories over time, that today includes some food items such as confectionery, chocolate, premium ice-cream or even smoothies. In this context, the main goal of the present study is to analyze the influence of the economic crisis of the year 2008 in the consumption of "affordable luxuries"; and for this purpose the sales and market performance of different product categories is examined.

Findings show that in times of economic downturn, marketers should focus on products and services that consumers can afford ant that provide them positive emotions, pleasure and hedonism, improving their quality of life and well-being in a recessionary context. That is, the psychological nurturing provided by these "affordable luxuries" that increase consumers' feelings of pleasure and happiness may the main explanatory factor for the "lipstick effect." The emotional gratification and affordable prices of these "affordable *luxuries*" may be the key factor underlying the recession-proof items.

1. INTRODUCTION

There is extensive research on consumption behavior during economic crisis. However, there are no previous studies on the effects of economic downturns on the increase of consumption in some product categories. In this context, the present study aims to provide an updated perspective on this contradictory consumption behavior during times of recession. Put it in other words, recessions are characterized by a widespread decrease in consumer spending and well-being. But, why are consumers increasing their spending on not necessity goods during times of recession?

The term recession is commonly defined as a significant decline in economic activity spread across the economy, lasting more than a few months, influencing the real income, employment, industrial production and wholesale retail sales (Leamer, 2008). The economic crisis of the year 2008 matches all the criteria above, being the most significant crisis in the last decades, affecting the global economies more universally than any other economic downturn since the Great Depression (Flatters and Willmott, 2009). Further, the crisis that began in 2008 is considered as one of the worst recessions since the Great Depression, characterized by a great decline in economic activity and product sales, affecting all industries and consumers.

An economic crisis influences the psychology and expectations of consumers, since consumers face a greater uncertainty; thus influencing consumer behavior and purchasing patterns. More precisely, the increasing uncertainty leads to a reduction in consumption, particularly in the consumption of discretionary non essential goods.

Surprisingly, data show that during the Great Depression, the sales of lipstick and other women's cosmetic products boomed unexpectedly (Koehn, 2001). Regarding the economic crisis of 2008, the 62% of US consumers reduced their household spending (Pew Research Center, 2010); but in this year the sales figures of the cosmetic company L'Oreal experienced a growth of the 5.3% in this recessionary context. Similarly, some other product categories different from cosmetics or beauty products tend to perform well and even increase their sales in an economic crisis environment, such as some food product items.

This unexpected outcome may be based on the consumer psychology in recessionary periods. Previous research supports that these non necessity products could be considered as "affordable luxuries" that provide psychological benefits and offer instant gratification. So, the lipstick could be considered as an indulgence item that lifts up the consumer morale in hard times.

In this context, the present study aims to examine the most important factors that influence the consumers' increased spending on non essential goods during economic crisis. In addition, this study aims to analyze how economic downturns influence consumer psychology and behavior, and whether this recessionary context may influence the increase in consumption of some product categories.

A deeper understanding of consumer behavior and the increased demand for non necessity products and the factors influencing the purchase of “affordable luxuries” to indulge oneself can play a crucial role in developing appropriate marketing and promotional strategies during economic crises.

2. Consumer Behavior Patterns during Economic Downturns

Recessions are commonly defined as two or more consecutive quarters of negative GDP growth, which decrease consumer spending and well-being and also influence the consumption behavior in several ways. In the first place, economic crisis can reduce disposable income through pay cuts, or unemployment, leading to a smaller consumer expenditure. So, in economic downturns consumers downsize their spending on every product, from groceries to homes (Bohlen et al., 2010). Further, consumers generally reduce their consumption budget either because their total income is lower or because they become more risk averse in a context of increasing uncertainty, allocating a greater share of their income towards saving (Kamakura and Du, 2012).

In the second place, during recession periods, consumers alter their consumption behavior. The reduced consumption budget forces consumers to satisfy the essential needs first. Accordingly and following the Engels’ Law, food increases as a percentage of total consumption expenditure, since consumers adapt their consumption patterns in order to minimize the impact on food spending (McKenzie, 2003). In addition, consumers show a lower demand for leisure-recreation activities and reduce the purchase of expensive durable goods, putting a greater emphasis on value for money (Anon, 1975). Similarly, consumers focus exclusively on low prices and achieve greater price consciousness (Lichtenstein et al., 1993), and as real disposable income is reduced, consumers become more careful with their spending and their purchase decisions (Ang, 2000).

Prior research provides empirical evidence of the changes in consumption behavior arising from the economic crisis (Shama, 1978, 1981; Schipchandler, 1982; Ang, 2000, 2001; Dutt and Padmanabhan, 2011; Hampson and McGoldrick, 2013, 2016; Kamakura and Du, 2012; Puelles et al., 2016), as depicted in Table 1. But, what are the main characteristics of consumer behavior during economic crisis?

In the seminal work of Shama (1978) this author analyzed the consumption behavior during the 1973 oil crisis. He reported that during economic crisis, consumers engage in greater comparative shopping, deliberate much more in their purchase decisions in order to get better value for money and tend to place greater importance on product durability. In addition, during recession periods, consumers buy less, become less wasteful and look for cheaper products. As a consequence of this search for cheaper products, consumers also become more promiscuous, using a wider variety of stores (Shama, 1981).

Regarding the oil crisis of the year 1973, Schipchandler (1982) examined the stagflation deep impact on US consumer behavior, reporting that during this period, consumers changed their behavior considerably, showing a greater caution in spending money. This author indicates that in recessionary periods, consumers mostly use price reduction strategies to cope with the crisis and show a greater willingness to purchase fewer products generally preferring products on sales and promotions. In addition, Schipchandler (1982) notes that in times of economic turbulence consumers reduce the purchases of non-essential products and delay the purchases of durable goods focusing on product durability. Similarly, consumers change their lifestyles drastically, since they become more comparative shoppers and move to a trend of home-made and do-it-yourself products (Schipchandler, 1982).

Table 1. Literature review on consumer behavior during economic crisis

Authors	Consumption/purchasing behavior
Anon (1975)	- Lower demand for leisure and recreation activities - Reduction of the purchase of durable goods
Shama (1981)	-Willingness to buy fewer products and to delay purchases of durable goods. - More time spent in shopping and less wasteful consumption - Consumers focus on product durability -Increased caution in spending money -Lower loyalty to stores
Shipchandler (1982)	-Consumers became more comparative shoppers and buy more on sale -Preference for product purchase on sales and promotions
Lichtenstein et al., (1993)	-Consumers focus exclusively on low prices -Greater price consciousness
Estelami et al., (2001)	-Consumers gather more information and plan every purchase -Greater product knowledge
Ang (2000, 2001)	-Reduction in overall consumption and wastefulness - Substitution by generic products and cheaper brands - Greater products' information search
Robles et al., (2002)	-Price becomes the great determinant variable in purchases -Greater willingness to buy lower priced products -Increase in expenditure for basic commodities -Avoidance of long-term and of big ticket purchases
Zurawicki and Braidot (2005)	-Gradual and absolute drop in consumption -Elimination of some non-essential products -Substitution of the expensive product brands with cheaper store brand -Increase in sharing behavior
Roche et al., (2009)	-Consumers spend more time at home and search for reduced prices -Cut back on spending by deferring nonessential purchases
Inman et al., (2009)	-Consumers get more inclined to purchase cheaper brands and show higher control of impulse buying
Dutt and Padmanabhan (2011)	-Smoothing of consumption, influencing how much to spend and how to spend on product categories -Consumers alter the composition of consumption
Kamakura and Du (2012)	-Larger budget allocating on more essential product categories -Increased tendency to save money, instead of spending it

Authors	Consumption/purchasing behavior
Hampson and McGoldrick (2013, 2016)	-Increased purchase planning -Greater price consciousness -Price becomes a core attribute in purchase decisions
Kaytaz and Gul (2014)	-Consumers opt for cheaper food and non-food products -Increased reduction of entertainment services and non necessity products/services
Puelles et al., (2016)	-Consumers change their preferred brand for cheaper ones - Better information before making purchase decisions -Consumers take greater advantage of sales promotions and coupons
Castilhos et al., (2017)	-Systematic price comparison for the best deals -Hierarchization of different consumption categories

Source: Own elaboration.

Then, Ang (2000, 2001) analyzed the consumption behavior during the Asian crisis that began in 1997, which caused a sharp decline in overall consumption and wasteful behaviors. This author provides an extensive report of a variety of consumer strategies developed to cope with the economic crisis. According to Ang (2000) in times of recession, consumers make some spending and consumption adjustments accordingly, such as for example concentrating in cheap prices, being more careful with money or engaging in greater product information search. Further, consumers during economic downturns economize reducing the purchase of all product categories, reducing the quantity of product purchase and replacing expensive products with cheaper affordable ones (Ang, 2001). Interestingly, consumers tried to maintain their products for a greater period of time; thus, placing greater importance to the durability of the products and saving in the long-term (Ang, 2001).

Later, in the research conducted by Robles et al., (2002) these authors examine the changing consumption patterns during the economic crisis of South America that began in 1997. These authors report that price became the most important determinant of purchases and that consumers showed a greater demand for lower priced products seeking for good value for money. Likewise, during the South American crisis, consumers increased their expenditure in basic commodities, while avoiding big-ticket items and long-term purchases. So, the demand for household appliances and cars decreased sharply. In addition, during this recessionary period, large hypermarkets and discount stores gained great popularity among consumers.

Other studies report evidence of consumers' shift towards frugality and simplicity during recessions to cope with the reduced income (Zurawicki and Braidot, 2005). More precisely, the research developed by Zurawicki and Braidot (2005) focused on the economic crisis that took place in Argentina in the years 2001 and 2002. These authors indicate that in a downturn context, consumers engage in a gradual drop in consumption, completely eliminating non-essential products and the total purchases of certain product categories. In addition, following Zurawicki and Braidot (2005), consumers develop pricing strategies extensively in order to substitute expensive product brands with cheaper affordable brands. However, the greater adjustment to the downturn context regarded the consumers' lifestyle, since consumers adopted a more frugal way of life. For example, consumers engaged in sharing behavior and in at-home activities in order to economize extensively, such as cooking at home, meeting friends at home and even producing their own food products. Finally, other authors report that during economic crisis, consumers gather more information regarding prices, achieve greater product knowledge and carefully plan every single purchase (Estelami et al., 2001).

The current global economic crisis started as a problem in the mortgage industry in the United States, but has turned into great recession that has altered the consumption in different ways worldwide. Accordingly, some recent studies emerged after the economic crisis of year 2008. In this vein, the research conducted by Inman et al., (2009) reports that during economic crisis, consumers evaluate the value for money more closely, are more inclined to purchase cheaper brands based on deals and control impulse buying. Likewise, in hard times, consumers increase purchase planning, preparing shopping lists and sticking to budgets, resulting in fewer unplanned or impulse purchases.

The study developed by Roche et al., (2009) also highlights that consumers search out value at reduced prices in every product, from tea to travel. More precisely, consumers are cutting back on spending by deferring non-essential products, buying products at promotional prices, and shopping around to find the best deals (Roche et al., 2009). Similarly, these authors indicate that consumers are changing their lifestyles. In fact, consumers are taking refuge from the economic storm by spending more time at home and are making products themselves instead of buying them.

Similarly, Dutt and Padmanabhan (2011) reported that during economic crisis a significant drop in per capita consumption expenditure takes place due to a decline in consumer confidence. Consequently, consumer behavior in a recessionary context is characterized by consumption smoothing at an inter-temporal, inter-category and intra-category levels, resulting in a significant reallocation of expenditures; or in other words, altering the composition of consumption expenditures. More precisely, these authors report that consumers respond to an economic crisis, reducing how much they spend, postponing the purchase of durable and discretionary goods and increasing the expenditure of necessity products. Additionally, Dutt and Padmanabhan (2011) note that consumers changed their lifestyle and that preferred to repair their old products, rather than purchasing new ones.

Later, Kamakura and Du (2012) also focusing on the crisis of the year 2008 suggests that during recessions, consumers tend to save more or pay down debt, leading to less money spent on goods and services. However, consumers faced with a smaller budget during a recession will cut more heavily in non-essential product categories. Accordingly, consumers have less money to spend on luxuries, allocating larger budget shares to more essential product categories (Kamakura and Du, 2012).

Likewise and referring to the economic crisis of 2008, Hampson and McGoldrick (2013; 2016) report that when household disposable income declines, price becomes more of a concern, becoming the core attribute in consumers' purchase decisions in times of recession. In turn, consumers increase their price consciousness and seek a good quality-price relationship in all types of products, from clothing to groceries (Hampson and McGoldrick, 2013). Finally, these authors highlight that due to the recessionary context, consumers reduce their purchase impulsive behaviors and increase their shopping patronage of cheaper brands.

Kaytaz and Gul (2014) developed an extensive study focusing on the economic crisis that took place in Turkey that began in 2008 and found that consumers opted for cheaper food and non-food products on a very large extent. Similarly, consumers decreased the amount of expenditures on non necessity products; considerably reducing the money spent on entertainment and social and leisure activities.

Later, the research conducted by Puelles et al., (2016) shows during recession periods the price variable gains importance and consumers purchase less than before changing their consumption habits. For example, consumers get better informed before making purchase decisions and take greater advantage of sales promotions and coupons, as a clear consequence of the reduction in the disposable household income. Similarly, and in order to cope with the crisis, consumers change their preferred brands for cheaper ones and change to private label brands.

Finally, a in a recent research Castilhos et al., (2017) reported some new consumption habits that emerged during the economic crisis of 2008. First habit is called smart shopping, which means a systematic price comparison for the best deals that allows consumers not to reduce their consumption dramatically. The second habit is labeled as prioritizing, and is related with the hierarchization of different consumption categories, so that consumers can select the items to be cut, reduced or kept.

3. The Changing Consumption Patterns during Downturns

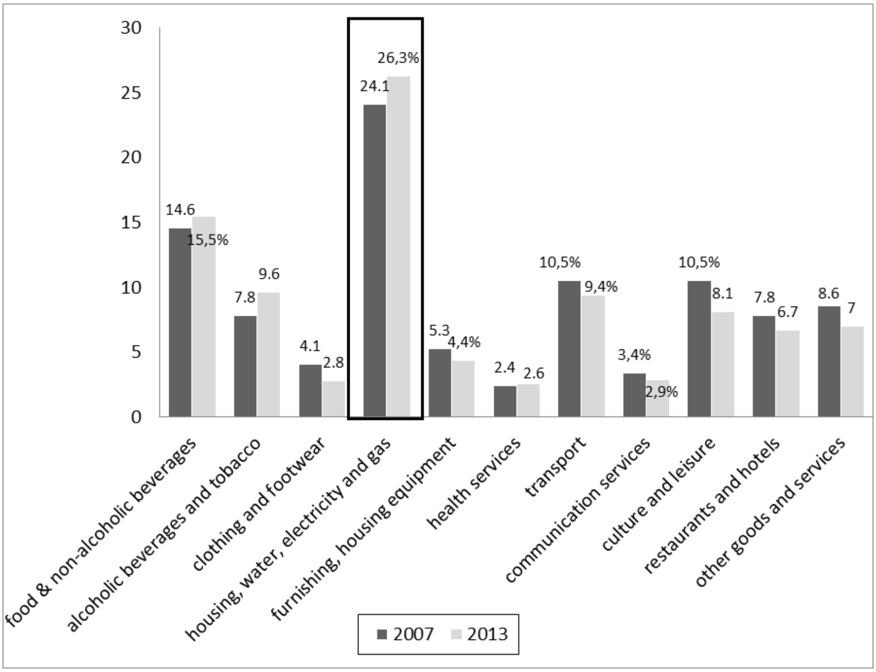
Economic recessions are often accompanied by a decrease in consumer spending and a change in consumption patterns, caused by the economic hardship.

Following Samuelson and Nordhaus (2000) consumers usually purchase products that provide them maximal utility in an attempt to try to maximize their utility or satisfaction. But in times of recession, most of the consumers are forced to economize and become rational (Quelch and Jocz, 2009), so that certain product categories such as food, clothing, shelter or transportation and health care become essential products (Figure 1).

Interestingly, it is commonly accepted in economic analysis that the utility the consumer derives from commodities at different levels of expenditure does not depend on economic conditions (Deaton and Muellbauer, 1980). Therefore, under this assumption, in times of recession when consumers face a reduced consumption budget, they cut expenditures disproportionately more in less essential product categories, such as for example dining out or holidays. On the other hand, in a context of economic hardship, consumers allocate larger shares of their budgets for the more essential products, such as for example food, shelter, electricity or gas (Kamakura and Du, 2012). However, when the economy grows again, consumers are expected to increase their total consumption budget and the budget allocated to the less essential product categories (Kamakura and Du, 2012).

Authors like Dutt and Padmanabhan (2011) show that consumers respond to an economic crisis by altering the composition of their consumption expenditures. More specifically, these authors report that the impact of the economic crisis of 2008 has changed the different product categories: consumers cut on discretionary goods and spend more money on necessity products. Nevertheless, it is not clear how consumers classify goods as necessity or discretionary goods in a context of crisis and differences could be found depending on the level of economic development. For example, in developing countries, consumers reallocate expenditure from durable products toward nondurable products; while in developed countries, consumers reallocate expenditure to services at the expense of durable products.

Therefore, prior research indicates that durable goods are the most affected during downturns (Dutt and Padmanabhan, 2011). In addition, other potential explanation would be that durable goods purchases entail higher performance and purchase risk; and in turn, are easier to postpone (Deleersnyder et al., 2004).



Source: Eurostat (2014).

Figure 1. Expenditures in product categories (comparison between years 2007 and 2013).

Similarly, other authors report that during recessions, consumers cut back on the frequently purchased consumer goods, increase the purchase of cheaper products and brands (Hampson and McGoldrick, 2016), increase spending on private label brands (Diallo et al., 2013) and increase their visits to discount stores (Hampson and McGoldrick, 2013). Further, some premium products perform well during times of recession (Piercy et al., 2010; Nunes et al., 2011).

When an economy is booming, there is an upturn in the consumption of luxury goods; while economic contractions in the economic activity result in fewer luxury purchases, such as for example jewelry, holidays, furniture or any big-ticket purchases (Eurostat European Commission, 2014). In fact, during the economic crisis of 2008 the consumption of luxury goods was very often postponed or simply deferred. One possible reason might be that during times of recession there is a social norm that favors frugal consumption, whereas opulent consumption is considered as inappropriate or as a sign of showing off, leading to the demise of conspicuous consumption (Nunes et al., 2011). So, consumers tend to purchase less socially-conspicuous products (Kamakura and Du, 2012). Another potential explanation would be that luxury spending patterns are under social scrutiny; leading to a decline in spending on luxury products (Piercy et al., 2010; Nunes et al., 2011).

During recessions, consumers do not only cut back spending on luxury products, since leisure and entertainment expenses -such as going to the movies- are also cut. This economization allows consumers to not lower their consumption standards on what they believe are the most important products (Castilhos et al., 2017). Similarly, consumers' tastes and preferences do not change in a recessionary context; and therefore, any adjustments in the consumption patterns are caused by the reduced disposable income (Kamakura and Du, 2012).

4. Are Consumers Behaving Rationally during Recessions?

According to rational choice theory (Friedman, 1953), rationality means that an individual acts balancing costs against benefits trying to maximize personal advantages when taking decisions. Thus, reducing spending significantly during times of recession is rational in the sense that the individual engages in a behavior to keep personal resources in a context of relative scarcity. Put it in other words, cutting on spending seems quite rational during economic downturns. More precisely, consistent with rational models of human behavior, a recessionary context is negatively correlated with spending on discretionary or non necessity goods.

In a recessionary context, consumers purchase more rationally, since many of them have suffered a decrease in their disposable income (Puelles et al., 2016). And prior research provides evidence indicating a macro trend of consumer frugality and increased austerity, meaning the consumers cut back, economize and are more responsible with money during recessions. In addition, previous studies report that consumers become more rational, reflexive, responsible and critical (Shipchandler, 1982; Hampson and McGoldrick, 2013; Puelles et al., 2016). For example, during economic crisis, consumers exercise more purchase planning, use shopping lists more often and do less impulse buying (McDaniel et al., 1986); dedicate more time to gather information about products and brands before purchasing and try to get greater value for money (Hampson and McGoldrick, 2013), select discount stores and search for products on sale (Ang, 2000), and cut back on luxury items, purchasing basic household products in order to pay less (Puelles et al., 2016).

Are consumers making rational selection of goods during times of recession? Or in other words, are consumers rational during economic downturns? Prior research shows that consumers do not always behave rationally and that the relationship between economic downturns and consumer spending priorities might not be logical.

A closer look to consumer behavior during times of recession indicates that not all consumption behavior is coherent with human rationality; and even consumers who, because of economic conditions, carefully plan their purchases may purchase some non necessity products.

Previous research generally emphasizes that the economic crisis depress the sales of products at an aggregate level, but this trend might not be unidirectional. In this vein, Shipchandler (1982) reports that during the economic crisis in the USA in the 1970s, the 24% of respondents consumed more prepared and frozen foods, while 17% spent more in premium food products.

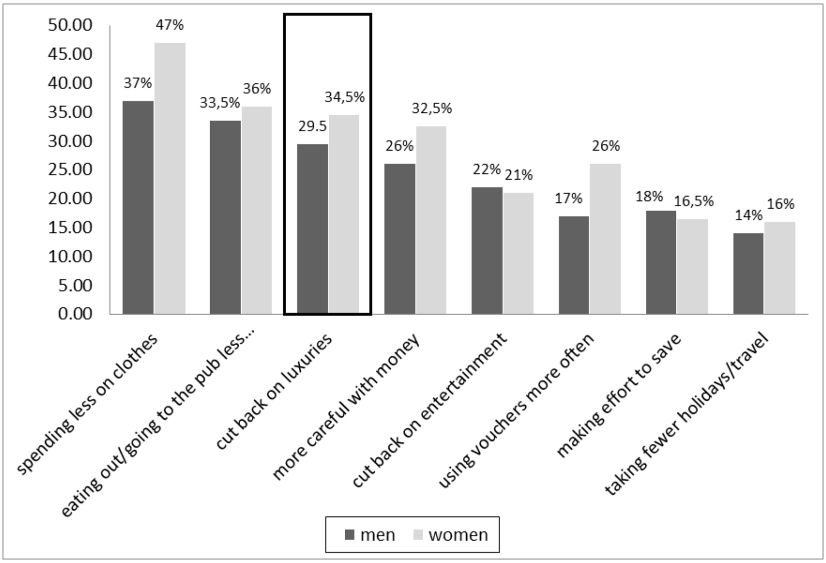
Similarly, and even though consumer spending and the desire for most products generally declines during economic downturns, recessions seem to increase the spending on beauty products and the desire for products that increase personal attractiveness (Hill et al., 2012). Consequently, during recessions and in times of high unemployment rate one product category has performed unusually well: beauty products. In fact, Hill et al., (2012) conducted a research to analyze unemployment fluctuations over 20 years and the percentage of money that US consumers allocated towards different product categories through total retail sales. These authors found that in times of high unemployment and economic hardship consumers reduced their spending on big-ticket durable products such as electronics, furniture or home appliances, which is a logical behavior. Surprisingly, the research found that as unemployment goes up, consumers increase the money spent on cosmetics, beauty and personal care products (Hill et al., 2012). In other words, the unemployment rate seems to be positively correlated with an increased spending on beauty products associated with attractiveness enhancement. Therefore, these findings report evidence that economic downturns lead to a consumer behavior that seems economically irrational.

There are some limits to the extent to which consumers economize in times of recession. In the first place, some of the goods that could have been considered as luxuries or non essential items in the past decades are now essential products, such as for example smartphones or mobile devices. Second, consumers cut down on spending, but not to the extent that this economization makes them unhappy (Social Issues Research Centre, 2009).

So, in what areas were consumers economizing during the economic crisis of 2008? In the EU consumers cut back spending on clothing as the biggest cut, followed by eating out of home and going to the pub less often, and cutting back on “luxuries” and entertainment (Figure 2).

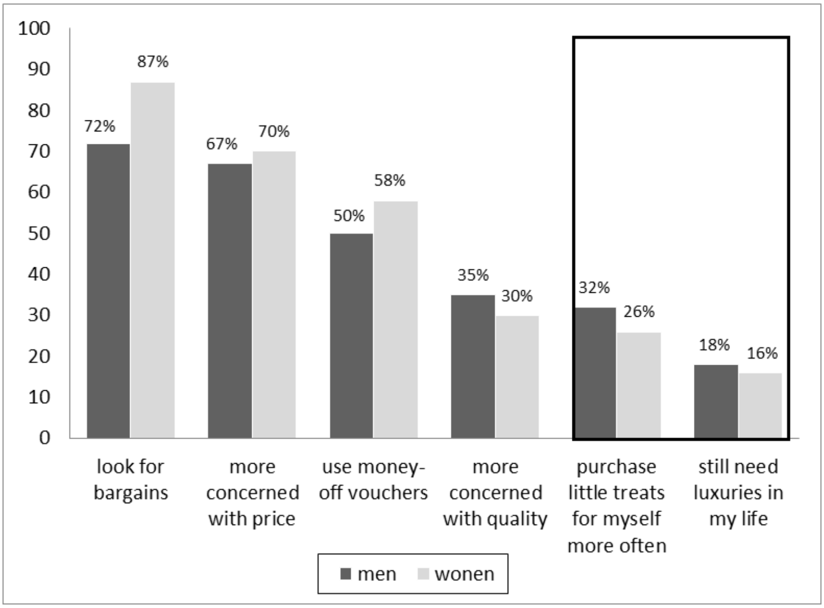
Interestingly, more than 25% of consumers during a recessionary period are purchasing more “little treats” for themselves as morale boosters, rather than making major or big ticket purchases (Social Issues Research Centre, 2009). These data show that even when times are hard, consumers still need a bit of pleasure to indulge themselves, and one way of doing this is purchasing little “affordable luxuries” (Figure 3). For example, one woman could purchase extra lipstick because she feels that she cannot afford to eat out of home as often as she would like to; but otherwise, she can afford to purchase one lipstick from the hypermarket.

Therefore, understanding the meaning or perception of what could be considered as an “affordable luxury” or “little treat” is quite important to understand the changing consumption patterns during times of recession.



Source: Own elaboration from Social Issues Research Centre (2009).

Figure 2. Main areas of economizing in year 2009.



Source: Own elaboration from Social Issues Research Centre (2009).

Figure 3. Changes in consumption patterns in year 2009.

5. THE "LIPSTICK EFFECT"

Consumer spending and the demand for most products generally declines during economic downturns; however, in recessions, one specific product category has performed unusually well: beauty products (Allison and Martinez, 2010; Hill et al., 2012; Netchaeva and Rees, 2016). In fact, prior research shows that during recessions the spending on beauty products seems to increase; and accordingly, industries selling beauty and personal care products that enhance appearance and attractiveness have flourished during recessionary periods (Hill et al., 2012; Kapferer, 2012).

This trend is commonly known as the "lipstick effect," suggesting that lipstick sales were inversely correlated to the economy performance. More precisely, Leonard Lauder, Chairman of the cosmetics company Estée Lauder, coined this term, meaning that the sales of beauty products inversely correlate to the health of the economy, because this effect also applies to other beauty and personal care products including nail enamel, eye mascara or hair dyes, which perform quite well during recessions.

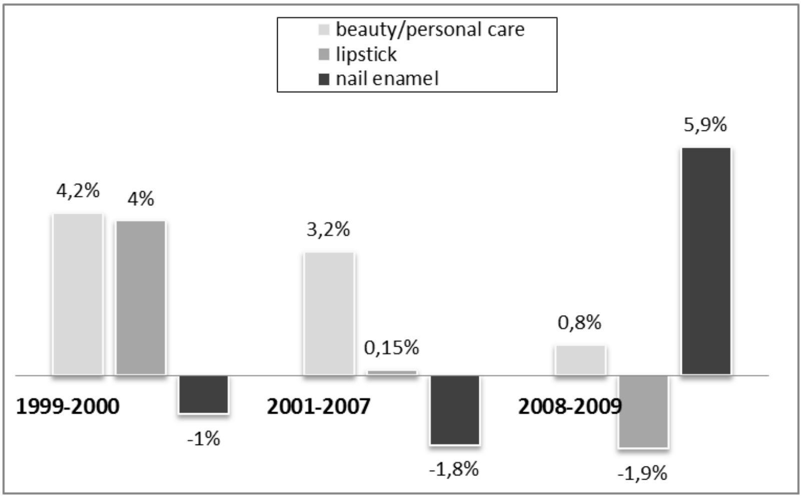
The "lipstick effect" can be traced back from the Great Depression of the 1930s -when the US industrial production halved, but sales of cosmetics rose- to the recent crisis of 2008, when the sales of beauty products such as nail enamel have experienced a great increase (Euromonitor, 2015). In fact, market sales show that consumers may be altering the type of beauty product they demand during economic crisis, since in the recent economic crisis nail enamel emerged unexpectedly as the beauty product category with the highest demand in Europe (Figure 4).

What are the theoretical explanations for this phenomenon? It is interesting to report the three major contributions to the "lipstick effect."

In the first place, Hill et al., (2012) indicate that the "lipstick effect" refers to the women's willingness to spend money on beauty or appearance-enhancement products despite their economically driven financial limitations, suggesting that this consumption behavior seems to be specific to female consumers. Similarly, these authors provide an evolutionary explanation for this phenomenon, suggesting that individuals allocate effort toward reproduction rather than personal growth (Belsky et al., 2012). According to the evolutionary theory, the main objective of women's desire for beauty and appearance- enhancement products is the procurement of a partner. In other words, women's demand for attractiveness enhancing products during economic crisis may be driven by the desire for financially secure or wealthy partners (Hill et al., 2012).

In the second place, Netchaeva and Rees (2016) indicate that the phenomenon of increased desire for beauty products during times of recession could be explained by the fact that women want to enhance the favorable impression of themselves in the workplace, as a clear strategy to become financially secure and to improve their professional credibility.

In the third place, Kapferer and Bastien (2009) and Kapferer (2012) suggest social and psychological factors as underlying the "lipstick effect." Kapferer and Bastien (2009) indicate that cosmetics -such as lipstick or make-up- have been the only product category that increased sales during recession, and provide as one potential explanation that consumers need to purchase products associated with certain social standing during economic crisis. So, according to these authors social factors would be motivating and driving this phenomenon.



Source: Euromonitor International (2015).

Figure 4. Market sales for beauty and personal care product categories in Europe (1999-2009).

More interestingly, Kapferer (2012) indicates that the term "lipstick effect" is the phenomenon whereby individuals purchase affordable luxuries as substitutes of more expensive items after experiencing psychological stress. Therefore, according to Kapferer (2012) the underlying motivation for the "lipstick effect" is that consumers substitute expensive purchases and big-ticket items for more affordable products that offer instant gratification in order to indulgence themselves in hard times. For example, one woman may buy a lipstick to feel well and to escape into an ideal world of beauty and luxury, taking care of herself -or pampering herself- in a context of psychological stress. Further, Kapferer (2012) provides a deeper explanation, suggesting that consumers purchase what they do not need, according to the product functional value to pamper or reward themselves in hard times or in contexts of psychological stress. In addition, the purchase of non necessity products in a context of psychological stress also applies to impulse purchase products (Kapferer, 2012) or to the purchase of "affordable luxuries" that consumers purchase to pamper themselves.

Therefore and according to Kapferer (2012) the "lipstick effect" could be explained by the psychological benefits provided by some product categories in times of recession, when individuals experience higher levels of psychological stress and increased concern about their own economic situation (Catalano and Dooley, 1983). So, while the recessionary conditions drive a decreased individual psychological wellbeing, these "affordable *luxuries*" could help to enhance the individuals' morale due to their psychological benefits.

Conversely, the fact that consumers may be increasing their consumption of non necessity products in times of recession could seem a contradiction of the Theory of Hierarchy of needs proposed by Maslow et al., (1970). This well known theory posits that individuals first attempt to satisfy their physiological needs, and only when these needs are met, individuals move on to satisfy psychological and social needs. According to Maslow et al., (1970) the satisfaction of the more basic needs cannot be easily postponed or substituted; and in turn, the consumer expenditure on essential goods should not change during recessions.

According to Kapferer (2012), when consumers purchase "affordable luxuries" that act as morale boosters in hard times, these products could be satisfying a psychological need, that should be met after satisfying physiological needs such as hunger or thirst. Maybe one potential explanation is that individuals try to satisfy the psychological need of wellbeing through the purchase of lipsticks or beauty products, when the major physiological needs have been met.

Finally, following Kapferer (2012) this study assumes that the psychological stress derived from the recessionary conditions motivates the increased demand for these "affordable little *luxuries*" that could be considered as morale boosters.

5.1. Impulse Buying during Economic Crisis

According to Beatty and Ferrell (1998) impulse buying could be conceptualized as a sudden and powerful urge that arises within the consumer to buy immediately. Other authors, like Kollat and Willet (1967) define the impulse purchase as a purchase decision made for which there is no prior recognition of need. More interestingly, prior research indicates that there is a positive relationship between money availability and impulse purchasing (Beatty and Ferrell, 1998), and for this reason impulse purchases are extremely significant. In other words, when consumers have less disposable income they are less likely to make impulse purchases. Moreover, previous research viewed impulse purchases as a consumer response to inexpensive or affordable product offerings (Hausman, 2000).

Could be considered the purchase of lipstick in a recessionary context impulse buying? When consumers purchase what they do not need in the midst of an economic crisis, could this purchase be considered as impulse purchasing? Previous studies suggest that the purchase of non functional products in a context of psychological stress -which is the case of a recessionary context- applies to impulse purchases.

The research conducted by Hausman (2000) indicates that the efforts to satisfy self-esteem needs drive consumers to make impulse purchases, such as beauty and attractiveness enhancement products. In fact, products with certain attributes and characteristics are more likely to hold hedonic appeal; and in turn, trigger impulse purchases (Hausman, 2000).

In addition, and as explained before Kapferer (2012) described the "lipstick effect" as the purchase of "affordable luxuries" that could be explained by the psychological stress experienced by consumers in times of recession. Likewise, Kapferer (2012) notes that consumers purchase unnecessary products to reward themselves in hard times and in contexts of psychological stress. Finally, prior research reports that hedonism is the main motivation for impulse purchases. Authors like Mudel et al., (2017) indicate that impulse purchases are unnecessary products with a strong hedonic motivation with the main characteristic of being an indulgence. Other authors, such as Hausman (2000) indicate that impulse buying satisfies consumers' hedonic desires.

Therefore, the purchase of lipstick -a non necessity affordable item with strong hedonic value- in a recessionary context could be considered as an impulse purchase, driven by the need to pamper and indulge oneself. Accordingly, marketers and companies offering "affordable luxuries" during times of recession often encourage consumers to purchase these type of products reminding consumers that "you deserve it," or even positioning these products in the marketplace as small indulgences as morale boosters.

6. Affordable Luxuries or Morale Boosters

6.1. What Is an "Affordable Luxury"

Some product categories perform well and even increase their sales and market growth in an economic crisis environment, like products considered "affordable luxuries" or "morale boosters" that provide psychological benefits.

The concept of luxury product typically evokes the image of rich and wealthy consumers, and could be also associated with the elites of the society (Kapferer and Bastien, 2009). It is interesting to remark that today, many product categories strive to be a luxury, but these products have become far more readily available and affordable in the last years. Further, mass-consumption mainstream products refer to themselves as "*deluxe*" or even qualify the consumption experience as "luxurious" (Kapferer and Bastien, 2009). However, in the present chapter and following Kapferer (2012) some products are considered as "affordable luxuries" in a recessionary context, and the term "affordable luxury" has a total different meaning. Kapferer (2012) uses the term of "my luxury" referring to small personal purchases to indulge oneself.

The distinction between luxury products, "affordable luxuries" and necessity products is often explained through different theoretical foundations, such as Theory of Hierarchy of Needs proposed by Maslow et al., (1970). According to his theory, individuals evaluate different products as being able to satisfy different physiological needs, such as hunger, thirst, security or self esteem. The lower-level needs are satisfied first and necessity products meet these lower-level needs; while "affordable luxuries" could meet psychological needs as well-being, and luxury products might satisfy the need of social status or personal prestige which are more superficial needs.

Further, previous research highlights that the terms "affordable" and "luxury" do not conform to luxury goods literature (Meyers, 2004). The term "luxury" has been traditionally associated with very exclusive, highly prized goods, difficult to find and available only to the wealthiest consumers (Meyers, 2004). But this term has been subjected to an interesting evolution in the recent years, resulting in the emergence of the term "affordable luxury."

"Affordable luxuries" are non-necessary items, that are often related to three product categories, namely relaxation or hedonic opportunities, impulse purchases and indulgence products (Mundel et al., 2017). Therefore, the "affordable luxuries" should be clearly differentiated from luxury products: "affordable luxuries" are perceived by consumers as unnecessary, as impulse purchases with a strong hedonic motivation and with the main characteristic of being an indulgence (Mundel et al., 2017).

Similarly, Kapferer and Bastien (2009) highlight that “affordable luxuries” are those products that consumers do not need or are not crucial for consumers, but they like to have as part of their daily life to treat themselves.

From the consumer standpoint “affordable luxuries” are those products that consumers enjoy consuming or using at a reasonable cost. Consequently, a number of products such as fine chocolate, specialty coffee or tea or other commodities could be considered as “affordable luxuries” (Mundel et al., 2017). Similarly, other authors report that products considered as “affordable luxuries” have been traditionally referred to as “premium products” (Brun and Castelli, 2013).

What products are perceived to be “affordable luxuries”? In the study developed by Mundel et al., (2017) these authors report that the 75% of consumers perceive fashion products to be “affordable luxuries,” followed by the 58% of consumers who consider fine wine and the 57% of consumers who consider jewelry as indulgences. Similarly, 56% of consumers considered food products to be an “affordable luxury,” such as chocolate, coffee or tea. Finally, most of the consumers expect high quality from “affordable luxuries” at a lower price.

6.2. Affordable Luxuries’ Performance during Economic Downturns

Research strongly supports that affordable luxury goods or indulgence products perform well during economic downturns.

Prior studies have established that due to budgetary constraints, economic crisis are strongly associated with an increased spending on two types of products, namely traditional inferior goods and “morale boosters” (Samuelson and Nordhaus, 2000). Inferior goods are those products that increase their demand when income declines; and in turn, consumers increase their spending on inferior goods during economic downturns. For example, consumers often increase their spending on canola oil rather than on olive oil during recessions; or increase their spending on canned tuna fish instead of fresh salmon (Samuelson and Nordhaus, 2000). On the other hand, products considered as "*morale boosters*" are products to indulge oneself at a reasonable cost that simply boost morale, such as for example, spending more on premium ice cream, in confectionery or in fine assorted chocolate during a recessionary period. So, "morale boosters" offer immediate gratification; and hence, can function as deserved "permissible treats." These "morale boosters" are propelled by consumers' desire to spoil themselves, and the sales of small, affordable luxury goods often benefit from this desire.

Other authors, like Mukhopadhyay and Johar (2009) report that indulgence purchases are likely to increase when prior consumption restraint is salient. More precisely, these authors indicate that consumers who experience consumption restraint feel justified in buying products that offer greater hedonic value or indulgences, increasing the tendency to reward oneself. Therefore, the consumption restraints caused by a recession may explain the self-rewarding behaviors of consumers when indulgences or "affordable luxuries." So, according to Mukhopadhyay and Johar (2009) consumers who reward themselves with an indulgence product did so because they thought they deserved it, suggesting that the act of rewarding themselves with an "affordable luxury" could be considered as a hedonic consumption.

Spending in non-essential product categories declines during economic downturns, but this decline is not uniform. Some authors like Roche et al., (2009) report that consumers might be spending money on the products and brands they love, despite the budgetary constraints. Consequently, in times of recession, consumers will trade up for high-quality items they love that provide great pleasure that comes from small indulgences.

In this vein, the "trading-up" phenomenon describes the behavior of consumers who are willing to shop cheaper goods in one category, in order to free up resources for higher spending in other product categories, which are often premium products (Kapferer and Bastien, 2009). Accordingly, this trading-up phenomenon has been extended to a wide array of products and services (Mundel et al., 2017), including specialty coffee, assorted chocolate, premium ice-cream, hair salons, spas and smoothie bars to splurge on every so often.

6.3. What Motivations Drive Affordable Luxury Consumption?

According to the Theory of Hierarchy of needs (Maslow et al., 1970) individuals first attempt to satisfy physiological needs and when these needs are met, then individuals move on to satisfy psychological and social needs, to finally attempt to satisfy self-esteem needs. Consequently, and because the satisfaction of the more basic needs cannot be easily substituted or postponed, the consumer expenditure on essential products will not change during recessions. However, the fact that consumers may be increasing their consumption of unnecessary products -such as lipstick or personal care products- in times of recession seems a contradiction of the Theory of Hierarchy of needs.

This contradiction might be explained by the hedonic nature and emotional appraisal of some products. The hedonic products have greater emotional appeal than utilitarian products and are purchased or consumed primarily for their ability to provide feelings of pleasure and well-being rather than utilitarian value (Hirschman and Holbrook, 1982). The positive emotions triggered by hedonic products may be crucial in a context of economic hardship; thus, not being easy to postpone or to substitute. In this line, Hirschman and Holbrook (1982) indicate that the hedonic consumption motivation -that includes tastes, sounds, scents, tactile impressions and visual images- describes a type of consumption that rather than satisfying the traditional economic view of maximization of the consumer utility, satisfies emotional needs. These emotional needs are not superficial needs and may be in the lower levels of the Hierarchy of needs, especially in a context of economic hardship. Therefore, these emotional needs should be fulfilled, regardless the level of disposable income.

The term hedonic consumption could be defined as these “facets of consumer behavior related to the emotional, multisensory and fantasy aspects of the individuals’ experience with products” (Hirschman and

Holbrook, 1982). Therefore, the concept of hedonic consumption or hedonic products is closely tied to the concept of “affordable luxury” -such as lipstick-, and this hedonic motivation may be causing the consumption of affordable luxuries and indulgence products in times of recession.

Authors like Mundel et al., (2017) support the idea that hedonic consumption is the key motivation for the consumption of “affordable luxury” products. The reason is that the purchase and consumption of these affordable luxuries involve more than the satisfaction of utilitarian needs or obtaining functional value. On the contrary, these products can satisfy consumers’ emotional needs, delivering emotional satisfaction (Mundel et al., 2017), self-directed pleasure and hedonism (Kapferer and Bastien, 2009). Further, Mundel et al., (2017) report that another important motivation to purchase and consume “affordable luxuries” is that these products can improve the individuals’ quality of life.

One example of hedonic consumption would be the case of specialty coffee at a coffee house or consuming a smoothie at a smoothie-bar. While coffee or the smoothie are readily available products that can be prepared easily at home, some consumers may be willing to pay a premium price to enjoy the atmosphere offered by specialty coffee house or the smoothie bar, even in a recessionary context. So, consuming these “affordable luxuries” is a way to experience pleasure and to improve quality of life through a hedonic experience.

Similarly, consumers may purchase affordable luxury products or services to pamper themselves in times of hardship. For example, consumers may go to a spa or enjoy a smoothie at a smoothie-bar to create a positive emotional experience and increase their pleasure and well-being (Haws and Poynor, 2008). In addition, indulgence consumption helps consumers pamper themselves in different ways: purchasing something affordable, through the exposure to pleasant and attractive shopping experiences or even enjoying the aesthetic components that retail environments (Okada, 2005; Xu and Schwarz, 2009).

Authors, like Fiske and Silverstein (2002) report some other driving forces behind the increasing demand for “affordable luxuries” even in times of recession. More precisely, these authors suggest that the rise in levels of education, the increase in the household available income, the increased travel opportunities and even the technological change influence in the higher demand for "affordable luxuries" and premium products. Accordingly, since many consumers are trading up to higher quality products, many products are accommodating to this type of demand.

Other authors, such as Okada (2005) and Xu and Schwarz (2009) indicate that the main motivation underlying the consumption of "affordable luxuries" is the psychological nurturing provided by indulgence consumption. Consumers engage in indulgent consumption to increase their feelings of pleasure, happiness, calmness and satisfaction (Okada, 2005). Further, these authors report the concept of rational or justified indulgence, suggesting that when consumers have a reason to indulge themselves, this improves the consumers' emotional experience of indulgence and reduces the tension between pleasure and costs -money spent- that are often associated with indulging (Okada, 2005; Xu and Schwarz, 2009). So, the rational or justified indulgence refers to consumers who feel like the indulgence was earned or deserved (Xu and Schwarz, 2009). For example, consumers may reward themselves for having suffered important reductions in their disposable income, for saving money or for having suffered stress or higher insecurity due to the economic crisis.

Similarly, other previous studies indicate that the immediate experience of pleasure or short-term happiness and well being may be the major drivers of indulgent consumption (Diener et al., 1999). These authors posit that consumers experience an immediate sense of pleasure from indulgence and that experiencing short-term happiness can potentially contribute to consumers' overall well-being (Diener et al., 1999). Therefore, the key motivation underlying the consumption of indulgent products is the instant gratification provided.

Marketers often provide consumers of reasons to indulge themselves, especially in hard times, reminding consumers that "you deserve it," a communication claim and message that have run for decades. However, companies and marketers promote indulgence in different ways. Some companies promote spontaneous indulgence or indulgence without a particular reason. One example would be the chocolate dessert maker Chocolate Origin, whose product claim is “you don’t need a reason for indulgence.” On the other side, other companies highlight the importance of rationalizing indulgences, such as for example the bakery and snacking company Modelez International that claims “treat yourself to health” in order to promote Belvita cookies. Or even the cosmetics company L’Oreal is featuring the simple message “because you’re worth it” for years (Table 2).

Table 2. Brands positioned as indulgences or “affordable luxuries”

Beauty And Personal Care Products		
Brand	**Product Category**	**Product Claim**
L’Oréal	Beauty products and cosmetics	“Because you`re worth it”
Dove	Personal care products	“Pamper yourself with a touch of indulgence” “Dove: Purely pampering”
Essie	Neil enamel	“Every now and then, I indulge in something wicked.” “Think of my luxeffects”
Food Products		
Brand	**Product category**	**Product claim**
Toblerone	Chocolate bars	“Toblerone is about embracing your indulgence side” Promoted as the “Indulgent side”
Cafe Origin	Chocolate desserts/ Coffee	“You don’t need a reason for indulgence”
Harvest Kitchen	Cookies	“We mix, we bake, you indulge”
Belvita	Cookies	“Treat yourself to health” Product line: “Indulgence Belvita”
Magnum	Ice Cream	“Indulge in the freezer aisle”
Breyers	Ice Cream	Product line: “Gelato Indulgences”
Tetley	Tea	“Indulgence flavor blends.”
Greek Goods	Yogurt	Product line “Seriously Indulgent”

Source: Own elaboration.

7. From the Lipstick to the Smoothie-Bar Effect

During the last years, the type of product categories that have increased their sales and market growth in times of recession has experienced an interesting shift, moving from beauty and personal care items to impulse food items that could be considered as "affordable luxuries." These products that experienced an increased market growth could be considered as substitutes for more expensive items.

There is some evidence of the increase of sales of some product categories during the economic crisis of the year 2008, such as beauty and personal care products like nail enamel, mascara or hair dyes. However, the data shows that some impulse purchase food items have recently emerged as "affordable luxuries," such as confectionery, chocolate, premium ice-cream, fine wine or even smoothies consumed in smoothie-bars.

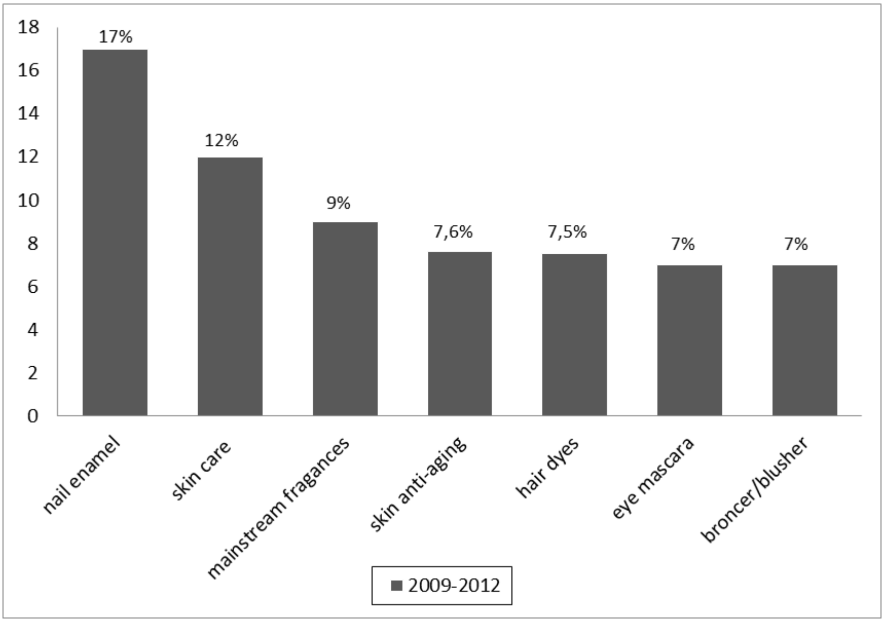
7.1. Personal Care and Beauty Products

A number of product categories emerged as "affordable luxuries" during the economic crisis of 2008, such as nail enamel, eye mascara or hair dyes (Figure 5). Below, the most interesting product categories are examined.

7.1.1. Nail Enamel

According to the increasing market growth and sales of this beauty product after the economic crisis of 2008, it can be stated that nail enamel should be considered the "new lipstick" of the last recessionary period (Figure 5). Further, it seems that European women just discovered the nail enamel as a great affordable fashion accessory and as a morale booster, becoming the "affordable luxury" hit in the UE markets. More precisely, from years 20009 to 2012, nail care category -which also is included in the nail care and hand care segments- was the fastest growing category in the beauty and personal care industry (Euromonitor, 2015). Despite the nail enamel product category experiences a significant change in 2011, the evolution of this category continues in the year 2013, with an increase of more than a 10% in the first half of the year over the same period of the previous year.

One potential explanation for this “affordable luxury” hit could be that nail enamel has become the ultimate fashion trend, in particular with the development of nail art, or even the recent trend of matching the nail enamel to the color of the purse. In addition, other possible explanation is the increasing trend of “do it yourself” - instead of going in beauty salons- has benefited the market growth of these beauty products.



Source: Euromonitor International (2015).

Figure 5. Market growth rate for beauty product categories in EU (2009-2012).

7.1.2. Eye Mascara

Eye mascara has experienced a great market growth and sales increase during the economic crisis of 2008, with an increase of a 7% from 2009 to 2012 (Figure 5). Moreover, the eye segment, which includes eye mascara, but also eye shadows, eyeliners or eyebrow pencils and similar products promising ever thicker and longer lashes and a beautiful eyesight has been performing well since the year 2012, with slight increases of the 0.5% each year.

One possible explanation for this “affordable luxury” hit during the economic crisis of 2008 are the relevant innovations developed in the eye segment and more precisely in the eye mascara item. These recent innovations, accompanied by successful product launches from some premium product players resulted in higher prices for consumers. The strong interest of consumers for eye mascara and other eye segment products could be based on the important influence of fashion trends such as the recent trend of “graphic eyes” make up.

7.1.3. Hair Dyes

In the EU, the recent economic downturn coincided with a renaissance of the hair dyes category (Figure 5). Following the start of the recession, supermarket sales of home hair color kits rose sharply, with some European retailers reporting a 200% sales increase in year 2008, while overall hair dyes market growth achieves the 9% in year 2008-2009 (Euromonitor, 2015).

One potential reason for the increase of this hair beauty product would be that some price-conscious or price sensitive consumers who before the economic crisis used to go to professional hair saloons for hair treatments or hair dye, are planning to do the hair treatment themselves in their own homes, but using “saloon quality” products purchased in the major retailers (Roche et al., 2009).

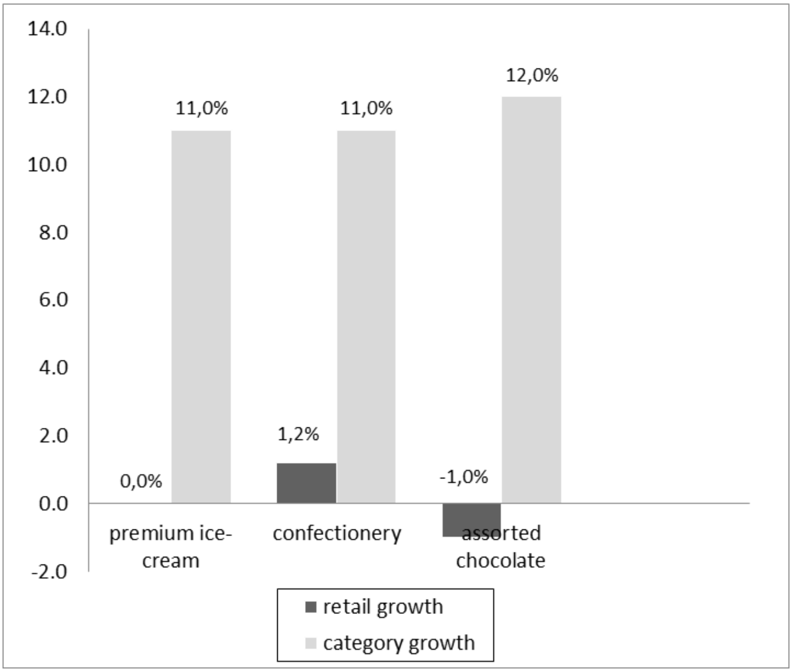
7.2. Food Product Categories

Other product categories different from beauty products, such as impulse food items have increased their demand and market growth during the economic crisis of 2008, such as for example premium ice-cream, confectionery or chocolate (Figure 6).

Beyond necessity products, many consumers increase the demand of items based on how these products make them feel, looking for products that help increase one's morale in times of recession. Premium products, "affordable luxuries" or "permissible treats" tap directly into a desire for products that provide experiences (Roche et al., 2009). For this reason, many manufacturers and major retailers have focused on premium product lines in a recessionary context.

In addition, home consumption is a natural inclination in stressful times. That is, during economic crisis, consumers often take refuge from the economic adverse context by spending more time at home and turning inward, since consumers seek comfort and safety.

This could be one coherent explanation of the market growth and sales for food product categories such as ice-cream, chocolate or confectionery, which are mainly purchased to be consumed at home (Roche et al., 2009).



Source: Euromonitor International (2015).

Figure 6. Market growth rate for food product categories in EU (2008-2012).

7.2.1. Premium Ice Cream

Premium ice cream is regarded as an occasional "permissible treat" or as an "affordable luxury," considering the sales value during the economic crisis of 2008. Data available regarding the EU shows that market growth achieved the 11% from year 2008 to 2012 (Figure 6), indicating a consumer increased demand despite recession. Further, the sales of premium ice cream have increased a 75.5% from 2012 to 2014.

The consideration of ice cream as an "affordable luxury" has been acknowledged by many manufacturers and companies, who have focused on premium and indulgent ice cream lines during the recession in order to drive the market forwards. However, this trend of "premiumization" for ice cream seems to be a global food trend worldwide, since in year 2016 ice cream premium lines accounted for 9% of ice cream new product launches.

7.2.2. Confectionery

Similarly, confectionery products experienced a market growth in some European markets throughout the recession (Figure 7), such as in the Germany, Italy or UK, being cupcakes the product category with the highest market growth in 2009 (Euromonitor International, 2015). Overall, the confectionery market experienced an increase of the 11% from 2008 to 2012. One possible explanation for this increase is that this type of food products remind recession-weary consumers of better times boosting their morale (Roche et al., 2009).

7.2.3. Assorted Chocolate

The resilience of assorted chocolate and premium chocolate during the current economic crisis of the year 2008 in some EU markets such as Germany, seems to be attributed to the fact that even fine chocolate could be considered as an "affordable luxury" by consumers.

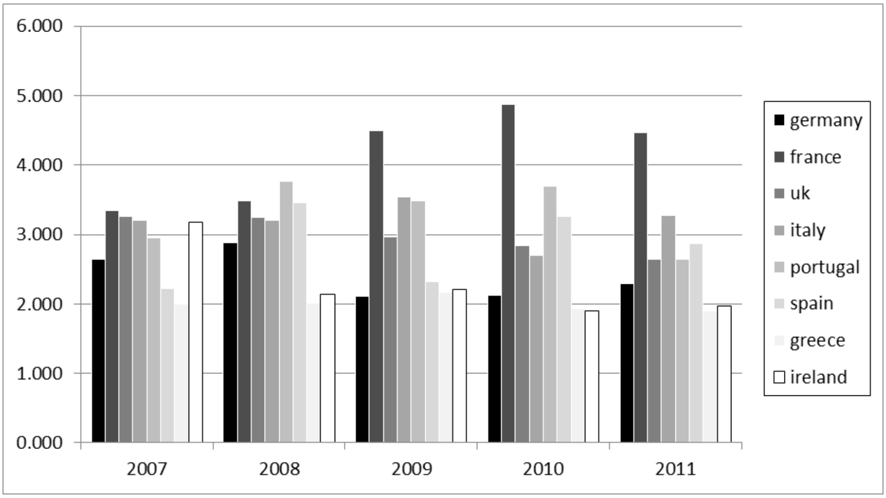
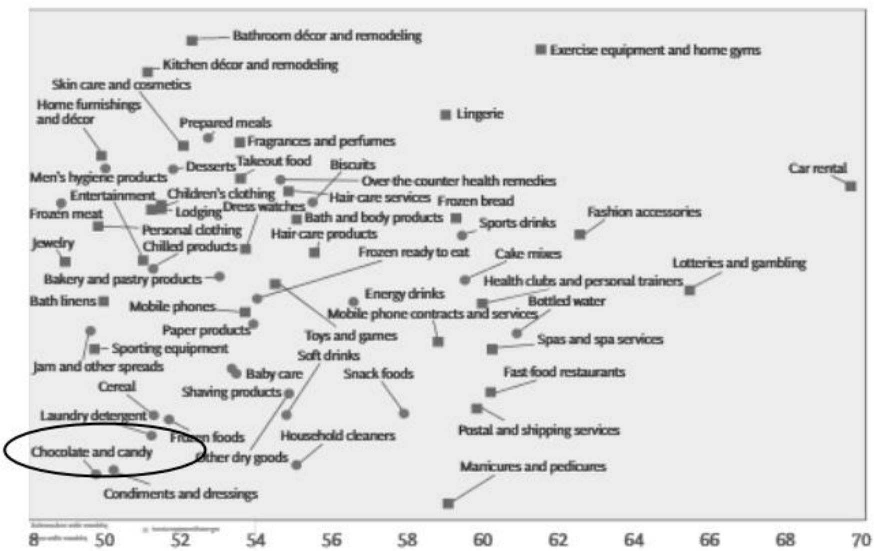


Figure 7. Confectionery demand (average units per person/month).



Source: Roche et al., (2009).

Figure 8. Percentage of consumers who are reducing purchases of product categories during the crisis of 2008.

In general terms, European consumers have increased their demand for assorted chocolate from year 2008 to 2012, with an increase of the 12% in retail value terms (Euromonitor, 2015) with many consumers demanding high-quality premium chocolate. Moreover, data from the major chocolate companies shows that premium chocolate has increased sales a 4.6% in year 2014, a 5.2% in year 2015 and a 8.2% in 2016 in the European market. Therefore, these data indicate that chocolate occupies a position as "permissible treat" in times of recession.

7.2.4. Fine Wines

There is evidence suggesting that the product category of fine wine has behaved anti-cyclically in the bad economic conditions of the economic crisis of 2008, since fine wines increased their prices and achieved a greater market demand despite the poor economy and the declining consumers' disposable income (Contini et al., 2015). So, it seems that consumers cope with the economic austerity seeking for higher quality wine at s fair price, suggesting that fine wine could be also considered as an "affordable luxury." Similarly, since the economic crisis of 2008, the wine industry has experienced two opposing trends. On one side, there is an evident demand increase in mass-produced wine with lower prices; and on the other side, there is also an increasing demand for fine wine, characterized by excellent quality in terms of terroir or geographical identity (Contini et al., 2015).

Interestingly, wine consumption in households increased in Europe from the year 2010 to 2012, due to consumers' reduced expenditure on drinking and eating out of home (Contini et al., 2015). So it seems that because of the economic crisis, consumers prefer to drink wine at home and data shows that in the US and in the EU more than 54% of drinking occasions are now held at home, increasing supermarket wine sales. However, this tendency to increase wine consumption at home could be a good opportunity for wineries to promote gourmet blends that are much more affordable when consumed at home (Roche et al., 2009). The reason for the increase of consumption of wine at home is that in times of recession, enjoying a cup of fine wine at home might be one of the few affordable luxuries still available to most consumers.

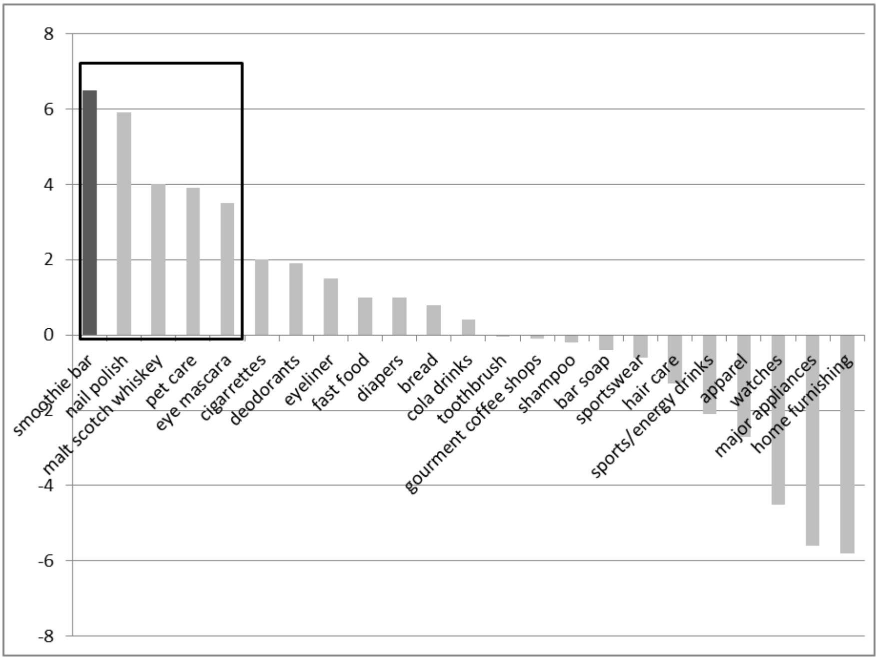
7.2.5. Smoothies

Smoothies are one of the fastest-growing segments in the beverage industry in the last years (Mordor Intelligence, 2017). Further, the smoothie market has experienced a great market growth since year 2008 (Figure 9); and in some countries such as the UK the smoothie market grew a 214% from 2008 to 2012 (Mordor Intelligence, 2017). It seems evident that this product has benefited from the premiumization trend for food products, since today smoothies could be considered as a high-end premium product range in the non-carbonated soft drinks sector. The premiumization of smoothies could be the explanation for the great market increase since the year 2008, despite the reduced consumer budgets and the increase of price sensitivity.

Similarly, some other factors appear to be major drivers behind the market growth of this product category. In the first place, smoothies are prepared with juice, fresh fruit and other healthy ingredients including milk or yogurt, and consumers could be embracing the smoothie trend because they are perceived as a healthier option to most sweets and on-the-go meals. Second, in a context of changing lifestyles and meal skipping, smoothies are seen as a meal alternative healthy snacking option being (Mordor Intelligence, 2017); that in addition are commonly available either a ready-made or made-to-order from smoothie-bars or even supermarkets. In the third place, in some markets such as Southern European markets, smoothies could be registering excellent sales due to warmer temperatures year round.

However, the consumption of smoothies in smoothie-bars involves much more that the utilitarian satisfaction of a healthy snacking option for a quick meal replacement or as a between-meal refresher. The smoothie-bars represent the lifestyle image of the product itself, satisfying consumers' emotional and hedonic needs, especially in hard times. For example, the smoothie can be prepared easily at home, but some consumers are willing to pay a premium price for the smoothie to enjoy the atmosphere offered by the smoothie bar.

The "lipstick effect" phenomenon reflects that consumers during recessions are drawn to cheap affordable indulgences, such as lipstick or nail enamel, rather than expensive luxuries. Therefore, the "lipstick effect" term may no longer be applicable to lipstick itself, because the lipstick effect varies across different markets and countries, an even varies on product categories over time. However, the concept of "lipstick effect" remains useful to explain the consumers' desire to splurge on small things so as to make life "worth living." Therefore, one key factor underlies all the recession-proof items: they offer gratification and are generally affordable products.



Source: Euromonitor International (2015).

Figure 9. Total product category growth/decline in developed markets (2008-2012).

CONCLUSION

Companies and marketers need to better understand consumer behavior during economic crisis. Whereas economic recessions decrease spending on most products, some product categories tend to perform well and even increase their sales in a recessionary context. This phenomenon is commonly known as the “lipstick effect,” when referring to the sales increase in beauty products.

However, economic recessions also boost the spending on goods that are considered as “affordable luxuries” that indulgence consumers. So, the term of “lipstick effect” may no longer be applicable to lipstick exclusively, because this interesting effect varies on product categories over time. In fact, some food product items have increased their demand during the recent economic crisis, such as premium ice cream, assorted chocolate, confectionery, fine wine an even smoothies consumed in smoothie-bars.

What is the main explanation for the “lipstick effect”?. The increased demand for “affordable luxuries” during hard times suggests that consumers seek for morale boosters or product categories that relieve stress -rather than the consumption of cheaper items- during recessions. Moreover, the psychological benefits provided by these products, when individuals could experience higher levels of psychological stress, may be the explanation for this phenomenon. The economic concern and the psychological impact derived from the recessionary conditions, as well as the decreased individual wellbeing might be motivating the increased demand for these affordable little luxuries that provide positive emotions, pleasure and hedonic value.

Hence, the “lipstick effect” theory is all about the psychological benefits provided by some product categories in times of recession, when individuals could experience higher levels of psychological stress. These product categories could be named as “affordable luxuries,” “permissible treats,” “morale boosters” or “indulgence” products. These product categories are non necessity unnecessary items, but provide pleasure and positive hedonic experiences, increasing the consumers’ wellbeing.

One major conclusion is that the concept of “lipstick effect” remains useful today, in order to explain the consumers’ desire to splurge on small things so as to make life “worth living.” In addition, other relevant finding is that one key factor underlies all the recession-proof items: they offer instant gratification and are generally affordable products.

Managerial Implications

Decisions concerning communication, merchandising and promotional activities become particularly challenging for marketing mangers during recessions. The economic crisis has left consumers thinking about how to cut back to save money, and most of them will become more price sensitive -consumers need a good reason to spend their money-, encouraging marketing managers to reduce product prices and to increase their sales promotional activities. So, products that mean a smart choice for consumers are a good option for companies. Accordingly, marketing managers should communicate the product benefits related to the smart purchase.

Even though, many consumers will continue to be price conscious, there are some actions that managers could develop in a downturn context to increase sales beyond the “cheapest price.” Considering that consumers demand “affordable luxuries” and indulgences during times of recession this study provides a number of suggestions for managers and marketers.

In the first place, marketing managers need to strongly focus on the hedonic motivation underlying the purchase of the “affordable luxuries” whose demand increases during hard times. Companies should offer products and services that provide pleasure and enhance positive emotions, increasing the well-being of consumers. One example would be the video games to workout at home, since they are a much more affordable alternative to a gym membership. Another example are all those products that make more comfortable to stay at home, such as for example comfortable furnishing. Finally, products or services that make consumers’ home much more entertaining are also a good idea in times of recession, such as for example “take-home-meals” or board games.

In the second place, managers should emphasize the hedonic provided by products in their promotional and communication activities. In addition, marketers should develop merchandising activities in order to attract consumers with emotionally appealing products and attractive retail atmospheres. Finally, marketing managers could target specifically those consumers who seek for fun and pleasure moments, and who cannot resist purchasing “affordable luxuries” in times of recession.

Therefore, instead of focusing on the cheapest possible products to boost sales, the successful marketing strategy during a recession is to offer those products that most consumers can afford that provide them with pleasure, positive emotions and hedonism.

REFERENCES

Allison, M., and Martínez, A. (2010). *Beauty-products sales bright spot during recession*. The Seattle Times.

Ang, S. H. (2000). Personality Influences on Consumption: Insights from the Asian Economic Crisis. *Journal of International Consumer Marketing*, 13(1), 5-20.

Ang, S. H. (2001). Crisis marketing: a comparison across economic scenarios. *International Business Review*, 10, 263-284.

Anon, M. (1975). Marketing in a recession: comments from our readers. *Journal of Marketing*, 78-79.

Beatty, S. E., and Ferrell, E. (1988). Impulse buying: modelling its precursors. *Journal of Retailing*, 74(2), 161-167.

Belsky, J., Schlomer, G. L., and Ellis, B. J. (2012). Beyond cumulative risk: Distinguishing harshness and unpredictability as determinants of parenting and early life history strategy. *Developmental Psychology*, 48, 662-673.

Bohlen, B., Carlotti, S., and Mihas, L. (2010). How the recession has changed US consumer behavior. *McKinsey Quarterly*, 1, 17-20.

Brun, A., and Castelli, C. (2013). The nature of luxury: a consumer perspective. *International Journal of Retail & Distribution Management*, 41 (11/12), 823–847.

Castilhos, R. B., Fonseca, M. L., and Bavaresco, V. (2017). Consumption, crisis and coping strategies of lower class families in Brazil: A sociological account. *International Journal of Consumer Studies*, 41, 379-388.

Catalano, R., and Dooley, D. (1983). Health effects of economic instability: A test of economic stress hypothesis. *Journal of Health and Social Behavior*, 24, 46-60.

Contini, C., Romano, C., Boncinelli, F., and Casini, L. (2015). Wine consumption and sales strategies: The evolution of Mass Retail Trading in Italy. *Wine Economics & Policy*, 4(2), 116-127.

Deaton, A., and Muellbauer, J. (1980), *Economics and Consumer Behavior*. Cambridge University Press: New York, NY.

Deleersnyder, B., Dekimpe, M. G., Sarvary, M., and Parker, P. M. (2004). Weathering tight economic times: The sales evolution of consumer durables over the business cycle. *Quantitative Marketing and Economics*, 2, 347-383.

Diallo, F. M., Chandon, J. L., Cliquet, G., and Philippe, J. (2013). Factors influencing Consumer Behaviour towards Store Brands: Evidence from the French Market. *International Journal of Retail & Distribution Management*, 41(6), 422-441.

Diener, E., Suh, E. M., Lucas, R. E., and Smith, H. E. (1999). Subjective well-being: Three decades of progress, *Psychological Bulletin*, 125, 276–302.

Dutt, P., and Padmanabhan, V. (2011). Crisis and Consumption Smoothing. *Marketing Science*, 30(3), 491-512.

Estelami, H. D., Lehmann, D. R. and Holden, A. C. (2001). Macro-economic Determinants of Consumer Price Knowledge: A Meta-analysis of Four Decades of Research. *International Journal of Research in Marketing*, 18(4), 341-355.

Euromonitor International (2015). Redefining the "lipstick effect": examples of recession-proof categories. *Euromonitor News and Resources.*

Eurostat European Commission (2009). *Consumers in Europe. Office for Official Publications of the European Comm*unities. Luxembourg.

Fiske, N., and Silverstein, M. (2002). *Trading up: The new luxury and why we need it.* In http://www.bcg.com/documents/file13925.pdf.

Flatters, P., and Willmott M. (2009). Understanding the post-recession consumer. *Harvard Business Review,* 87(7/8), 106-113.

Friedman, M. (1953). *Essays in positive economics*. University of Chicago Press: Chicago, IL.

Hausman, A. (2000). A multi-method investigation of consumer motivations in impulse buying behavior. *Journal of Consumer Marketing,* 17(5), 403-19.

Hampson, D. P., and McGoldrick, P. J. (2013). A Typology of Adaptive Shopping Patterns in Recession. *Journal of Business Research,* 66(7), 831-838.

Hampson, D. P., and McGoldrick, P. J. (2016). Antecedents of consumer price consciousness in a turbulent economy. *International Journal of Consumer Studies,* 41, 404-414.

Haws, K. L., and Poynor, C. (2008). Seize the day! Encouraging indulgence for the hyperopic consumer. *Journal of Consumer Research*, 35, 680–691.

Hill, S. E., Rodeheffer, C. D., Griskevicius, V., Durante, K., and White, A. E. (2012). Boosting Beauty in an Economic Decline: Mating, Spending and the Lipstick Effect. *Journal of Personality and Social Psychology*, 28, 1-17.

Hirschman, E. C., and Holbrook, M. B. (1982). Hedonic consumption: Emerging concepts, methods and propositions. *Journal of Marketing,* 46 (3), 92–101.

Inman, J. J., Winer, R. S., and Ferraro, R. (2009). The Interplay among Category Characteristics, Customer Characteristics and Customer Activities on in-store Decision Making. *Journal of Marketing*, 73(5), 19-29.

Kaytaz, M., and Gul, M. S. (2014). Consumer response to economic crisis and lessons for marketers: The Turkish experience. *Journal of Business Research*, 67, 2701-2706.

Kamakuram W. A., and Du, R. Y. (2012). How economic contractions and expansions affect expenditure patterns. *Journal of Consumer Research,* 39, 229-247.

Kapferer, J. N., and Bastien, V. (2009). The specificity of luxury management: Turning marketing upside down. *Journal of Brand Management,* 16(5/6), 311-322.

Kapferer, J. N. (2012). Abundant rarity: The key to luxury growth. *Business Horizons,* 55, 453-462.

Koehn, N. F. (2001). Estee Lauder and the market for prestige cosmetics. *Harvard Business School Cases*, 44 (1), 801-862.

Kollat, D. T., and Willett, R. P. (1967). Customer impulse purchasing behavior. *Journal of Marketing Research*, 4 (2), 21–31.

Leamer, E. E. (2008). What's a Recession, Anyway?. Working paper 14221. *National Bureau of Economic Research*. Cambridge, MA.

Lichtenstein, D. R., Ridgway, N. M., and Netemeyer, RG. (1993). Price perceptions and consumer shopping behaviour. *Journal of Marketing Research,* 30(2), 234–45.

Maslow, A. H., Frager, R., and Cox, R. (1970). *Motivation and personality*. Fadiman, J., McReynolds, C. (Eds.). Harper & Row: New York, NY.

McKenzie, D. (2003). How do households cope with aggregate shocks? Evidence from the Mexican Peso crisis. *World Development,* 31(7), 1179–1199.

Meyers, T. (2004). Marketers learn luxury isn't simply for the very wealthy. *Advertising Age* 75, 37.

Mordor Intelligence (2017). *Global smoothies market: major trends, growth and opportunities*.

Mukhopadhyay, A., and Johar, G. V. (2009). Indulgence as self-reward for prior shopping restraint: A justification-based mechanism. *Journal of Consumer Psychology,* 19, 334–345.

Mundel, J., Huddleston, P., and Vodermeier, M. (2017). An exploratory study of consumers' perceptions: What are affordable luxuries?. *Journal of Retailing & Consumer Services*, 35, 68-75.

Netchaeva, E., and Rees, M. (2016). Strategically Stunning: The Professional Motivations Behind the Lipstick Effect. *Psychological Science*, 27(8), 1157-1168.

Nunes, J. C., Drèze, X., and Han, Y. J. (2011). Conspicuous consumption in a recession: Toning it down or turning it up?. *Journal of Consumer Psychology*, 21, 199-205.

Okada, E. M. (2005). Justification Effects on Consumer Choice of Hedonic and Utilitarian Goods. *Journal of Marketing Research*, 42 (1), 43–53.

Pew Research Center (2010). A Balance Sheet at 30 Months: How the Great Recession Has *Changed Life in America. Pew Social and Demographic Trends report*, Pew Research Center: Washington, DC.

Piercy, N. F., Cravens, D. W., and Lane, N. (2010). Marketing out of the recession: Recovery is coming, but things will never be the same again. *The Marketing Review*, 10, 3-23.

Puelles, M., Diaz-Bustamante, M., and Carcelén, S. (2016). Are consumers more rational and informed purchasers during recession periods?: The role of Private Labels and retailing strategies. The International Review of Retail, *Distribution and Consumer Research*, 26(4), 396-417.

Quelch, J. A, and Jocz, K. E. (2009). How to market in a downturn. *Harvard Business Review*, 87(4), 52-62.

Robles F., Simon F., and Haar J. (2002). *Winning strategies for the new Latin markets.* Upper Saddle River (NJ): Prentice-Hall.

Roche, C., Silverstein, M. J., Ducasse, P., and Charpilo, N. (2009). Winning Consumers through the Downturn. Boston Consulting Group *Global Report on Consumer Sentiment.* Boston, MA.

Samuelson, P. A., and Nordhaus, W. (2000). *Economics* (19^{th} ed.). McGraw-Hill Irwin: New York, NY.

Shama, A. (1978). Management and Consumers in an Era of Stagflation. *Journal of Marketing*, 42(3), 43-52.

Shama, A. (1981). Coping with stagflation: voluntary simplicity. *Journal of Marketing*, 45(3), 120-134.

Shipchandler, Z. E. (1982). Keeping down with the Joneses: Stagflation and Buyer Behavior. *Business Horizons*, 25(6), 32-38.

Social Issues Research Centre (2009). *Generation Recession: A report from the Social Issues Research Centre.* Commissioned by Friends Provident.

Xu, J., and Schwarz, N. (2009). Do we really need a reason to indulge? *Journal of Marketing Research*, 46, 25–36.

Zurawicki, L, and Braidot, N. (2005). Consumers during crisis: responses from the middle class in Argentina. *Journal of Business Research*, 58(8), 1100–1109.

In: Progress in Economics Research … ISBN: 978-1-53618-248-4
Editor: Albert Tavidze

Chapter 2

RESHAPING INSTITUTIONAL BASIS FOR REGIONAL ECONOMIC PROGRESS: FINDINGS FOR PRESENT-DAY UKRAINE AND PROMISING DEMOCRATIC COUNTRIES

Igor Dunayev[1,*], Natalya Stativka[1,†], Oksana Milash[2,‡], PhD, Alla Nadtochii[1,§], PhD and Natalya Kovalenko[1,¶], PhD

[1]Kharkiv Regional Institute of Public Administration of the National Academy for Public Administration under the President of Ukraine, Ukraine

[2]Kharkiv Humanitarian Pedagogical Academy, Ukraine

[*] Corresponding Author's E-mail: igor.dunayev@gmail.com.
[†] E-mail: nstativka@ukr.net.
[‡] E-mail; milash01@ukr.net.
[§] E-mail: pollana@ukr.net.
[¶] E-mail: nkovalenko2008@ukr.net.

ABSTRACT

Problem Statement

In the last 3-4 years, Ukraine has demonstrated its impressive pace of reforms and social modernization. This country has accumulated a gigantic public demand for a significant modernization of public administration methods: from people in power to numerous institutions of governance and economic liberalization in virtually everything. As a consequence, being in a volatile external environment heated by active national reforms, such as decentralization, the Ukrainian regions are forced to constantly adapt their economic policies, institutional structures and competencies.

Chapter objective is to design and justify the authentic approach to reshaping the institutional basis for regional economic progress inspired by the ongoing national economic reforms to further implement it in the present-day Ukraine.

Methods Applied and Chronology

An empirical part of the chapter was compiled by the results of the author's all-Ukrainian expert survey on the issues of the economic policies of the Ukrainian regions in 2017-2018. The theoretical basis for conclusions obtained is drawn from the modern theory of new institutionalism, as well as the complex approach and synthesis and induction as scientific methods.

Structure

The chapter consists of 8 parts: Introduction, Definition of key notions, Description of the empirical background, "Ukrainian decentralization and the "new normal" for regional economic growth," "Decentralization prioritizes the individual. Will the Ukrainian regions be able to cope with their problems and to upgrade?", "Institutional renewal of the basis for economic policy modernization: proposals for Ukraine and ideas for other emerging democratic countries," Conclusions, and References.

Connection with Previous Studies

The chapter is logically linked to the author's methodology for renewal of the Ukrainian regional economic policy, already published in Volume No 41 (2018), and develops it, expanding its institutional structure and frame as an essential element. The resulting methodology is believed to be universal, and findings can be relevant for many developing countries.

Chapter General Characteristics

The chapter is generally methodological in its nature with a clear link to modern processes of reforms at the national and sub-national levels. In our opinion, they often allow conclusions to be drawn far beyond an individual country or region and may be useful to different countries as an analogy.

Keywords: institutes and institutions, institutional basis, the new normal, regional economic policy, public policy, modernization, Ukraine, decentralization, complex mechanism, regional funds

INTRODUCTION

A global trend of the recent years is that the regions of different countries of the world have felt in full their vulnerability to unexpected macroeconomic factors and changing social, geopolitical and other conditions (Mau & Ulyukayev, 2014) that are associated with macroeconomic and banking crises, preparation for a new technological revolution, a sluggish economic growth, redistribution of zones of influence of the largest economic centers, etc. This adds to the need for the regions to revise and adapt their plans and strategies for development and growth in order to fully reveal their own potential and attract external resources (Barca, 2012). The Ukrainian regions are no exception; however, apart from the mentioned macroeconomic component, they are now beginning to look for new drivers for their recovery, which are contained in the initiated national reforms. Disappointingly, by no means have all the regions found the inner volition and initiative to seek and master new ways to grow.

Moreover, local budgets that are increasing due to financial decentralization and the first state structural funds cannot provide a sustainable solution to most of the regional problems yet, especially in regards to infrastructure development. All of this points to the lack of a holistic and sufficiently scientific foundation for prompt updating of regional economic policy on the basis of a complex of the appropriate modernization mechanisms. In addition, the problems of scientific substantiation and timely preparation of regional authorities for the implementation of mechanisms for an essential upgrading of economic policies at the sub-national level are becoming acute. And this is a matter of a particular scientific interest and a practically relevant research area for many developing countries.

The present chapter is an independent scientific work, and at the same time it is a logical continuation of our first work in the collection of works of the series "Progress in Economic Research" No 41 (Dunayev, 2018) published by this publishing house. The work is based on the then focus set on a coordinated self-development of regions and a comprehensive methodology for updating Ukraine's regional economic policy. The proposals were put forward by the co-author Igor Dunayev (Dunayev, 2018), and are now being promoted by the Ukrainian scientists at the regional and national levels. For an inquisitive reader, this can help to better understand the context and target vector of research in developing countries.

The chapter objective is to design and justify the authentic approach to reshaping the institutional basis for regional economic progress inspired by the ongoing national economic reforms to be further implemented in the present-day Ukraine.

DEFINITION OF KEY NOTIONS

To define the key notions, the authors use the key terms in the following meanings (Dunayev, 2017a):

- by modernization, a 'growing capacity for social transformations' (Roxborough, 1998) is meant;
- by a regional economic policy, we mean a public socio-economic policy of multilevel development of a region and its territorial communities which includes a system of integrated and coordinated plans and actions of local development actors that is aimed to reduce internal economic inefficiency and social inequality (Dunayev, 2017b);
- by modernization of regional economic policy, we mean "progressive and guided social transformations of complex public-administrative and economic relations at the regional and interregional levels that manifest themselves in different ways, depending on the system of values and priorities under specific historical conditions" (Dunayev, 2017b).

DESCRIPTION OF THE EMPIRICAL BACKGROUND

The next theoretical developments are based on the results of an original expert poll "Determining the capability of the Ukrainian regional economic policy to change," undertaken by Igor Dunayev in February-March of 2017 in Ukraine. The poll participants were 44 experts from 14 regions of Ukraine and the capital city of Kyiv; this poll was conducted by way of filling out an online questionnaire in *Google Forms*, with no possibility for the experts to correct their answers after form completion. The questionnaire included four questions concerning the general information about an expert (region, occupation, education, and gender), and 43 questions about the subject matter. This chapter will present only part of the poll results. Thus, based on the empirical results obtained, the author builds his own theoretical concept of designing a regional economic policy, using a comprehensive approach and the scientific methods of synthesis, induction and deduction (Dunayev, 2018: 56).

Ukrainian Decentralization and the "New Normal" for Regional Economic Growth

Logically, the objective of this section is to overview and reshape the conclusions for decentralization that emerged from the macroeconomic "new normal" of the recent global financial crisis.

Indeed, over the recent decade, regions of the countries worldwide have fully perceived their vulnerability to unexpected macroeconomic and transient social, geopolitical and other kinds of conditions, related to macroeconomic and banking crises, preparation for a new technological revolution, a sluggish economic growth, redistribution of areas of influence of the biggest economic centers, etc. (OECD, 2009; Barca, 2012; Sentence, 2013). This has emphasized the need for regions to revise and adapt their plans and development strategies to fully realize their potential and attract external resources.

Among the concepts and theories that describe the new global macroeconomic reality, the "new normal" concept (El-Erian, 2015; Ketels and Summa, 2015; Gross, 2009) is most popular. The financial and economic crisis which has affected the Ukrainian economy to the full extent is forming the new normal i.e., a situation when a trajectory of development is described, as Voronkova (Voronkova, 2016) points out, by an L-shaped scenario: "fast fall – long-lasting stagnation (recession) with incremental "reaching the bottom" – late and slow recovery."

As Silin et al. (2016) says, "the new normal concept allows casting light upon the issue of realizing the new economic reality within the boundaries of a specific territory" (Silin et al. 2016). At present, the previous drivers of renewable growth are a thing of the past, namely: involvement of workforce reserves, reduced production facilities, high prices for raw material, application of traditional mechanisms of state macroeconomic policy (monetary, fiscal, stimulating demand). Although the content of “the new normal” concept still remains inexplicit, the core of the idea is like this: the world economy will never recover in full and will not return to the pre-crisis norm.

By the year-end of 2016 – start of 2017, Ukraine had at last reversed the negative tendency of its macroeconomic recession, and the forecasts for 2017 foreshowed a sustained economic growth of not less than +3.2%. However, it is another proof of the exhaustion of the Ukrainian economic development model built on using favorable foreign economic environment factors. A new economic situation of the new normal is formed, posing a just question of searching for new sources of growth, which will hardly be related to accelerated development of primary industries. This means that the new normal requires new approaches to clarifying and [an] initiative designing of processes in the changeable world. In the view of J. Gharajedaghi (Gharajedaghi, 2010), their content is determined, in the first place, by a shift in our understanding of the nature of organization – from a biological model to a socio-cultural one; secondly, there is a change (to a considerable degree) in our views on the scientific cognition method, a means of knowledge acquisition – from analytical thinking to integral, holistic mentality. A starting point for the public-administrative changes caused by the new normal is a changed attitude of the state towards the individual and community.

With respect to the economic and integration issues of the Ukrainian regional development, the new normal covers at least three statements:

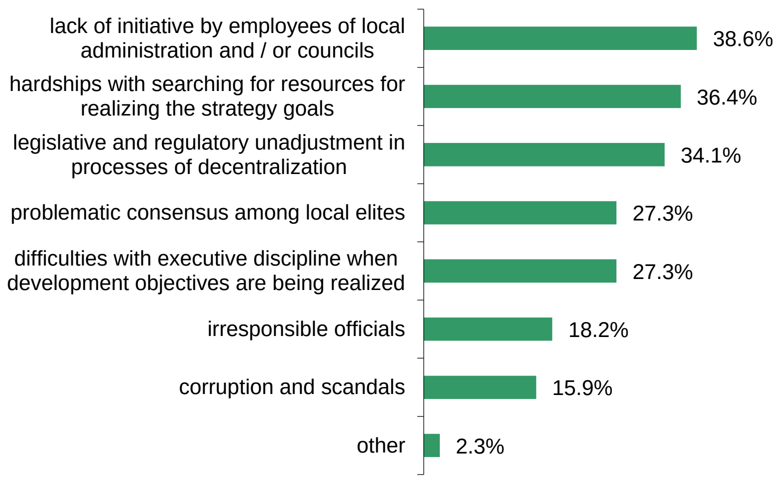
1. conclusions with account of almost guaranteed vulnerability of regions to the de-industrialized economy of Ukraine and economies of some regions. Reduction of the real sector portion in the GDP of Ukraine is traced nearly in all of the regions which testifies to their instability, while the expanding service sector cannot be regarded as self-sustainable, since it is unable to provide a stable independent development of the country and consequently – of its territory;

2. conclusions based on understanding of the role and status of Ukraine and the extent of its integration into international economic processes. Consequences of the state policy of “too open doors” will first of all hit particular enterprises, localized in specific territories. Without a growing industrial basis, the current accelerated and self-motivated international integration of Ukraine and its regions practically guarantees their weak negotiating capacity and actual position;
3. modernization of relations in economic development and in budget decentralization for the benefit of a concrete, not statistically average, individual – a concrete consumer or producer. Although decentralization in Ukraine was meant to be an asymmetric response to the military aggression of Russia in 2014 and to the inability of the Ukrainian state to solve promptly the accumulated economic problems, at the moment it is reasonable to support the initiatives of searching for new growth drivers, creating an adequate industrial basis in the regions, for the unstable macroeconomic growth is likely to become permanent.

Thus, apart from macroeconomic and budget sense, consideration of the new normal also presupposes a value reorientation to a much greater anthropocentricity of state and regional policies, improvement of real capacity of entrepreneurial people – the ideas that run through all of the European agenda.

A new normal component in Ukraine is a year-from-year escalation of “a discrepancy between the regions’ economic might and their social welfare and life quality indices” (Support to Ukraine’s regional development policy, 2013) under large economic and social disproportions. The regions associate this situation with the sizable fluctuations of production output of the recent years, scarce internal resources and lack of opportunities to cope with the long-standing trends with little effort. For example, the polled experts have emphasized the difficulties of searching for resources to achieve the set goals of regional strategies (36.4%) and passivism of local administration and self-government staff (38.6%)

(Figure 1). At the same time, some of researchers highlight a link between a weak regions' crisis and "a substantial intellectual challenge requiring a profound rethinking of its causes, mechanisms of its evolving, and ways to curb it" (Support to Ukraine's regional development policy, 2013). This means that, apart from financial resources, there should also be the relevant staff, development technologies and strategies, soldered together within a strong value and ideological frame.



Source: Igor Dunayev's elaboration.

Figure 1. Distribution of expert responses to the question: 'What problems affect most considerably the regional power bodies' adaptation to their enhanced role and responsibility in the course of decentralization?', in %.

An enhanced adaptability of the regions due to increased economic and social capacity of territories, expansion of their production basis, an essential emphasis on self-development, a shift of most of regulatory means from the national level to the regional one should become effective means of prevention and elimination of serious negative macroeconomic and institutional impacts on the economy and regions. Fulfillment of regional potential due to its economic independence will make only part of measures that are supposed to provide a transition to a new economic and administrative model of development; the rest of them will concern the problem issues of transparency, institutional weakness, investments, governance, local education and innovations.

A complete unlocking of the regions' own potential through their economic independence can be considered from two perspectives:

- in connection of the economic independence of a region with efficient utilization of the territorial property (public and communal). According to Article 327 of the Civil Code of Ukraine, it includes material assets, including financial resources that belong to a territorial community. In this case a territory serves as an economic activity entity in the form of a particular corporation. On this premise, as V. Lazhentsev (Lazhentsev, 2014) says, modernization of regional economic policy depends on "a balanced and effective utilization of natural-resource, material and technical, and human potentials" during rationalization of creating material wealth;
- through connection of the economic independence of a region with impossibility for the region to limit its activity to a mere building up of material wealth. Regional power authorities and policies are to serve human development. That is why the main characteristic of a territory's economic independence is not only augmenting of material wealth, expressed in gross regional product values, but also a gain in "the economic opportunities of people, economic capacity of local businesses, and budget capability" (Sabluk, 2017). To realize the function of personal development, each region has a possibility, firstly, to keep the main part of gross added value, gained due to their population's activity; secondly, to act in the local community's interests when using it, and not under external constraint. Without sticking to these two conditions, the wealth of some of the territories is redistributed unjustifiably in favor of other territories.

The underlying cause for insufficient use of the added value, created by local population for its own needs, "lies behind the formed state economic policy that involves implicit (hidden) centralized regulation of territorial relations" (Bochko, 2016). Since this policy is enforced through certain institutions, the roots of the problems of successful or unsuccessful territorial development should be looked for in the institutions quality.

It should be acknowledged that the present economic policy of the Ukrainian regions is at the stage of formation, being in the wake of the ideology of Ukraine's state regional policy. The current supersophisticated macroeconomic and political challenges to Ukraine have forced the country and its regions to take responsible steps to stabilize the situation and gain positive dynamics. Under the influence of macroeconomic and politico-institutional new normal, the important steps taken in 2015-2016 were as below.

1. Practically, the process of strategic planning of the country's regional development has been institutionalized. The regulatory documents on the State Strategy for Regional Development up to 2020, regional strategies and performance plans, procedures for monitoring and evaluation of the measures efficiency have been developed and adopted. On the regional level, the process of making regional strategies comply institutionally with the regulatory requirements and the best practices gained a new momentum in the late 2016 – early 2017 at the stage of developing regional strategy implementation plans for 2018-2020, which set a requirement of searching for sources and specification of adequate scales of financing of the regional targets and projects from the regional budget and other funds. At the same time, the issues of evaluation and quality selection of projects that will be included into implementation plans, and preparation of the necessary technical documentation to propose them to potential investors and loan suppliers have been brought up to date anew.
2. The local governments' financial basis has been strengthened substantially, including that of the regional level. The dynamics of local budget incomes in 2015-2017 was forecast to make: +52.4% of UAH 120.5 bln. in 2015; UAH 149.1 bln. (+23.1%) in 2016;

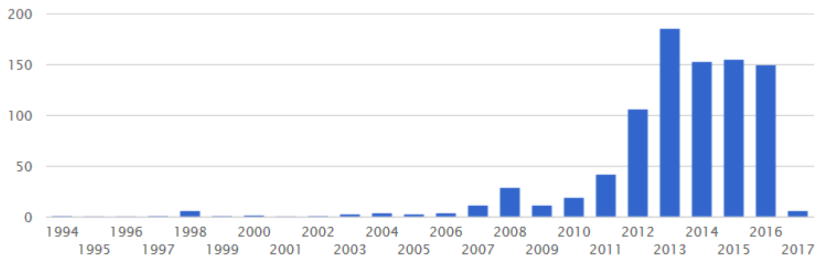
and UAH 183.6 bln. in 2017 (Hroysman, 2017). The growth of revenues to the general fund of local budgets in 2015, compared with 2014, amounted to UAH 29.6 bln. or 42.1%.

3. The active practical stage of forming associated territorial communities is underway. As of June 2016, 172 associated territorial communities were formed, and their new local government bodies elected. In 2015, the first elections took place in 159 associated communities; in 2016 – 288 associated communities were added; and for 2017, over a hundred more elections were planned. A factor important for further intensification of regional socio-economic processes is the Law of Ukraine No 4772, adopted on 18.03.2017, which entitled communities to join the already formed associated communities under the simplified procedure (the so-called “oil spot law”). The Law simplifies the process of amalgamation of communities around those recognized by the government as capable, without a full compliance with a regional perspective plan of forming community territories, on condition that formation of the communities conforms to the methods (Cabinet of Ministries of Ukraine, 2015) set by the Ukrainian government. Thus, communities that do not want to amalgamate will not hinder others who want to support the decentralization reform.
4. As early as spring of 2014, an organizational and legal mechanism was introduced to provide for territorial communities’ cooperation, offering them an opportunity of a prompt pooling of their internal material and financial resources to solve their common socio-economic problems. With about 50 agreements of that kind available by summer of 2016, those cooperation cases were distributed very irregularly among the regions: Poltava region – 20 agreements; Ivano-Frankivsk region – 10; Chernihiv region – 5; Cherkasy region – 3; Khmelmytsk region – 2; and by one agreement for Vinnytsia, Zhytomyr, and Dnipropetrovsk regions (NISD, 2016a).

5. Combination of the state and international tools for co-funding of regional priorities. The State Regional Development Fund (SRDF) is regarded as a promising tool, the first one in Ukraine modeled on the European pattern; however its positive impact on investment and economic activity of the regions is of insignificant pinpoint character. A much more profound positive influence is being exerted now (and presumably will be exerted in future) by other tools, namely: investment subventions (according to the Budget Code of Ukraine – "subventions for fulfillment of programs (projects)"); public orders together with their implementation documents – public contracts that are "effective, since they facilitate the activity of some enterprises which are system-forming for the regional economy and important for the functioning of the entire industry" (NISD, 2015). Also, apart from the above-mentioned state tools, a series of international investment projects were agreed upon, and some of them even launched, the maximum number of them having been observed in 2015. In particular, the projects of the International Bank for Reconstruction and Development on road-building and urban infrastructure, the Program for the upgrade of municipal infrastructure of Ukraine supported by the European Investment Bank, an unbound financial loan for the needs of power industry and infrastructure from the German "KfW" bank, and many more, the amounts of each exceeding €300 mln. (Ministry of Economic Development and Trade of Ukraine, 2017).
6. Obtaining new impulses for modernization of the state and local institutions that support regional development policy and decentralization with the annually increasing amounts of international technical aid and the Sector Policy Support Programmes (See: Agreement on financing of the Sector Policy Support, 2014) (Figure 2). In 2016 alone, at once two topical projects of international technical aid, relatively large-scale in terms of funding, got underway, namely: the program of the European Commission's "U-LEAD with Europe" and the USAID-

funded “DOBRE” program deliver working standards and directly impact on local communities’ economic development and unification, as well as on local civil society and regional authorities.

Finally, this sub-section percepts are aimed to bring out regional capacities to handle regular regions’ problems to enable regions prioritize the individual as the main goal of decentralization reform wherever.



Source: Data of the Ministry of Economic Development and Trade of Ukraine (Openaid.gov.ua), 2017.

Figure 2. Total number of projects of international technical assistance rendered to Ukraine arranged by the years, pcs. (as of April 2017).

Decentralization Prioritizes the Individual. Will the Ukrainian Regions Be Able to Cope with Their Problems and to Upgrade?

However, a number of serious problems remain, limiting regional economic policy’s capacity for modernization with an emphasis on the residents, individuals, and calling for response:

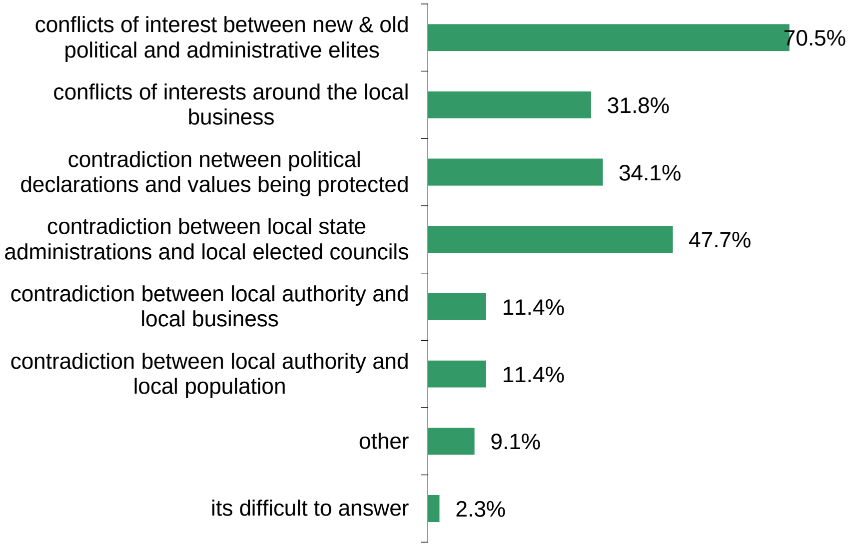
1. An absolute majority of planned actions of both the state regional policy and the region’s economic policies require much larger amounts of financing from budgets of different levels. Alongside with additional revenues to local budgets in 2015, their subsidization grew up as well. In particular, as O. Vlasiuk

(Vlasiuk, 2016) says, "the portion of inter-budgetary transfers in local budget revenues has grown to 59.1%, which is by 2.7% higher than in 2014." This is a considerable constraint to regional economic policy modernization, since regional budgets practically always take part in co-financing (in different ratios), but not in full funding of regional, district, and local initiatives.

2. Implementing decentralization of power in the direction from the state bodies to the lowest-ranking local governments, it is necessary to promote it within territorial communities – both at the regional level and that of a city or village. A serious corruption problem is augmenting: concentration of power and, more important, of additional funds in the hands of the heads of local councils who are repeatedly reelected, continuing to mold "clans" and to pose new institutional obstacles to reformative impulses. Consequently, the only real tools for prevention of modernization blocking can be enhancing awareness, consciousness, and strengthening the civil society impact on the local power bodies.
3. A problematic dichotomy of unstable state planning and inefficient regional application of financial resources of the State Regional Development Fund. On the one hand, in 2015-2016 the funds of SRDF were not made maximum use of, since a significant, up to 25%, portion of projects was rejected due to their formal non-compliance with the government requirements, while some part of the SRDF finances was not used altogether. None of the country's regions was able to use their yearly quota for the allocated money in full measure, with Zaporizhzhia region showing the lowest rate of utilization in 2015 (only 56%). In total, 2015 saw realization of 876 projects, 532 or 60.7% of them fully completed (Vlasiuk, 2016). By the end of 2016, in all the spheres there was a lack of developmental projects which could help capitalize the value of the local land; however in communal and social infrastructure, the "band aid" projects prevailed.

On the other hand, under the deficit of state budget and the current state of the balance of payments (4.1% of GDP in 2016), a specific feature of the government impact on regional economic policy was relating regional priorities to secondary processes, in particular in 2017, revenues from selling property were forfeited to the state. In this way, the risk of the regions' and associated territorial communities' incapacity to realize their projects at the expense of SRDF was practically ensured. For example, the law "On the State Budget of Ukraine for 2017" provided for the allocation of UAH 3.2 bln. to realize SRDF programs and projects: UAH 1.0 bln. from the general fund, and UAH 2.5 bln. from the special fund mostly through selling of confiscated property, which is a very unreliable and unstable financial source. As the practice of 2016 showed, the sales of seized goods made only 78.4 thousand UAH of the planned UAH 7.7 bln. countrywide. Indeed, if 1% of the planned state budget income was included into the general fund for realization of SRDF programs and projects, the guaranteed amount would amount to UAH 6.5 bln., while the other UAH 1.5 bln. could be supplied from the special fund.

4 Decentralization reveals the hidden conflicts of interest between local elites, as well as between the branches and levels of local power i.e., state administrations and councils of different levels. This fact is supported by the results of the conducted surveys, in which these types of conflicts are mentioned by majority of respondents (70.5% and 47.7% respectively; Figure 3). The conflicts are underlain by a variety of reasons, but their orientation is the same: perpetual fighting for influence and power. This problem complicates essentially the reaching of a primary internal consensus at the regional level, which necessitates initial building of clear-cut processes and step-by-step guides into the mechanisms of unblocking modernization processes in the context of enhanced openness in public governance.



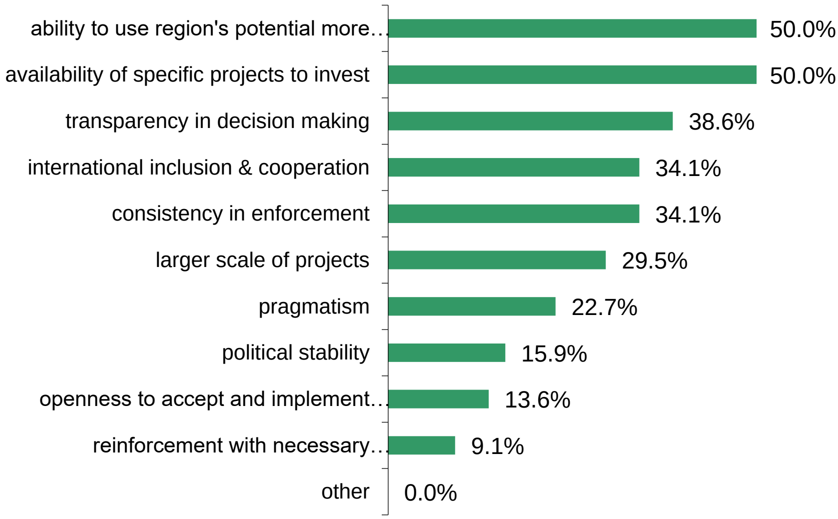
Source: Igor Dunayev's elaboration.

Figure 3. Distribution of respondents' answers to the question "What contradictions and conflicts are most evident at the regional level during decentralization?", in %.

5 Due to depopulation and the current anti-terrorist operation in the east of Ukraine, there is an increasing risk for the post-conflict territories to turn into depressive ones in the government-controlled districts of Donetsk and Luhansk regions. The regions lack proper institutional and financial resources for their reconstruction, which the state is unable to guarantee by itself, without sizable foreign aid. There is still a shortage of state programs for a comprehensive recovery of the said territories, providing a reliable transport accessibility to small cities and villages, without the risk of contacting production or infrastructural facilities (in particular the railway) in the temporary occupied areas of these regions.

6 Despite the ongoing redistribution of tax revenues in favor of local budgets, the financial and economic capacity of the regions and communities does not allow them to ensure a desired development or even satisfy their everyday needs, in the first place, housing,

utilities, and social. The main financial resource, though untapped so far, lies in an effective utilization of the inner potential.

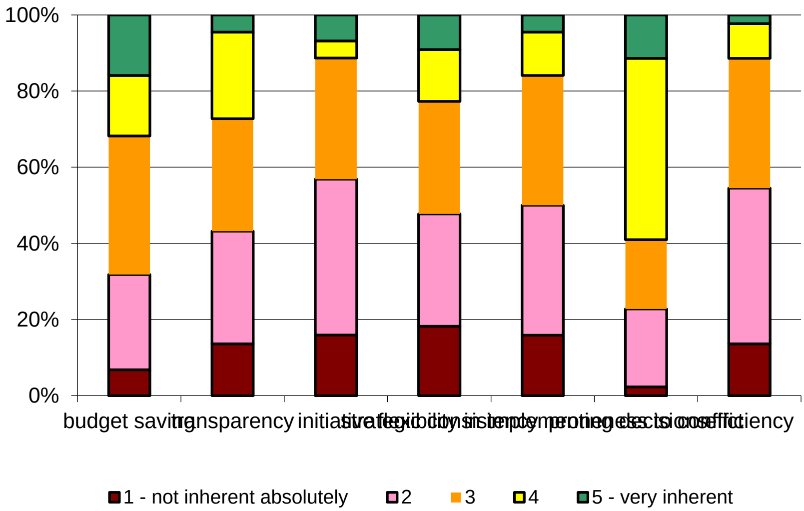


Source: Igor Dunayev's elaboration.

Figure 4. Distribution of respondents' answers to the question: 'What parameters of the regions' economic policy and strategy, currently established by their councils and administrations, should be improved most significantly?', in %.

To meet the above-mentioned challenges effectively, the government and regional authorities must renovate the mechanisms and tools for regulation of regional development with an emphasis on strengthening of institutions, improving their readiness to attract resources and use their own potential (Figure 4). Particularly, among other tasks, a special attention should be paid to preparation of specific projects, work on development of large-scale initiatives able to attract middle- and large-size investors or loan suppliers; international involvement and cooperation, openness and consistency in decision-making. If wasted, the reform time will by no means be made up for due to progress in isolated spheres – it is vital to deliver full-scale general changes.

Presently, we observe an unimpressive "portrait" of regional authorities against the background of the problems stockpiled over years through ineffective and inflexible decision-making. When evaluating the general current quality of the regional governance in Ukraine, without specification by branches of power (Figure 5), the most positive summary assessments were given to such qualities as ‘cost saving,’ ‘transparency,’ and ‘strategic consistency’ which, compared to other qualities, are rather a result of implementation, in the first instance, of the state reform of 2015-2017. There is a large extent of conflict and inefficiency of actions and decisions within the regional tier of governance, which indicates their direct interdependence and the initial stage of a continuing modernization transit towards the Ukrainian regions’ decentralized development.



Source: Igor Dunayev’s elaboration.

Figure 5. Distribution of respondents’ answers as to evaluation of the governance efficiency features characteristic of the current regional administrations and regional councils, in %.

So, as a preliminary conclusion, we see that a reasonable balance between “dirigisme” and “institutionally-liberal” approaches in Ukraine’s regional economic policy has not been found yet. There is little understanding that the region’s economic policy should be aimed to maximize the use of competitive advantages of specific areas, coordinating regional strategies with business strategies, and mitigating market failures through effective redistribution. But it's possible if cardinal modernization of institutions as well as human capital development occurs.

Institutional Updating of the Basis for Economic Policy Modernization. Proposals for Ukraine and Ideas for Other Emerging Democratic Countries

Unlike other countries, Ukraine currently lacks both effective resource-sufficient institutes of regional economic development (e.g., even the aggregate annual budget of the State Regional Development Fund is now a few dozen times smaller than the real needs of any Ukrainian region) and the horizontal subnational network of interacting institutes and institutions. It is still difficult to judge the effectiveness of SRDF, since the record of successfully solved problems is not long enough, and the amount of funding is small, for instance:

1. instead of UAH 5 bln. ($178.5 mln.) planned for 2016, that year the State Budget approved only UAH 3.2 bln. ($114.2 mln.), which amounted to 0.0048% of the total expenditures of the State Budget of Ukraine in 2016. In 2019, the overall budget of SRDF is UAH 7.6 bln., or $281.5 mln.;
2. in 2019, the government of Ukraine was granted the right to spend 50% of the SRDF funds on their set priorities, which reduced the funding of regional development strategies more than two-fold;
3. the members of the Ukrainian Parliament were entitled to submit projects to be included in financing outside the established rules set for regional development actors – through regional commissions;
4. in 2019, as in 2018, SRDF may be less than 1% of the state budget expenditures (in fact, UAH 6.67 billion (or $ 242.5 million)) (U-Lead, 2019).

These circumstances alone can urge to improve the procedure for the distribution of SRDF finances; now there is a need to clarify and identify the criteria for the fund distribution. There is a need for a more rigid legal regulation of the formation and use of the SRDF funds intended to support regional development, rather than to compensate for the regional leaders' welfare mentality by distributing funds in a "manual way".

The world experience of the past two decades has shown that traditional (cost) mechanisms and competition institutes are gradually being replaced with other mechanisms of cooperation between the state, business, higher educational establishments, and communities (Heintze, 2007 : 6-9). For the chosen reference model of a coordinated self-development, this means that the interregional network of development and self-development institutes can only appear under the condition of external coordinating assistance, in the first place – the state one, and, as foreign experience shows, intensive assimilation of foreign technologies [261; 294; 399]. Moreover, to fulfill the tasks of catch-up modernization (modernization transition "outsider → follower"), it is expedient to have modernization institutes rather than development ones, which will help to bring about a new type of more flexible planning, a clear economic motivation for broad participation, transfer of technologies and development of industrial policy and localized production. This should be taken as a framework principle for the emergence and formation of the institutes and status institutions in the regions.

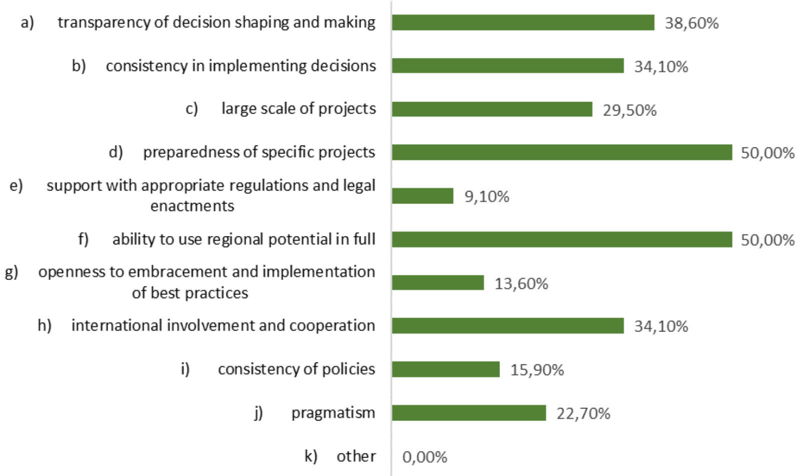
This fully fits into the concept of an interactive growth management system by V. Polterovich (Polterovich, 2008: 19), which contains "three components: a national innovation system; coordination of various types of economic policies for an increased absorption capacity of the country; and a system of interactive planning with an active cooperation of the state, business, and civil society in the processes of forming and implementing large-scale modernization projects". In the present-day Ukraine, there are only parts of the elements which respectively make up the above components. The most noticeable, yet apparently insufficient progress can be seen in the ongoing reform of the state regional policy, in particular in the formation of a single vertically coordinated system of goals and co-financing of regional priorities. Indeed, with very limited financial and material resources, the Ukrainian government is still trying to support separate highly viable points and to synchronize in this way the development of local priorities with the national ones. In other words, we speak here of a consistent, coordinated strategic planning at different levels. This means that the concept of V. Polterovich is in good agreement with the above-mentioned model of “coordinated self-development of the regions” (Polterovich, 2008), since they both provide for a coordinating, securing, and foundational role of the state at the start, with a subsequent transfer of the ‘centers of gravity’ to subnational levels.

For the national system of coordinated strategic planning to become an effective tool for the economic growth of Ukraine and its regions, it is not enough to have strategic planning alone. Additionally, new institutes of sliding planning should be created and widely distributed: medium-term and yearly plans of the country’s territorial and branch-related development, and a three-year budget planning, based on well-calculated large-scale modernization projects in the real sector of the economy – in particular, in the form of anchor projects or investment programs of public-private partnership, e.g., in the energy-saving, energy-efficiency or waste-management spheres in the regions and large cities. Furthermore, taking into account the modern possibilities of collecting, transmitting and processing information, yearly average plans for five years should be updated each year, specifying the plans for the second to fourth years of a previous five-year plan and, accordingly, including a new fifth year in the planning horizon. A similar principle of continuous (sliding) planning should be used also for regional development strategies. This requires a hierarchical planning system with the interaction of its levels with business associations and local reputable civil society institutions. This interaction at the regional level should involve expert groups and commissions including competent representatives of regional authorities, leading universities, specialized civic and business associations. The prerequisites for good performance in this case will be as follows (Dunayev, 2017):

- an iterative process of collecting and analyzing information "as it is" with further development and coordination of decisions, based on visual simulation and econometric modeling;
- the interaction of the government and regional authorities with specific important enterprises, in particular with reputable civic associations, in order to make the interaction process as open as possible, reducing the risks of non-transparent lobbying and conflicts of interest;
- elaboration of common requirements for projects of economic and infrastructure modernization at the branch-related and regional level, which would include implementation scenarios and efficiency estimates performed with the same calculation method. To accomplish this, new project offices will be needed, which are to be staffed with personnel of specialized branch-related research institutes, HEIs, business schools and technology transfer centers, aiming to deal with the technical issues of analysis and technical and economic design of specific projects. This challenging niche is still unoccupied in Ukraine, claiming the involved participants' time and trust.

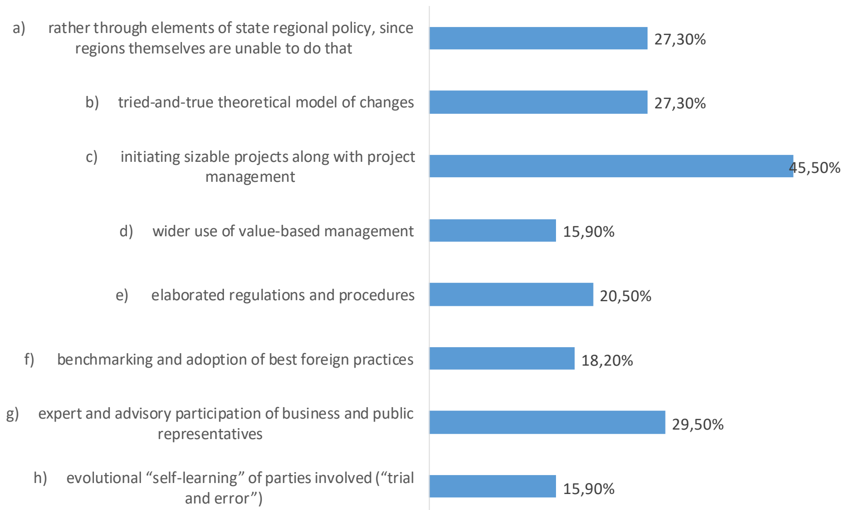
In addition to a more flexible planning, the system of institutes and institutions of the modernized REP should include the economic incentives for economic development and horizontal cooperation. According to the results of the author's expert survey (Figures 6 and 7), large-scale joint projects supported by well-laid-out documentation have a very large potential for the revival of development and cooperation; however, currently they are but few.

This problem is well known in Ukraine, although it still remains unsolved at any level, its solution being largely based on the organizational and institutional framework and motivation. It should be built on a regional infrastructure for attraction of investment that does not exist in any of the Ukrainian regions.



Source: Igor Dunayev's elaboration.

Figure 6. Distribution of expert responses as regards the parameters of regional economic policy and strategy, which should be largely improved, in %.



Source: Igor Dunayev's elaboration.

Figure 7. Distribution of expert answers as to the best instruments that could improve coherence and consistency in the changes of the rules for the regional economic policy and strategy, in %.

This infrastructure is to include such basic elements as expert groups united around large-scale problems that can be solved through investment programs (See: Dunayev, 2018: 83), established relations with big institutional creditors or investors, and an interregional network of project offices.The following is a description of the method of building an institutional framework for the organizational and institutional mechanism to be used by the regional governance tier (Table 1) in Ukraine. It is underpinned, firstly, by the logic of the functional relationship between the proposed functions of the complex mechanism of REP modernization and institutional forms, and secondly, by the idea of the three conditions (time, political will, institutions) crucial for the introduction of institutions at the stage of formation, and not further realization, of REP. When using such an organizational and institutional mechanism, one of the guides will be not the quantity but the quality (functional usefulness) of the institutions as carriers of a certain status, since they always conceal significant risks of non-transparency and inactivity. The method is a novelty in science.

The description of the presented method covers the actual and required institutes and institutions of REP modernization, which are correlated with the pre-determined functions of the complex modernization mechanism according to its four elements: public administration, economy, space, and institutes. All the proposed functions comply with a classical set of management functions (planning, organization, motivation, and control).

It is proposed to include with the group of institutes "a fairly significant number of new and relatively new formal institutes for consolidation of relations, supporting the consolidation of certain required functions and roles. Similar institutes are widespread in the world due to their fulfillment of the same functions, whereas their long-term absence indicates non-priority and non-transparency of the renewal of certain relations at certain stages of forming the economic policy of a region. The effectiveness of a particular institute will depend, to a significant extent, on coherence of functional and social modernization mechanisms, minimal resource sufficiency, and the will to change" (Dunayev, 2017: 247).

Table 1. The method of building an institutional framework for the organizational and institutional mechanism providing regional economic policy modernization at the stage of its formation

Proposed functions of the complex mechanism for REP modernization	**Actual and required institutes of REP modernization**	**Institutions of REP modernization**	**Three crucial conditions for introduction of institutions**
1	2	3	4
Public administration as element of REP modernization system			
Coordinating	Clear structural priorities. Strategic normative acts of national and regional levels. Associated strategies of several territories. Layouts of strategic document. Target conditions and indicators.	Expert groups and inter-branch commissions. Regional development agencies (RDA). Coalitions of regional business associations. Development institutes that support regional internationalization and export. Regional and national commissions for 'smart specialization' of regions.	Political will, common vision, principles
Integrating	Strategic forecasts. Framework development programs. Technological platforms. Selected best practices. HEI and training centers (project management, property management etc.). Regimes of facilitated investment.	RDA, HEI and centers for technologies transfer. Education and analytical centers. Demo centers for advanced technologies. Industrial unions. Business incubators and clusters. Regional funds of funds.	Trajectory of changes, regional specificity, new capacities.
Staff training	International exchange programs for HEIs and business. Municipal orders. International technical assistance programs.	Inter-branch expert councils for establishing key competences. Regional and national commissions for 'smart specialization' of regions. Specialized social funds. Business incubators and business schools.	People, goals, time

Proposed functions of the complex mechanism for REP modernization	**Actual and required institutes of REP modernization**	**Institutions of REP modernization**	**Three crucial conditions for introduction of institutions**
1	2	3	4
Economy as element of REP modernization system			
Analytical	Regional benchmarking. Foresight. Expanded geoinformation systems. Technological platforms.	HEI-based expert groups and specialized analytical centers.	Trends, new capacities, regional specificity.
Selection of strategizing options	Principles of 'smart specialization' of regions. Target conditions and indicators. Investment map (profile).	Inter-branch expert groups and HEIs. Project offices for PPP needs. Specialized civic associations. Coalitions of regional business associations.	Trajectory, people, common vision.
Mobilizing	State and municipal orders and guarantees. Protected property rights. Facilitated investment regimes (laws of Ukraine). Branch and inter-branch investment programs. Inter-municipal partnership agreements. Town twinning.	National investment board. Regional investment boards. Regional fund of funds, development corporations in the form of public companies. Project offices for PPP needs. RDA. Directorates for industrial development zones. HEI-based expert groups.	Objective restrictions, regional specificity, time.

Table 1. (Continued)

Proposed functions of the complex mechanism for REP modernization	Actual and required institutes of REP modernization	Institutions of REP modernization	Three crucial conditions for introduction of institutions
1	2	3	4
Forming new resources	Clear structural priorities. Systems of municipal guarantees. Supervisory councils under effective institutions. Participation in EU technological platforms via Horizon-2020. Projects of SRDF. Waste management projects.	Regional funds of funds, special-purpose regional funds with multi-channel capitalizing, and funds of funds. SRDF. State (regional) revolving loan fund. National and regional offices of international institutions (EBRR, UNCTAD, NEFCO and others). Project offices. Industrial parks and clusters. International oversea offices. Exhibitions and international forums.	People, regional specificity, balance of interests.
Space as element of REP modernization system			
Mutual integration of space	Anchor projects. Large-scale infrastructure projects. Investment projects of town-forming enterprises.	RDA, specialized civic associations. Project offices. Coalitions of regional business associations. Centers for promoting local self-government.	Regional specificity, people, balance of interests.
Evaluation and monitoring	Integrated systems of statistical monitoring and modeling. PPP projects.	Public expert analytical centers (outsourcing). Business schools. Specialized courses for training civil servants.	People, trajectory, new capacities
Spatial planning	SRDF projects. Associated territorial communities. Branch and inter-branch investment programs.	Centers for promoting local self-government. Developmental corporations, RDA, specialized civic associations.	Time, objective restrictions, common vision.

Proposed functions of the complex mechanism for REP modernization	**Actual and required institutes of REP modernization**	**Institutions of REP modernization**	**Three crucial conditions for introduction of institutions**
1	2	3	4
Institutes as element of REP modernization system			
Coordinating development	Clear structural priorities. “Soft” educational projects. Participatory budgeting. Institutes of sliding planning.	Specialized civic associations, RDA. Public councils.	People, technologies, common vision
Leadership	Anchor projects. International technical assistance. Exchange programs. Town twinning.	Coalitions of public organizations. Associations of municipalities.	People, strategic vision, common vision.
Public monitoring and control	Comparative analytical systems and models. Participatory budgets. ProZorro system and lowered purchase thresholds. Participatory management.	Coalitions of public organizations. Public councils. Program councils. Associations of municipalities.	People, principles, trust.

Source: Igor Dunayev’s elaboration.

The institutions are suggested to include "non-state organizations, endowed with status functions, which, without duplicating one another, can ensure performance of certain tasks, provided that the work is systemic rather than fragmentary. Every institution presents its own specificity; most of them have currently no successful model to follow in Ukraine. The majority of the institutions are not linked to a particular project, such as public-private partnership or technology platforms; however they perform more numerous and challenging tasks" (Dunayev, 2017: 247).

The described method of building an institutional framework can be used as a scientific guideline for the development and institutionalization of economic relations in a specific region of Ukraine or some other developing country that is still facing similar problems. Without proper in-depth analysis, it is problematic to recommend which specific institution should be chosen for a particular Ukrainian region. We propose the principles of loyalty, coordination and cooperation as basic and sufficiently universal functional principles of the institutes that would determine the effectiveness of the renewed economic policy of a region. It is these principles that were put forward and grounded by the World Bank (Worldbank, 2017: 7) for new institutes and institutions in the countries with less potential institutional structure that are undergoing sweeping reforms.

The implementation of each function of the complex mechanism for modernizing regional economic policy will require elaboration of a relevant legislative and regulatory framework, as well as specification of the needed extent of its updating and frequency of adoption. In order to provide more comprehensive regulation, it is necessary to plan the development of a roadmap for regional authorities to draft legal and regulatory acts. Its goal is to help regional administrations and regional councils at least to draw plans for the preparation of the regulatory framework for making key management decisions and carrying out actions – in advance, with enough lead time, preventing the traditional for civil service delays.

Nevertheless, it may seem that for a successful fulfillment of the key task – implementing modernization projects in the regional economy and the economic policy of a region – it is necessary, in the first place, to solve the problem of collecting and processing information, and then to create new relevant associations or asset management companies, to develop a system of sliding plans, and so on. According to this logic, one should not expect real results soon – they will be only on chapter and a mere waste of time. It is proposed to plan a system of institutions within the organizational and institutional mechanism, based on understanding of the prospects of each organization through its consistent actions and ability to show rapid results during the first year. It is worthwhile to start by taking inventory of the projects existing in regional enterprises and universities, improving their selection, with a subsequent representation and step-by-step support for promoting and replicating them in other regions. This work is challenging for the regional authorities, and therefore it is sound to rely on the public sector and leading HEIs, as was the case in Kharkiv region in 2016-2017.

Given the traditional passivity and inflexibility of the regions in creating a new regulatory framework, today there is hardly any discussion on the regions' acquiring their own specialization, or considering their specificity in the national and international positioning. We believe that the modern answer to the challenges of the time will be smart specialization of the regions of Ukraine. It is no sooner than in April 2017 that some of the Ukrainian regions began a thematic debate on defining their European-inspired smart specialization, and Kharkiv region was the first to receive a letter of inducement from Borys Paton, the president of the National Academy of Sciences of Ukraine in February 2017. With the Academy's help, it is possible to deepen the integration of the country's regions into the European technological platforms, to arrange the exchange of their knowledge, and to develop their competencies.

Now, as we have shown in (Dunayev, 2017), the national economy of Ukraine should evolve beyond the departmental or branch-related limits. There should be a transition from mono-sector projects to inter-sector ones; from purely construction projects (consolidation, growth, and technological modernization of fixed assets) – to complex, cooperative projects of using these assets by various parties. At present, for any region of Ukraine, formation of new ties based on infrastructure solutions and solutions in the sphere of housing and communal services creates fundamentally new opportunities to last for several decades, which can be capitalized quickly in the cost of the surrounding land, localized production, etc. Joint creation and use of infrastructure facilities means a growth of the scarce social capital of Ukraine and its regions. Local companies and sector-related goals as to the new social capital appear to be included into a more effective techno-industrial and socio-cultural practices in a natural way.

CONCLUSION

On the whole, the present chapter contains the authors' substantiation of the proper functional influence of regional authorities – in particular, that of specialized, formal institutions – on the economic development of the region, taking into account the modern theory of 'new institutionalism'. Accordingly, it is proposed to base the method of building the relevant institutional framework on the idea of maintaining the links between the pre-determined supporting functions (on the one hand) and: (a) public institutes involved, (b) status institutions of modernization, and (c) critical conditions for the introduction of these institutions (on the other hand). As a consequence, this approach has allowed several significant scientific conclusions to be drawn.

1. The peculiarity of the modern stage in the development of society is the transition from hierarchically managed systems where a top-down interaction (organization) dominates to network partnerships and self-governing systems which are formed from bottom to top (co-organization and self-organization). Self-development of entities and co-organization significantly accelerate the processes of progressive transformations and bring the harmonization of certain social subsystems to the required level. Unlike organization, co-organization and self-organization produce a

variety of decisions based on life experiences. Centralized organization and co-organization, given their optimal correlation, make up a single mechanism for an advantageous development of society. The proposals put forward in this chapter, following on from the new budget authorities and a new resource potential, will form the basis for productive interregional cooperation and developmental co-organization, which is part of the concept of a modernized regional economic policy.

2. The development of the methodological basis for forming a complex mechanism and ensuring the integration and stability of its components includes a target vector of the mechanism for the regions' coordinated self-development; it is proposed to form updated regional economic policies with an emphasis on coordination of the two – external and internal – modernization configurations: coordination by the state with a gradual easing, and a parallel coordination by the regions with a gradually increasing mutual influence. Consequently, the functions of the public administration system are improved and new institutes are formed that are oriented towards a steady management of competencies.
3. The renewal of management relations according to each of the four modernization system elements – public administration, economy, space, and institutes – is essentially related to certain functions and institutes, which are currently non-existent in Ukraine. On this premise, a method of building an institutional framework for organizational and institutional mechanisms providing modernization processes in the regions of Ukraine was developed. It is suggested to relate the mechanisms directly to implementation of the specific functions of the complex modernization mechanism at the stage of forming the economic policy of the region. The substantive basis of the institutional framework for the mechanisms will be laid by the appropriate institutes and institutions, the emergence of which is deemed useful for the regions. A critical analysis of the capacity for change has allowed designing an additional "filter" in the form of three critical

conditions for the introduction of institutions in order to focus the managers' attention on the problems. At the next stages, particularly in policy implementation, these functions will be different, and the structure of the institutional and organizational mechanism may change accordingly.

4. It is necessary to create, implement and transform various types of market development institutes which should be diverse, providing for the multi-purpose orientation of territorial development. However, this poses the threat of a discrepancy between the development strategy of the region and the narrow objectives of the development institutes involved in the institutional and organizational mechanism of REP modernization. This problem can be solved only by the comprehensiveness and strategic orientation of the system of regional development institutes. Given the fact that the Ukrainian regions have already started the formation of investment portfolios for proper financing of specific investment projects, it is now possible to revise and redesign the ways of solving numerous investment problems using public-private and municipal-private partnership mechanisms. The Ukrainian regions are in need of the institutes and institutions that would simultaneously meet the general requirements of the national legislation and take into account the specific features of the regions due to forming unique combinations of various tools.

REFERENCES

Barca, F., McCann, Ph., Rodriguez-Pose, A. (2012). The case for regional development intervention: place-based versus place-neutral approaches. *Journal of Regional Science.* Vol. 52, # 1: 134-149.

Bochko, V. S. (2016). "Economic self-dependency of regions within the new normal," *Ekonomics of a Region*. Vol. 12, Issue 2: 342–58 (in Russian).

Cabinet of Ministers of Ukraine (2015). “On approval of a Methodology of formation of capable territorial communities”: Decree of Cabinet of Ministers of Ukraine dated to 08.04.2015 № 214, *Governmental currier*, 06.05.2015, №80.

Dunayev I. (2018). The modernization logics and principles of designing a new generation of regional economic policies: findings for recent Ukraine and Eastern-European countries in transition/*Modernization: Progress in Economics Research*. Vol. 41/Edited monograph: ed. Albert Tavidze. – New York: NOVA Publ. – 264 p. : 53-90.

Dunayev, I. (2014). Value objectives of modernization of regional economy through a smart specialization prism, *Analytics & Power*. № 9: 260–266 (in Ukrainian).

Dunayev, I. (2017). *Public regional economic policy in Ukraine: designing the mechanisms of modernization* [Monograph]. Kharkiv: “Magister.” 296 p. (in Ukrainian).

El-Erian, M. (2015). *Navigating the New Normal in Industrial Countries Per Jacobsson Foundation Lecture*, URL: www.imf.org/en/News/Articles/2015/09/28/04/53/sp101010.

Gharajedaghi J. (2010). “System thinking. How to manage a chaos and complicated processes. A platform for modeling a business architecture.” *Minsk: Grevtsov Books*, 480 p. (in Russian).

Heitze, T. (2007). Binding a science and an economy in knowledge-based technologies. *Sociological Journal*. № 4: 5–24 (in Russian).

Hroysman, V. (2017). *Priorities of the Budget 2017.* URL: www.kmu.gov.ua/document/249608418/Budget_priorities-2017.pdf (in Ukrainian).

Ketels, Ch., Summa, T. (2015). *State of the Region Report 2014. The Top of Europe – Emerging from the Crisis, Adapting to a New Normal.* Copenhagen: Baltic Development Forum. 132 p.

Lazhentsev, V. N. (2014). *The content, systemic organization and planning of territorial development.* - Ekaterinburg — Syktyvkar : ISEiEPS Komi NTS UrO RASc. 236 p. (in Russian).

Mau, V. and Ulyukayev, A. (2014). “The global crisis and trends of economic development.” *Voprosy ekonomiki*. №11: 4-24 (in Russian).

NISD (2015). Regional economy in 2015: new realoties and opportunities in terms of started reforms, Kyiv: National Institute for Strategic Studies, 92 p. (in Ukrainian).

NISD (2016). *Directions for boosting a mechanism of cooperation of territorial communities* Kyiv: National Institute for Strategic Studies, 20 p. - URL: http://www.niss.gov.ua/content/articles/files/AZ-Sp-vrob-tnitstvo-TG-d2e37.pdf (in Ukrainian).

OECD (2009). *How Regions Grow. Trends and Analysis.* Paris: Organization for Economic Growth and Development. – 144 p.

Polterovich, V. M. (2008). Modernization strategies, institutes and coalitions. *Voprosy Ekonomiki*. № 4: 4–24 (in Russian).

Roxborough, I. (1998). Modernization Theory Revisited: A Review Article. Comparative Studies in *Society and History, 30 (4)*, 753–761.

Sabluk, V. (2017). *Failed decentralization: why do attempts to "raise" a rural country come wrong?* URL: http://agravery.com/uk/posts/show/nevdala-decentralizacia-comu-sprobi-pidnati-selo-ne-vdautsa (in Ukrainian).

Sentence A. (2013). *The "New Normal" for the Global Economy*//Nuffield Health Summit, 2013, March 7. – URL: www.nuffieldtrust.org.uk/sites/files/nuffield/andrew_sentence_global_economic_outlook.pdf.

Silin, Ya., Animitsa, E. and Novikova N. (2016). "The new normal" in the Russian economy: a regional specificity," *Economics of a region*, Vol. 12, Issue 3: 714–725. – doi: 10.17059/2016-3-9 (in Russian).

Support to Ukraine's regional development policy (2013). *Regional development and regional policy in Ukraine: a state and prospects of changes in a context of global challenges and European standards of policy. Analytical report*, Kyiv: EU SURDP, 342 p.

U-Lead (2019). *Analytical report on financing to State regional development fund through the State Budget in 2019.* - URL: https://rpr.org.ua/wp-content/uploads/2019/01/RD-in-budget-2019-1.pdf (in Ukrainian).

Vlasiuk, O.S. (2016). "Social and economic development of Ukrainian regions in conditions of power decentralization: challenges, threats, new mechanisms," *Regional economy*, № 3: 5-9 (in Ukrainian).

Voronkova O.N. (2016). “The new normal” of global development and a strategy for Russiona business,” *Financial research*. №3 (52): 119-23 (in Russian).

World Bank (2018). *World development report 2018: ending poverty, investing in opportunity*. Washington, DC: World Bank, 2018. 97 p. – URL: http://documents.worldbank.org/curated/en/630671538158537244/pdf/130320-v1-english-replacement-PUBLIC.pdf.

World Bank (2017). *World development report 2017: Governance and the law*. Washington, DC: World Bank, 2017. 307 p. – URL: www.worldbank.org/en/publication/wdr2017.

Reviewed by Prof. Mykola Latynin (m.a.latynin@gmail.com), Kharkiv Regional Institute of Public Administration of the National Academy for Public Administration under the President of Ukraine.

In: Progress in Economics Research …		ISBN: 978-1-53618-248-4
Editor: Albert Tavidze	

Chapter 3

ENERGY AND ECONOMIC SECURITY OF THE SOUTH CAUCASUS REGION AND NEIGHBORING COUNTRIES

Alexander G. Tvalchrelidze*
A. Tvalchrelidze Caucasus Institute of Mineral Resources,
Tbilisi State University, Tbilisi, Georgia

ABSTRACT

The South Caucasus Region is one of the most interesting and, at the same time, one of the most vulnerable regions in the world. In addition, strategic interests of the USA, the EU, Russia, China, Turkey, and Iran conflictingly intersect here. After the collapse of the USSR the South Caucasus states displayed intense social & economic development in several years. Among the South Caucasus states electricity market is deficient only in Georgia. However, the liberalization of the market provides a flexible possibility to distribution companies for signing futures contracts on electricity purchase, which allows the Operator to perform seasonal electricity export, import and transit. In-depth analysis of energy efficiency in these countries identifies two basic problems as

* Corresponding Author's E-mail: sandrotval@gmail.com.

follows: (i) Incompatible legislations according to which the electricity market is entirely liberalized in Georgia and rigidly controlled by governments in Armenia and Azerbaijan; (ii) Incompatible consumer tariffs, which are diversified on wholesale and retail tariffs in Georgia and imposed by governments in Armenia and Azerbaijan. Experience of the last decade has shown that the liberal energy market with competition of private distribution companies is a precondition for the development of the electricity sector. From this point of view perspectives of Georgia are optimistic whereas in Armenia and Azerbaijan at a certain stage and in near future farther growth is doomed to fail. Picturesque GDP growth in Azerbaijan in 2005-2008 with the sniper accuracy coincides with the period when Baku-Tbilisi-Ceyhan (BTC) oil pipeline became operational. This peculiarity outlines volatility of the Azerbaijani economy, lion's shear of which is governed by the hydrocarbon sector. Correspondingly, decrease of the world oil prices in recent years at the background of diminished oil production determined not only deterioration of economic indicators but also devaluation of the Azeri Manat in the beginning of 2015. Azerbaijan is exporting basically hydrocarbons, Armenia – commodities and clothing, export structure of Georgia is much more complex: in 2019 the country exported 778 kinds of commodities & goods including Hi-tech products. In 2019 the exports volume from the South Caucasus roughly equaled US$ 26.5 billion or 32.63% of the bulk regional GDP. In case of Initial Public Offering (IPO) and capitalization of commodities, the added value derived from financial instruments would be, at least, three times more. Correspondingly, we are proposing foundation of the Caucasus Commodity and Stock Exchanges, which may be launched only in Georgia due to the geopolitical framework. Today, the Southern Gas Corridor consists of three pipelines: (i) South Caucasus Pipeline (SCP), which started gas transportation in 2006; (ii) Trans-Anatolian Pipeline (TANAP), which pumped the first gas in autumn 2018, and (iii) Trans-Adriatic Pipeline (TAP), which is under construction phase. When all the system of the Southern Gas Corridor becomes entirely operational, it will be able to diminish the European energy dependence on Russia only by 10-15%. Huge increase of the capacity seems to be impossible due to limited gas reserves of Azerbaijan. Correspondingly, we have launched an idea to include Iranian gas reserves in the pipeline system. The project has the following important positive features: (i) Its execution will destroy the Russia-Iran partnership in gas sector and create their severe competition in gas supply to Europe; (ii) European energy dependence on Russia will be diminished at least twice; (iii) Added value of the Southern Gas Corridor will be tripled; (iv) The project will significantly improve the economic and, therefore, the social background of Iran, create hope for the better future and this way promote democratic changes in the country; (v) The project

will merge Iran with the civilized world and this way decisively mitigate influence of Iran on terroristic organizations.

Keywords: security, energy, electricity, economy, export, GDP, pipeline, SCP, TAP, TANAP, Southern Gas Corridor

INTRODUCTION

Within the concept of security [1], the energy security implies adequate, reliable supplies of energy at reasonable prices and in ways that do not jeopardize major national values and objectives [2]. Similarly, economic security corresponds to a situation of having a stable source of financial income that allows for the on-going maintenance of one's standard of living currently and in the near future [3]. It should be said that political economy considers both approaches as an inseparable part of a country's security [see 4], and, for instance, national security concepts of all the three South Caucasus states [5-7] pay significant attention to national energy and economic independence and security.

The South Caucasus Region (Figure 1) is one of the most interesting and, at the same time, vulnerable regions of the world. Different confessions, national traditions, lifestyles, human philosophies, economic approaches, and a lot of other fundamental values are united here in a single contradictory node.

It is traditionally believed that the region consists of three countries – Armenia, Azerbaijan and Georgia. It was proposed recently [8] to include northern parts of Turkey and Iran in the region, hence, "South Caucasus Region" is a geopolitical rather than a geographic notion and must include countries instead of territories.

After the collapse of the USSR and a huge economic crisis the South Caucasus states displayed picturesque and intense social & economic development [9] and now merged with the Upper-Middle Income Countries' category, according to the new classification of the World Bank Group [10].

Figure 1. Political Map of the South Caucasus.

Table 1 provides general data on the South Caucasus states based on the World Development Indicators released by the World Bank Group [11] and countries' statistical yearbooks [12-14]. Figure 2 demonstrates GDP per capita dynamics as a ratio of GDP in current U.S. Dollars by the population headcounts.

Table 1. Basic Country Indicator of the South Caucasus States, 2019

Indicator	**Unit of measure**	**Country**		
		Armenia	Azerbaijan	Georgia
Surface area	km^2	29,760	86,600	69,700
Population	men	2,937,026	10,047,718	3,996,765
Population growth	%	0.19	1.07	0.02
Population, male	%	47.04	49.88	47.71
Population, female	%	52.96	50.12	52.29
Population density	people per km^2	103.68	120.26	65.27
Life expectancy at birth	years	74.62	72.03	73.26
Infant mortality rate	per 1,00 live birth	11.30	20.5	9.7
Mobile subscriptions	per 100 people	121.26	103.92	136.38
GDP	current US$ billion	12.69	48.74	19.78
GDP per capita	current US$	4,320.00	4,851.20	4,948.66

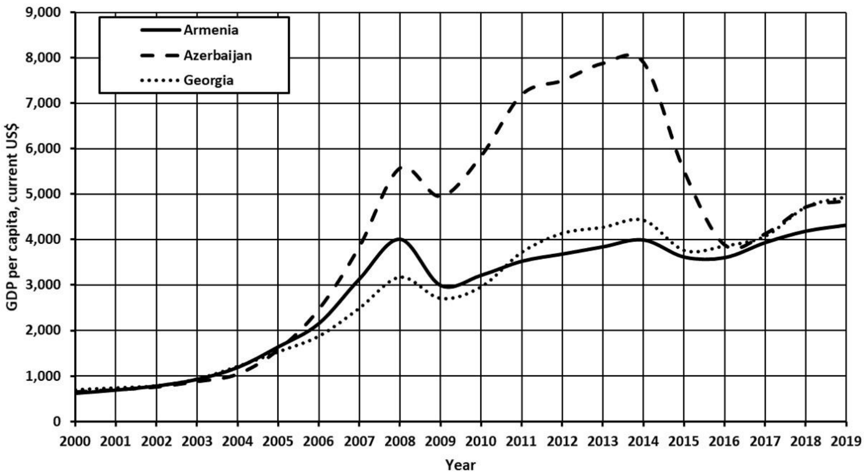


Figure 2. GDP per Capita in the South Caucasus States, 2000-2019.

The sharp and fast increase of this indicator in Azerbaijan in 2006-2014 and the subsequent severe decline is determined by the economic peculiarities of this country, the welfare of which is entirely determined by hydrocarbon exports [15]. Correspondingly, decrease of the world oil prices in recent years [16] at the background of diminished oil production [17] determined not only deterioration of economic indicators but also devaluation of the Azeri Manat in the beginning of 2015 [18].

Together with my co-author, Prof. Paata J. Kervalishvili, President of the Euro Mediterranean Academy of Arts and Sciences, I have published two consecutive articles dedicated to energy [19] and economic [20] security of the South Caucasus. In this chapter, of course, I tried to avoid reduplication of main findings in the cited publications and to provide some new data and approaches.

Hence, it should be boldly outlined from the very beginning that the South Caucasus Region is located on the strategic crossroad of the main world policy makers. I tried to demonstrate on Figure 3 the basic stakeholder countries, which are vitally engaged in the regional development.

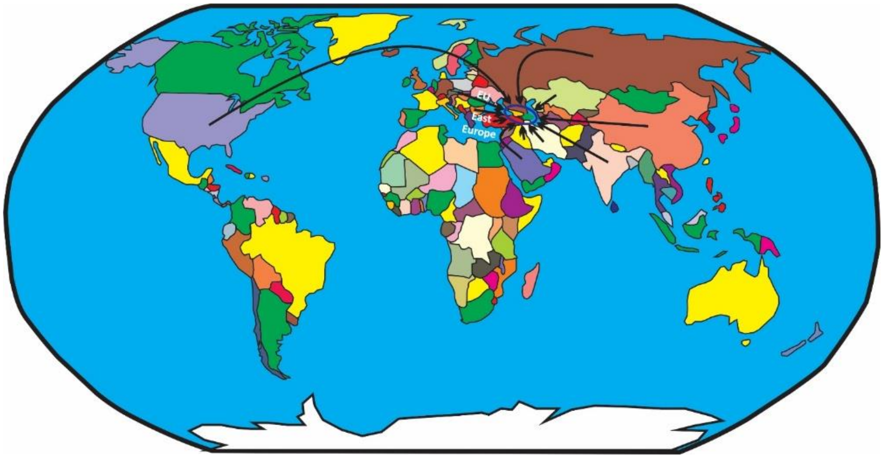


Figure 3. Stakeholder Countries Engaged in the Development of the South Caucasus Region.

It should be mentioned that the Russian approach radically differs from other countries' policy. As it is declared in a large number of researches [see, for instance, 21-26, etc.], Russia considers the region as its "near abroad" and includes all the three now independent countries in schedules of its military security. From this point of view, especially after the Russia's actions in Ukraine, it is clear that the USA and the European Union must oppose Russian activities in the region, and harder this repulsion is, closer all the three countries will approach the EU and the USA [8, 27, 28, etc.]. From this point of view, the most volatile situation is created in Armenia, the national security of which, due to Nagorniy Karabakh conflict, is a hostage of the Russian goodwill. This sad reality is well understood by Armenian analysts, who call for gradual diminishing of the Russian influence and to step-by-step approaching to the EU [29, 30].

The USA interests in the region were primarily designed by Zbigniew Brzezinski in his famous book "The Grand Chessboard" [31]. During 22 years the basic imperatives of his approach have not altered but adjusted and diversified.

Firstly, the USA promotes and supports all energy transit projects from the Caspian Sea to Europe aiming at diminishing European energy dependence on Russia. From this point of view, the most promising seems the Southern Gas Corridor, which will be described below [32-34]. Secondly, the USA considers Georgia as a strategic partner in a number of sectors including military missions in Afghanistan and Iraq, cyber security, intelligence, etc. and boldly supports democratic development of the country [35].

After 2006 and 2009 "cold winters" and Russia-Ukraine "gas wars" [36, 37], the European Union in particular, and Europe, in general, are interested in diversifying its gas supply schedules and from this point of view have vital interests in the Southern Gas Corridor project, which will give them access to the Caspian Sea gas resources [36-44, etc.]. Secondly, as soon as the three South Caucasus countries gained independence, EU started to support stability and economic development in the region. On the next stage, the EU proposed the "Eastern Partnership" project [46], which includes Deep and Comprehensive Free Trade Agreements (DCFTA) [47] and in the case of Georgia – Association Agreement [48]. However, there is a concern on efficiency of the EU polity in the South Caucasus [49] as far as Armenia merged to the Eurasian Economic Union with Russia, Belarus, Kazakhstan and Kyrgyzstan and this way created challenges to Azerbaijan and Georgia [50].

Turkey maintains closest relations with Azerbaijan based on the principle "two states – one nation" [51] and strategic partnership with Georgia based on hydrocarbon transit projects [52-55].

Iran is supplying Armenia with gas (see below) in barter exchange for electricity. Thus, Armenia has developed strong political and economic ties with Iran in order to counter the Turkish-Azerbaijani axis [56, 57]. In response, Azerbaijan seeks to reinforce its links with the West, especially the USA, as its main extra regional source of diplomatic and economic support, while it remains cautious towards both Russian and Iranian ambitions in the region [56].

China actively develops the Silk Road Project [58, 59] promoting an active interstate commerce via the Free Trade Agreements with all the three South Caucasus countries [60].

Surprisingly, however, neither Armenian [5], Azerbaijani [6] national security strategies nor strategic economic development plans [61-63] consider multibranch regional cooperation as keystones for further development, and only the Georgian concept, despite of often unfair criticism [64], suggests that the regional cooperation represents a fundamental basement for social & economic growth. Moreover, due to its geographic framework (see Figure 1), close bilateral relations both with Azerbaijan and Armenia, access to the offshore zone, etc. valid ambitions have risen in Georgia to become a regional energy and economic hub [65-66].

At the same time, it is unequivocally clear that without regional cooperation development in energy [67, 68] or economic [20, 69] sectors is impossible.

REGIONAL SECURITY CHALLENGES OF THE ELECTRICITY SECTOR

It is a banal but, at the same time, a true remark that energy governs economy of the globe. Figure 4 displays correlation between the world GDP as released by the World Bank Group [see 11] and the world energy consumption [see 17] measured in million tons of oil equivalent (Mtoe)[1]. Extremely high value of the correlation coefficient (*r*) outlines the mentioned regularity.

From this point of view, in our previous article [19] we have proposed the model of gradual growth of the energy generation installed capacities in all the three South Caucasus states. The available data [70-72] demonstrate, however, that such a growth, and with the predicted rate, is observed only in Georgia, whereas in Armenia and Azerbaijan the installed capacity of power plants even diminished (Figure 5).

During this period a solar power plant was constructed in Azerbaijan, and a wind power plant – in Georgia. Structure of the installed capacity has not changed in Armenia (Figure 6).

[1] 1 toe = 10^7kkal = 42GJ = 12MWh [17].

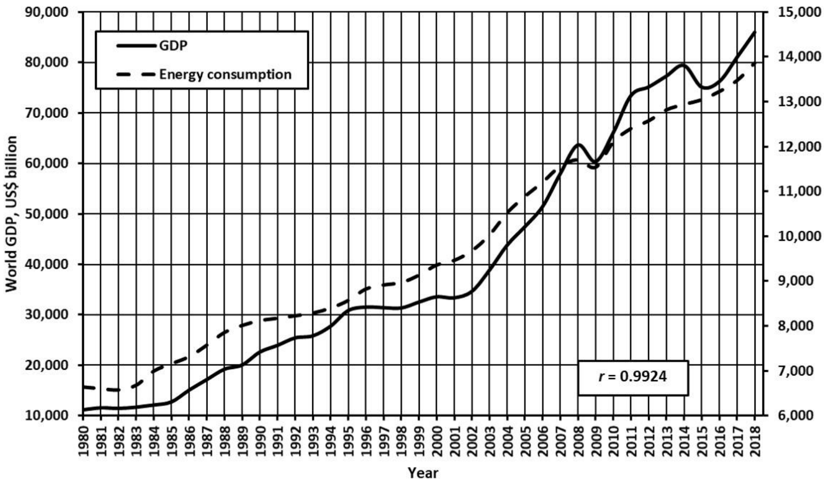


Figure 4. Interrelation between the World GDP and Energy Consumption.

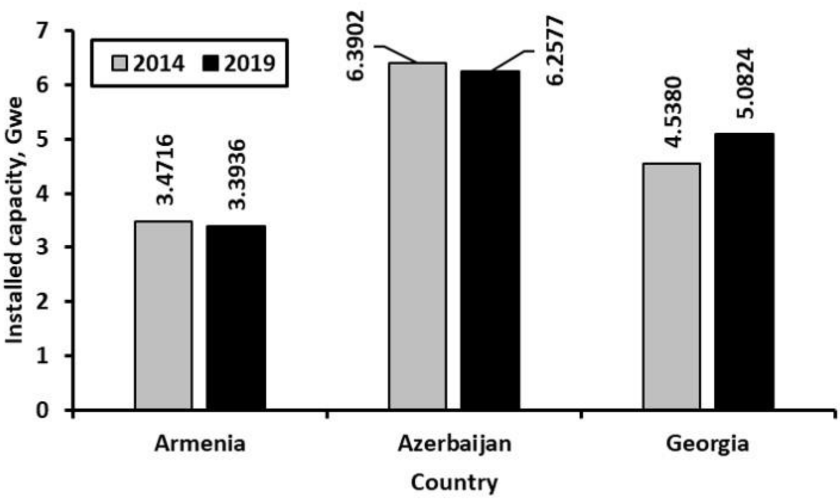


Figure 5. Installed Capacities of Electric Power Generation in the South Caucasus States in 2014 and 2019.

Figure 7 demonstrates production and consumption of electric power in the analyzing countries in 1992-2019, e.g., since they gained independence.

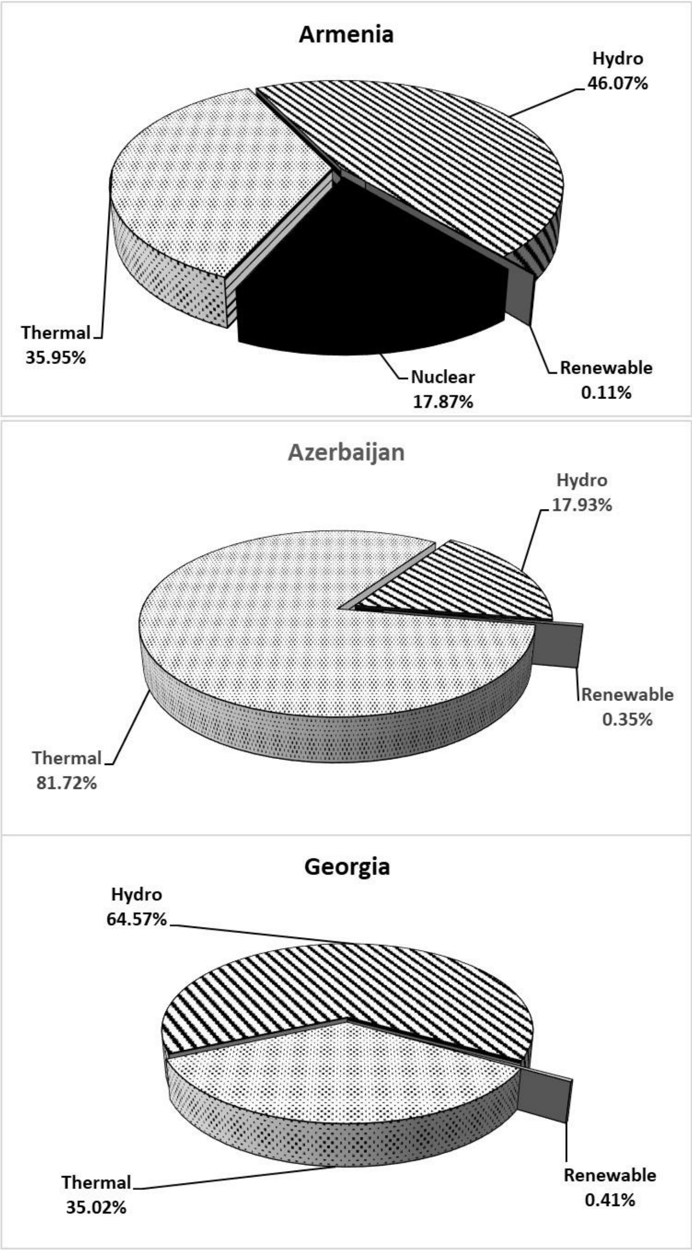


Figure 6. Structure of Electricity Generation in the South Caucasus States, 2019.

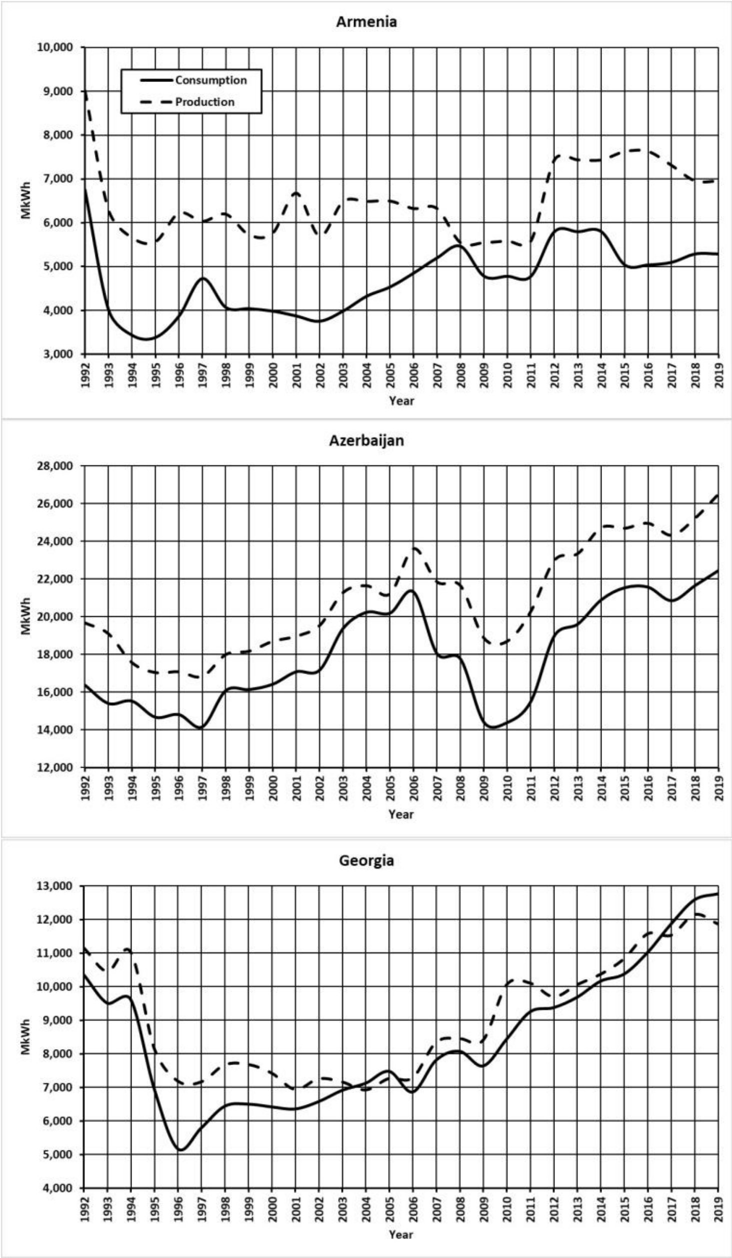


Figure 7. Electricity Consumption vs Production in the South Caucasus States in 1992-2019.

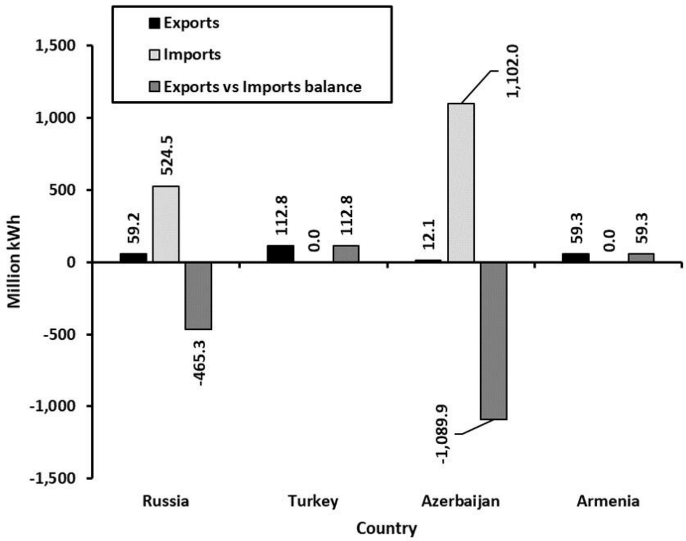


Figure 8. 2019 Electricity Exports vs Imports Balance in Georgia.

It may be seen that only Georgian electricity market is deficient. However, the liberalization of the market and activities of the Electricity Market Operator provides a flexible possibility to distribution companies to sign futures contracts on electricity purchase, which allows the Operator to perform seasonal electricity export, import and transit. Figure 8 bears information on 2019 export vs import balance of Georgia with neighboring countries as released by the Electricity Market Operator [73].

In addition, Georgia started to implement a 10-year electricity sector development plan approved by the Decree № 1-1/207 of Ministry of Economy and Sustainable Development on April 24, 2019 [74].

Now, it is true that all the three South Caucasus states are united by a synchronized electric grid [75] the map of which we have published earlier [19], hence, in-depth analysis of energy efficiency in these countries [76-78] identifies two basic problems as follows:

1. Incompatible legislations according to which the electricity market is entirely liberalized in Georgia and rigidly controlled by governments in Armenia and Azerbaijan

2. Incompatible consumer tariffs, which are diversified on wholesale and retail tariffs in Georgia by the public entity – Georgian National Energy and Water Supply Regulatory Commission and imposed by governments in Armenia and Azerbaijan.

Experience of the last decade has shown that the liberal energy market with competition of private distribution companies is a “Hobson’s choice” for development of the electricity sector. From this point of view perspectives of Georgia are optimistic whereas in Armenia and Azerbaijan at a certain stage and in near future farther growth is suggested to fail.

GENERAL ECONOMIC ANALYSIS: CHALLENGES AND OPPORTUNITIES

Figure 9 describes GDP growth dynamics in Armenia, Azerbaijan and Georgia in 2000-2019 calculated by us based on the data cited above [11-14].

Picturesque GDP growth in Azerbaijan in 2005-2008 with a sniper accuracy coincides with the period when Baku-Tbilisi-Ceyhan (BTC) oil pipeline became operational. Thus, economic expectations of this project happened to be correct [79]. However, today the GDP growth in this country is the least in the region. This peculiarity is entirely determined by the macroeconomic structure of the country.

Figure 10 explores correlation between Azerbaijani GDP and the average annual world crude oil prices, which are driven according to IMF Primary Commodity Prices data bank [16]. Extremely high correlation coefficient value outlines volatility of the Azerbaijani economy, lion’s shear of which is governed by the hydrocarbon sector.

This feature is boldly pronounced when the export structure from the three South Caucasus states are thoroughly studied (Figure 11). Data for these and consecutive graphs were borrowed from the official statistical sources [80-83].

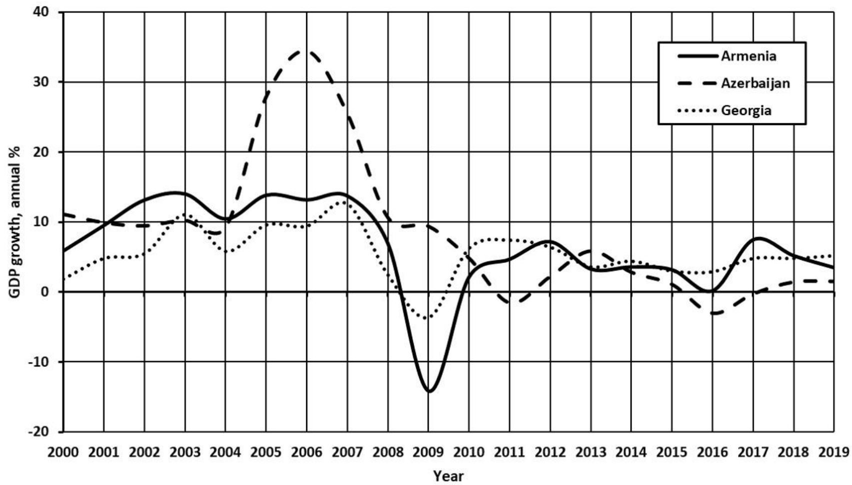


Figure 9. Annual GDP Growth in the South Caucasus States in 2000-2019.

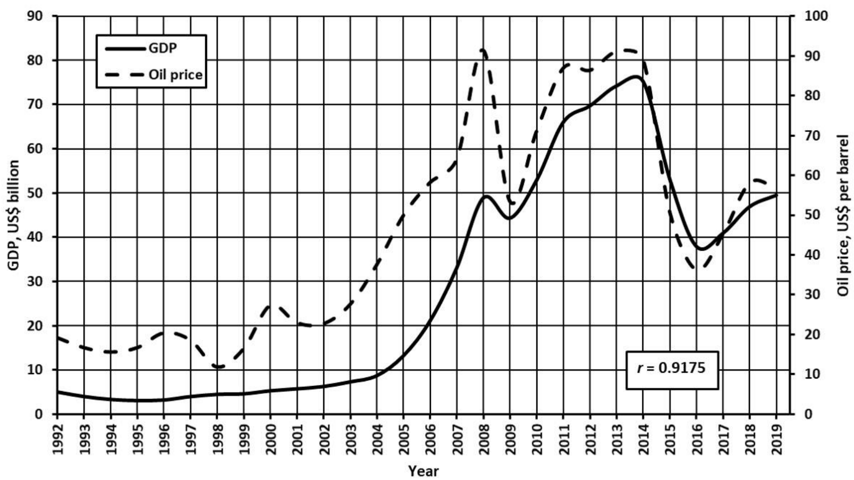


Figure 10. Correlation between Azerbaijani GDP and Average Annual World Crude Oil Prices in 1992-2019.

The share of top ten goods & commodities exported from Georgia is 68.5%, from Armenia – 81.5% and from Azerbaijan – 93.4%, including 87.1% of hydrocarbons exports (75.1% – crude oil exports).

The paradoxical situation when the main exported item form Georgia were cars & trucks, imported from the EU, the USA, Japan, etc., is determined by unsynchronized excise tax rates in the South Caucasus states analyzed in our previous publication [20].

It is necessary to outline that if Azerbaijan is basically exporting primary commodities, and Armenia – commodities and clothing, export structure of Georgia is much more complex. According to data by the National Statistics Office of Georgia [83], in 2019 the country exported 778 kinds of commodities & goods (according to four-digit UNCTAD Codes) including such Hi-tech products as ferroalloys (ferro-silico-manganese), medicaments, construction modules, electronic musical equipment, gauge devices, X-ray and radiometric apparatus, hydrographic and meteorological equipment, optic fiber, carbon electrodes, integrated circuits, radiolocation equipment, turbojet engines, etc. [87].

At the same time, using its access to the offshore zone, Georgia tries to ensure its transit function [84] and intensively develops its infrastructure. In addition, the country has a liberal economic legislation, which is in synergy with the EU standards [85, 86].

These consistent efforts ultimately brought to positive results:

1. Step-by step Georgia becomes a regional hub of freight turnover, as it is shown on Figure 12 [88]
2. Georgia ensures hydrocarbon transit in neighboring countries using export pipelines (South Caucasus Pipeline – SCP, Stavropol-Yerevan, Baku-Tbilisi-Ceyhan – BTC, Western Route Export Pipeline – WREP, for details see [19, 20]). Data on hydrocarbons transit are shown on Figure 13 [89]
3. Georgia is a regional leader according to number of international passengers served in airports [90-93] annually (Figure 14)
4. Georgia succeeded to develop dramatically its tourism sector. Today, the country is an undisputable regional frontrunner (Figure 15) and a world leader (Figure 16) according to tourism sector growth [94-97].

Azerbaijani officials realize the country’s volatility due to its dependence on hydrocarbon exports and are trying to develop non-oil-and-gas extracting economic branches, as it is mentioned in the National security concept [6]. Hence, just due to abundance of hydrocarbon resources, Azerbaijan is a sole country in the region having a sustainably positive external trade balance (Figure 17). Accordingly, the country has a special strategic Action Plan [98]. Analysis of main trade partners of Armenia, Azerbaijan and Georgia leads to some important conclusions as follows (Figure 18):

1. All the three countries enjoyed the Chinese approach to the region described in Introduction and increased their exports to this state (compare Figure 17 to Figure 19 of our previous article [20])
2. Georgia has close bilateral trade relations with both Armenia and Azerbaijan but direct businesses between the last-mentioned are nil
3. Basic trade partners of Azerbaijan are mainly those countries, which imports hydrocarbons
4. Bulgaria imports copper concentrate from both Armenia and Georgia for farther downstream processing at its copper refineries
5. Armenian and Georgian gold is mainly exported to the Switzerland gold refineries
6. Georgia is importing gas and electricity from Azerbaijan and consumer items form Armenia supplying those countries with grape wines, mineral water as well as with re-exported second-hand cars and trucks.

This brief trade assay was necessary for bold outlining of a simple reality surprisingly incomprehensible for a great majority of the western stakeholder countries and their analysts. Regional economic relations between the South Caucasus countries if feasible only via Georgia, on a bilateral basis. From this point of view Georgia represents a natural energetical and economic hub without which neither inner nor external energy and economic flows are possible.

Due to this feature, in our previous article [20] we have proposed an idea of the regional Caucasus commodity and stock exchanges. This idea is based on the following simple fact.

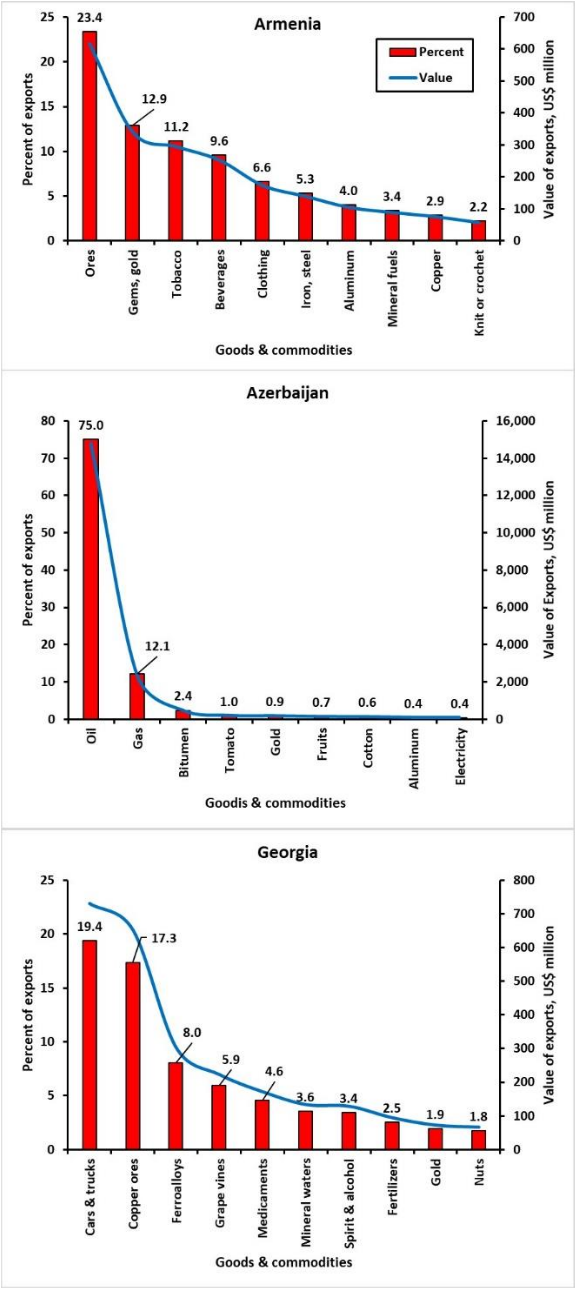


Figure 11. Top 10 Goods & Commodities Exported from the South Caucasus States in 2019.

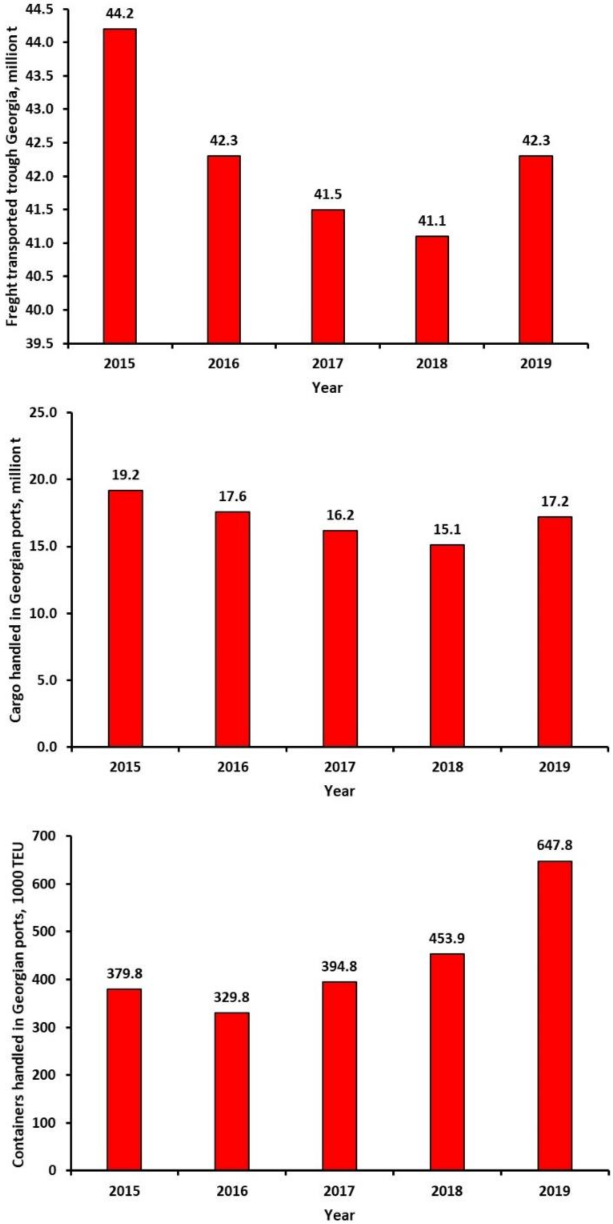


Figure 12. Freight Transported through Georgia and Handled in Georgian Ports[2].

[2] TEU = The twenty-foot equivalent unit.

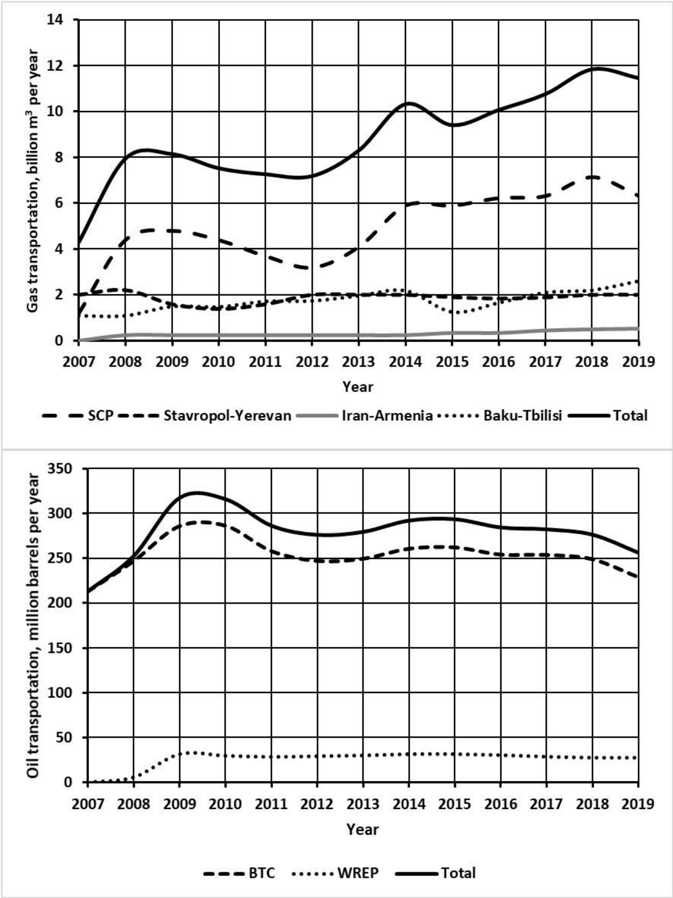


Figure 13. Gas and Oil Transportation Dynamics trough Georgia.

In 2019 the exports volume from the South Caucasus roughly equaled US$ 26.5 billion or 32.63% of the bulk regional GDP. Shares of countries in this total export value are shown on Figure 19. Taking into account the tendencies of modern commodity and derivative markets [99, 100], and the fact that the main commodities exported are hydrocarbons as well as base and noble metals, the commodity markets of which are well-known [101, 102, etc.], it is easy to assess that in case of Initial Public Offering (IPO) and capitalization of commodities, the added value derived from financial instruments would be, at least, three times more. Due to geopolitical framework, such exchanges may be founded only in Georgia.

Later the project is launched, more the economy of the South Caucasus states would hamper.

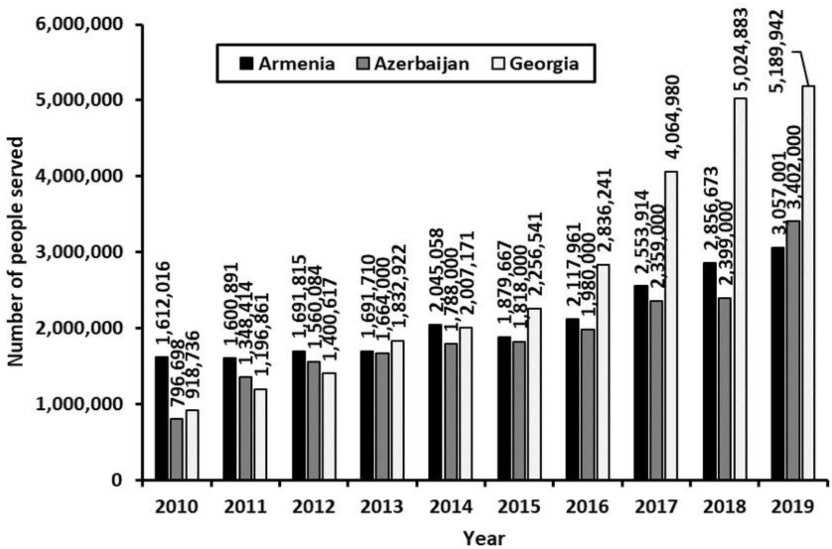


Figure 14. Number of International Passengers Served in Armenian, Azerbaijani and Georgian Airports.

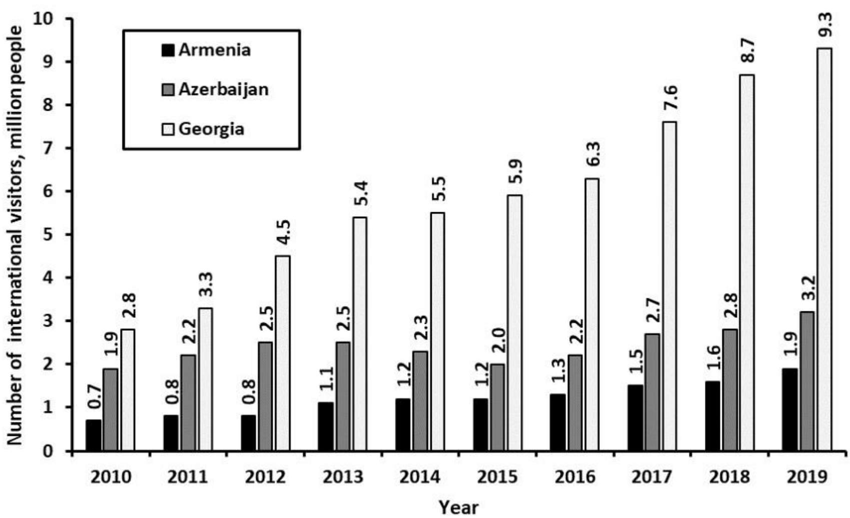


Figure 15. Number of International Visitors to Armenia, Azerbaijan and Georgia in 2010-2019.

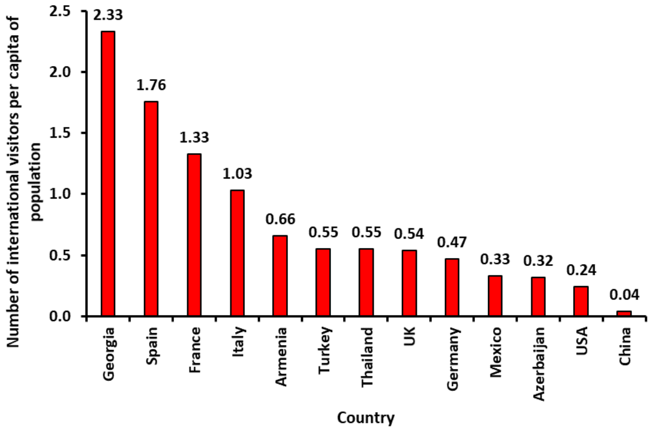


Figure 16. Number of International Visitors per Capita of Population in Basic Touristic Countries in 2019.

The Southern Gas Corridor: Challenges and Opportunities

In 1996, following ideas of Mr. Brzezinski [32], the EU launched a so-called INOGATE project [103]. The abbreviation INNOGATE implies Interstate Oil and Gas Transport to Europe. Today, the INNOGATE project changed its approaches and mainly promotes development of renewable energy in the post-Soviet countries. However, in 2006 it supported the Baku Initiative, which was officially signed on 13 November 2004, during the First Ministerial Conference on Energy Cooperation between the EU and the Black and the Caspian seas basin countries [104]. The Baku Initiative implies: (a) launching of Shah-Deniz II project [105]; (b) construction of the Southern Gas Corridor [106, 107]. Necessity of this project, firmly supported by the USA [108] and the EU [109] is based on the following framework. In spite of the fact that after the 2009 Russia-Ukraine "gas war" [37] the EU actively started to diversify gas supply schedules, the share of Russia in European gas supply is still extremely high. According to BP's statistical yearbook [17], in 2018 Europe imported 478.9 billion m^3 of natural gas by pipelines and 71.5 billion m^3 as LNG.

Figure 20 demonstrates percentage of gas supply to Europe by different countries calculated by us. One may see that the share of Azerbaijan is very low, hence, the country is able to provide much more gas to Europe technical possibilities allowing. In this context, the Southern Gas Corridor Project became extremely important, namely after the Russia-Ukraine war and annexation of the Crimea [110]. Today, the Southern Gas Corridor consists of three pipelines (Figure 21): (i) South Caucasus Pipeline (SCP), which started gas transportation in 2006; (ii) Trans-Anatolian Pipeline (TANAP), which pumped the first gas in autumn 2018, and (iii) Trans-Adriatic Pipeline (TAP), which is under construction phase.

TANAP is a natural gas pipeline in Turkey [111]. It is the central part of the Southern Gas Corridor, which will connect the Shah Deniz gas field in Azerbaijan to Europe through the SCP at the east and TAP at the west. The construction of the 1,841-km-long pipeline started in March 2015 and, in spite of skepticism before the consortium was founded [112], it was inaugurated in June 2018. Shareholders of the TANAP Consortium are: (i) SOCAR, Azerbaijan – 70%; (ii) BOTAŞ, Turkey – 18%, and (iii) BP, UK – 12%. That is why there is a huge criticism of the EU countries, which avoided investing in the project [113]. Nonetheless, crucial importance of the project for the European energy security [109], Azerbaijani-Georgian strategic partnership [114] and economic benefits of stakeholder countries [115] is firm.

TAP is a natural gas pipeline, which starts at the Turkey-Greece border, crosses Greece, Albania, and the Adriatic Sea and ends in Brindisi, Italy. It has a length of 878 km including 550 km in Greece, 215 km in Albania, 105 km on the bottom of the Adriatic Sea and 8 km in a tunnel in Italy [116].

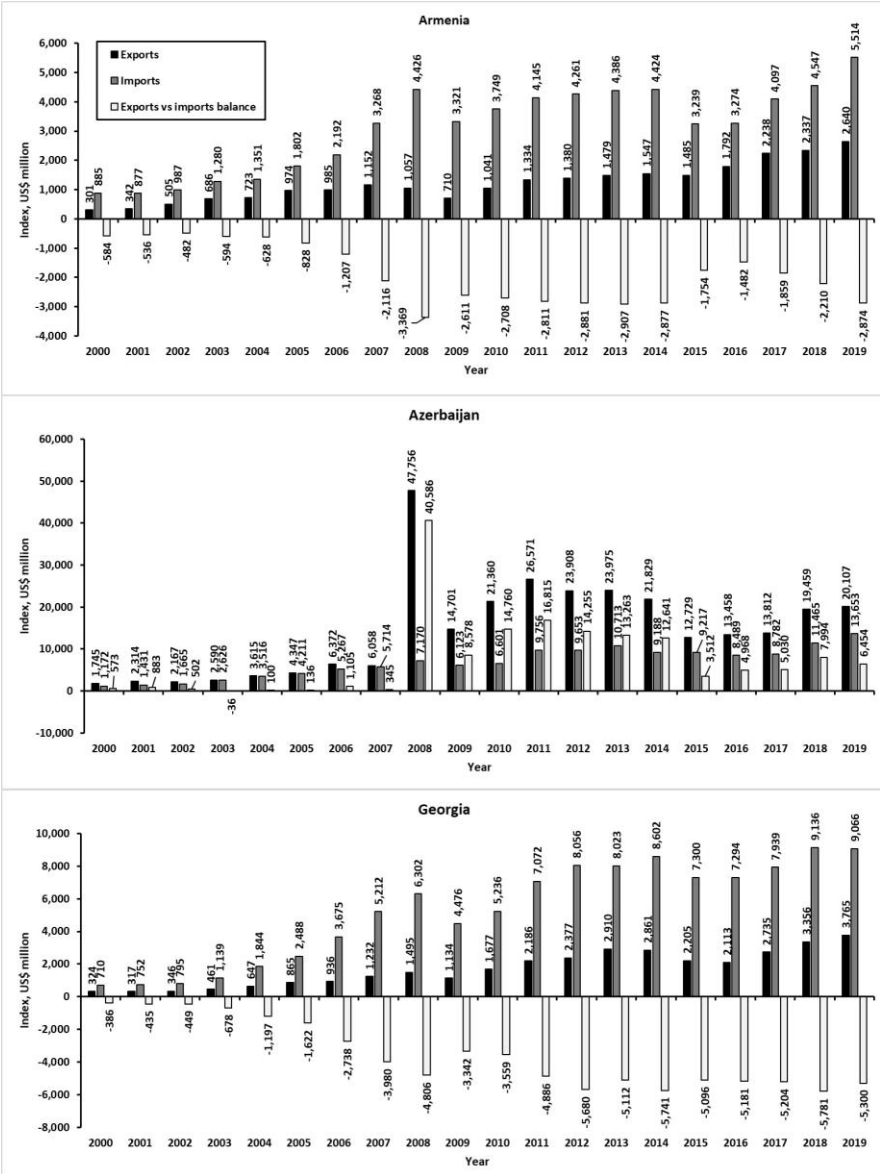


Figure 17. External Trade Statistics in the Southern Caucasus States in 2000-2019.

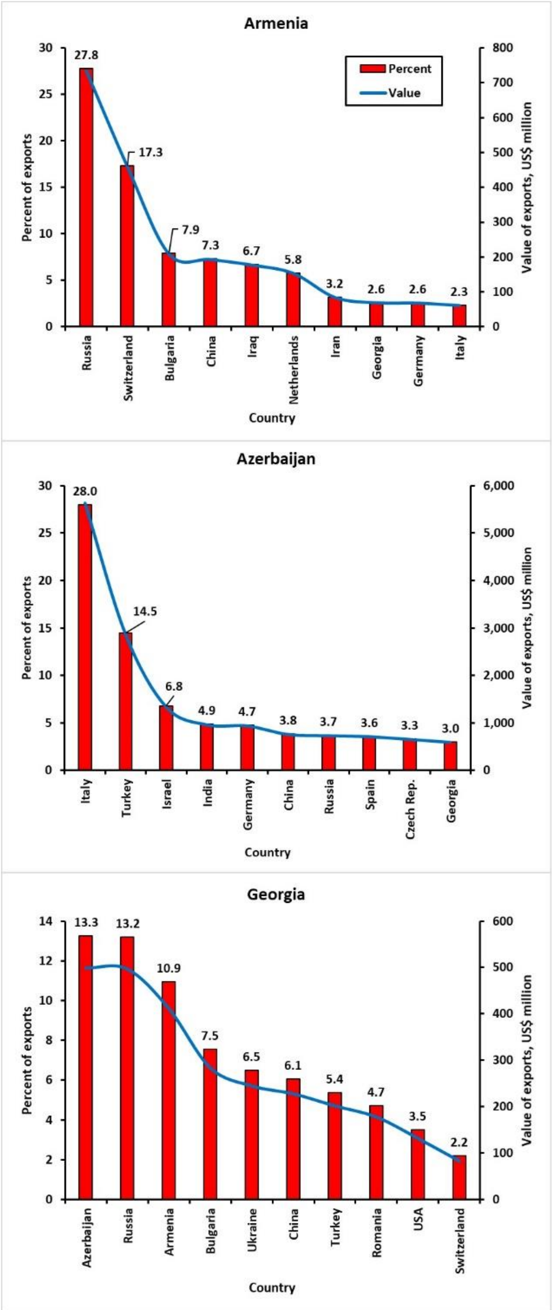


Figure 18. Top 10 Export Destinations of the South Caucasus States in 2019.

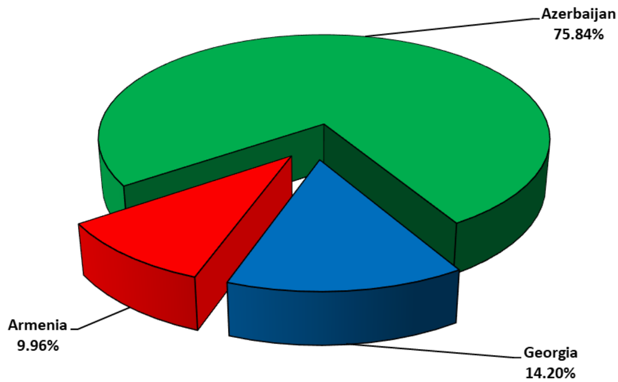


Figure 19. Shares of Armenia, Azerbaijan and Georgia in Exports in 2019.

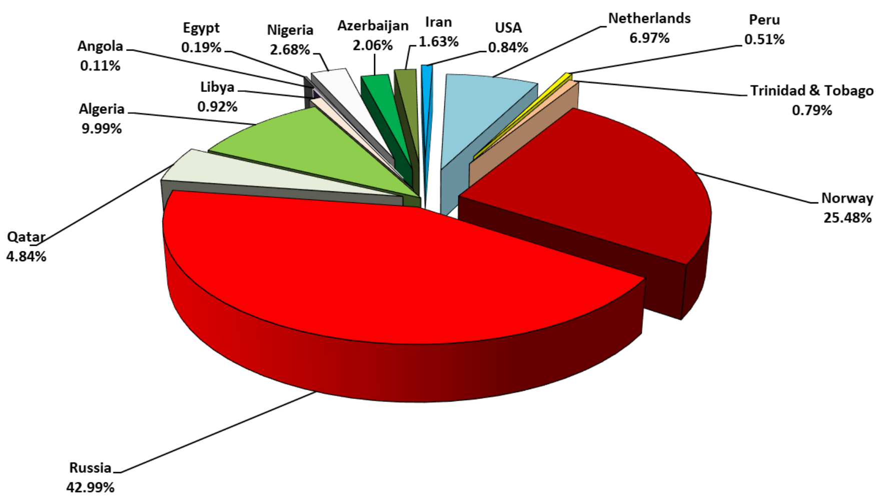


Figure 20. European Gas Supplier Countries in 2018.

Shareholders of the TAP Consortium are: (i) BP, UK – 20%; (ii) SOCAR, Azerbaijan – 20%; (iii) Snam, Italy – 20%, (iv) Fluxys, Belgium – 19%, (v) Enagás, Spain, 16%, and (vi) Axpo, Switzerland, 5%. Due to majority of European shareholders, the TAP project is suggested to be the sole European contribution to the Southern Gas Corridor [117]. At the first stage, the TAP pipeline will transport 10 billion m^3 of natural gas per year to Brindisi, at the second stage its capacity will be increased to 20 billion m^3 a year. Greek analysts forecast huge economic effect of this project on the country's welfare [118].

At the same time, it is clear that when the Southern Gas Corridor becomes fully operational, it will be able to diminish the European energy dependence on Russia only by 10-15%. Huge increase of the capacity seems to be impossible due to limited gas reserves of Azerbaijan. According to the BP's assessment [17], the overall gas reserves of this country at the end of 2018 were 2.1 trillion cubic meters, including 1.2 trillion m^3 at the Shah-Deniz Gas Field [119]. For this reason, from the very beginning construction of the Trans-Caspian Pipeline was proposed [120].

The starting point of the pipeline was suggested to be in Türkmenbaşy, Turkmenistan and the end – at the switch to the South Caucasus Pipeline near Baku. Its approximate length was estimated to be 300 km, and annual capacity – 30 billion m^3 [121]. However, Russia and Iran, which actually are transporting Turkmen gas, are strongly against this project, and Turkmenistan has no choice either than postponing the construction [122]. Hence, in 2019, after the USA imposed rigid economic sanctions on Iran and Russia, American analysts concluded that time has come to offer political support for the construction of the Trans-Caspian Gas Pipeline [123]. At the same time, execution of this project will meet a lot of pitfalls and it is quite uncertain if and when it will be executed.

Figure 21. Sketch Map of the Southern Gas Corridor.

And yet, there is another alternative. From the very beginning, when new sanctions were imposed on Iran in late 2018 [124], aiming to drop Iranian oil exports to zero, we have predicted that they will fail [125]. As we have proven using corresponding statistical models, and farther development of events confirmed our conclusions, the sanctions might have caused difficult but not dramatic consequences for the economic life of the country. Moreover, all the attempts of President Rouhani to modernize the Iranian society [126] failed, and President Trump's administration caused just the back effect than the target they wanted to reach. The sole possibility to provoke democratic movements within the Iranian society is to imply the country into international energy projects, in which Rule of Law is governing partnership relations.

Having the second world rank with proven gas reserves of 31.9 trillion cubic meters [17], in 2018 Iran produced 239.5 billion m^3 of natural gas, consumed 225.6 billion m^3 and exported only about 13 billion m^3. Therefore, the potentiality of the country is enormous.

There are only two alternatives for exporting Iranian natural gas to Europe – installation of an LNG export terminal in Bender Abbas or directly at the South Pars Gas Filed seems to be economically and infrastructurally unfeasible.

The first alternative consists in pumping gas through Ardabil-Baku and then by Baku-Gazah-Tbilisi 27 inch-thick (700 mm) pipelines [see, 19, Figure 10]. Afterwards gas may be transported by the Georgian inner gas distribution grid (Figure 22) to the Poti Port [127]. Simple calculations show that such a way about 10 billion m^3 of gas may be pumped. Quick installation of the FSRU terminal in the Poti Port will allow transportation of LNG to either Constanza or Burgas Ports on the Black Sea western shore.

However, increasing of the gas volume to be pumped annually to Europe is feasible via construction of a 42-inch-thick (1050 mm) Ardabil-Gardabani 300 km-long pipeline. In the Gardabani Gas Dispatching Station this eventual pipeline may be switched with SCP (Figure 23).

Simple calculations demonstrate that in this case capacity of TANAP may be increased to 40 billion m^3 per annum. About 20 billion cubic meters of natural gas may be delivered through TAP to Brindisi and the remaining volume is suggested to be provided to the Greece-Bulgaria border (see Figure 21), where Europe has to improve its inner gas distribution grid (see Figure 21).

I understand very well that this project cannot be executed immediately due to both tight geopolitical situation in the Middle East and the USA sanctions against Iran. However, the discussion is to be launched as soon as possible because the project has the following important positive features:

1. Its execution will destroy the Russia-Iran partnership in gas sector and create their severe competition in gas supply to Europe
2. European energy dependence on Russia will be diminished at least twice
3. Added value of the Southern Gas Corridor will be tripled
4. The project will significantly improve the economic and, therefore, the social background of Iran, create hope for better future and this way promote democratic changes in the country.

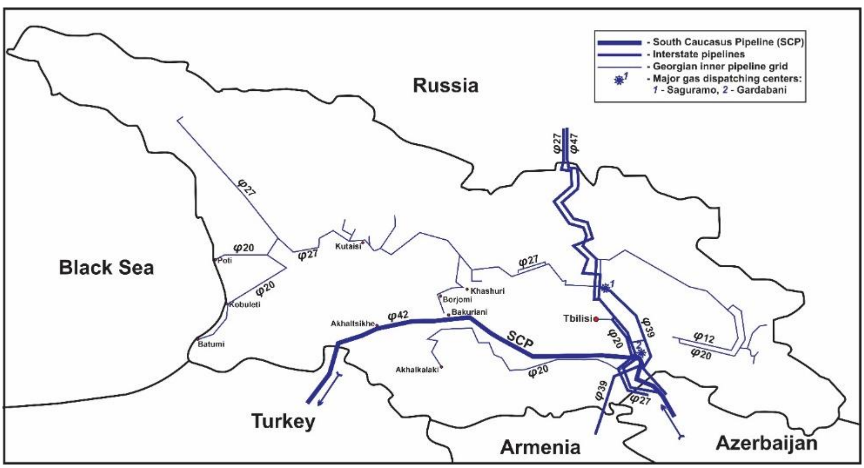


Figure 22. Inner Gas Distribution Grid of Georgia. Pipeline Diameters Are Shown in Inches.

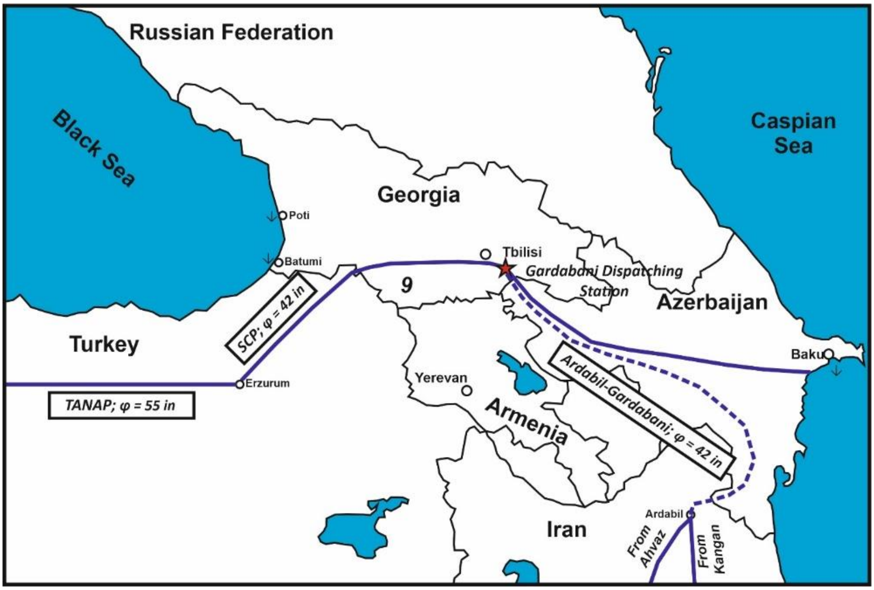


Figure 23. Eventual Development of the Southern Gas Corridor.

The project will merge Iran with the civilized world and this way decisively mitigate influence of Iran on terroristic organizations.

CONCLUSION

The South Caucasus Region is one of the most interesting and, at the same time, one of the most vulnerable regions of the world. Different confessions, national traditions, lifestyles, human philosophies, economic approaches, and a lot of other fundamental values are united here in a single contradictory node. In addition, strategic interests of the USA, the EU, Russia, China, Turkey, and Iran contradictory intersect here.

After the collapse of the USSR and a huge economic crisis, the South Caucasus states displayed intense social & economic development: all the three South Caucasus countries within several years have left the group of low-income countries and merged to upper-middle income states.

Among the South Caucasus states electricity market is deficient only in Georgia. However, the liberalization of the market and activities of the Electricity Market Operator provide a flexible possibility to distribution companies for signing futures contracts on electricity purchase, which allows to the Operator to perform seasonal electricity export, import and transit. It is true that all the three South Caucasus states are united by a synchronized electric grid, hence, in-depth analysis of energy efficiency in these countries identifies two basic problems as follows: (i) Incompatible legislations according to which the electricity market is entirely liberalized in Georgia and rigidly controlled by governments in Armenia and Azerbaijan; (ii) Incompatible consumer tariffs, which are diversified on wholesale and retail tariffs in Georgia by the public entity – Georgian National Energy and Water Supply Regulatory Commission and imposed by governments in Armenia and Azerbaijan. Experience of the last decade has shown that the liberal energy market with competition of private distribution companies is a precondition for development of the electricity sector. From this point of view perspectives of Georgia are optimistic whereas in Armenia and Azerbaijan at a certain stage and in near future farther growth is doomed to fail.

Picturesque GDP growth in Azerbaijan in 2005-2008 with the sniper accuracy coincides with the period when Baku-Tbilisi-Ceyhan (BTC) oil pipeline became operational. This peculiarity outlines volatility of the Azerbaijani economy, lion's shear of which is governed by the hydrocarbon sector. Correspondingly, decrease of world oil prices in recent years at the background of diminished oil production determined not only deterioration of economic indicators but also devaluation of the Azeri Manat in the beginning of 2015.

Azerbaijan is exporting basically primary commodities (hydrocarbons), Armenia – commodities and clothing, export structure of Georgia is much more complex: in 2019 the country exported 778 kinds of commodities & goods including such Hi-tech products as ferroalloy, medicaments, gauge devices, X-ray and radiometric apparatus, hydrographic and meteorological equipment, optic fiber, integrated circuits, turbojet engines, etc. In 2019 the exports volume from the South

Caucasus roughly equaled US$ 26.5 billion or 32.63% of the bulk regional GDP. In case of Initial Public Offering (IPO) and capitalization of commodities, the added value derived from financial instruments would be, at least, three times more. Correspondingly, we are proposing foundation of the Caucasus Commodity and Stock Exchanges, which may be established only in Georgia due to geopolitical framework. Later the project is launched, more the economy of the South Caucasus states would hamper.

Today, the Southern Gas Corridor consists of three pipelines: (i) South Caucasus Pipeline (SCP), which started gas transportation in 2006; (ii) Trans-Anatolian Pipeline (TANAP), which pumped the first gas in autumn 2018, and (iii) Trans-Adriatic Pipeline (TAP), which is under construction phase. When all the system of the Southern Gas Corridor becomes entirely operational, it will be able to diminish the European energy dependence on Russia only by 10-15%. Huge increase of the capacity seems to be impossible due to limited gas reserves of Azerbaijan. Correspondingly, we have launched an idea to include Iranian gas reserves in the pipeline system. The project has the following important positive features: (i) Its execution will destroy the Russia-Iran partnership in gas sector and create their severe competition in gas supply to Europe; (ii) European energy dependence on Russia will be diminished at least twice; (iii) Added value of the Southern Gas Corridor will be tripled; (iv) The project will significantly improve the economic and, therefore, the social background of Iran, create hope for better future and this way promote democratic changes in the country; (v) The project will merge Iran with the civilized world and this way decisively mitigate influence of Iran on terroristic organizations.

ACKNOWLEDGMENTS

I am deeply thankful to Prof. Paata J. Kervalishvili from the Georgian Technical University, who some 20 years ago proposed investigations of the South Caucasus energy security to me.

I would also like to express my sincere gratitude to Prof. Jeremy Ramsden from University of Buckingham with whom I discussed problems of economic security and the idea of launching Caucasus commodity and stock exchanges.

REFERENCES

[1] Baldwin, D. A. (1997). The concept of security. *Review of International Studies*, 23, 5-26.

[2] Yergin, D. (2006). Ensuring energy security. *Foreign Affairs*, 85 (2), 69-82.

[3] Mankiw, N. G. (2012). *Principles of Economics* (6 ed.). Mason, OH: South-Western Cengage Learning, 855.

[4] Chapter 5. Energy and security (2012). Edited by O. Davidson. In: *Global Energy Assessment – Toward a Sustainable Future*. Cambridge, UK and New York, NY, USA: Cambridge University Press, 325-383.

[5] National security strategy, Republic of Armenia (2007). *Approved at the session of National Security Council at the RA President office on January 26, 2007*. Yerevan: National Security Council at the RA President Office, 18.

[6] National security concept of the Republic of Azerbaijan (2007). *Approved by Instruction No. 2198 of the President of the Republic of Azerbaijan on 23 May 2007*. Baku: President Office, 23.

[7] *National security concept of Georgia* (2012). Tbilisi: Government of Georgia, 28.

[8] Ismailov, E. and Papava, V. (2008). A new concept for the Caucasus. *Southeast European and Black Sea Studies*, 8 (3), 283-298.

[9] Korganashvili, L., Mammadova, N., Tsotskolauri, P. and Kochlamazashvili, L. (2017). Transformation of South Caucasus countries during 25 years of independence. *European Journal of Social Sciences, Education and Research*, 4 (4), 253-262.

[10] New country classifications by income level: 2018-2019. *The World Bank.* Accessed on February 10, 2020. https://blogs.worldbank.org/opendata/new-country-classifications-income-level-2018-2019.

[11] World Development Indicators. *DataBank. The World Bank.* Accessed on February 25, 2020. https://databank.worldbank.org/source/world-development-indicators.

[12] *Statistical yearbook of Georgia (2019)*. Tbilisi: National Statistics Office of Georgia, 290.

[13] Statistical yearbook of Armenia, 2019. *Statistical Committee of the Republic of Armenia.* Accessed on February 25, 2020. https://www.armstat.am/en/?nid=586&year=2019.

[14] *Statistical yearbook of Azerbaijan (2019)*. Baku: State Statistical Committee of the Republic of Azerbaijan, 788.

[15] Tvalchrelidze, A. and Silagadze, A. (2013). Macroeconomic model for oil-exporting countries. *Central Asia and the Caucasus*, 14, 118-145.

[16] *IMF primary commodity prices*. Accessed on March 4, 2020. https://www.imf.org/en/Research/commodity-prices.

[17] *BP statistical review of world energy (2019).* 68th Edition. London: BP, 66.

[18] *Devaluation of Azerbaijani national currency; causes and consequences (2015).* Baku: Center for Economic and Social Development (CESD), 8.

[19] Tvalchrelidze, A. G. and Kervalishvili, P. J. (2015). Energy security of the Southern Caucasus: Opportunities and challenges. *Nanotechnology Perceptions*, 11, 88-105.

[20] Tvalchrelidze, A. G. and Kervalishvili, P. J. (2019). Economic security of the Southern Caucasus: Opportunities and challenges. *Nanotechnology Perceptions*, 15, 21-47.

[21] Indans, I. (2007). Relations of Russia and Georgia: Developments and future prospects. *Baltic Security & Defense Review*, 9, 131-149.

[22] Nation, C. (2015). Russia and the Caucasus. *Connections*, 14 (2), 1-12.

[23] Novikova, G. (2015). The South Caucasus between Russia and the West: How pragmatic are the stakeholders' approaches? *Connections*, 14 (2), 37-50.

[24] Nuriyev, E. (2015). Russia, the EU and the South Caucasus: Forging an efficient over-arching cooperative regional security scheme. *Connections*, 14 (2), 51-64.

[25] Shirinyan, A. (2019). *Armenia's foreign policy balancing in an age of uncertainty*. London: Chatham House, The Royal Institute of International Affairs, 30.

[26] Shiriyev, Z. (2019). *Azerbaijan's relations with Russia closer by default?* London: Chatham House, The Royal Institute of International Affairs, 33.

[27] Nuriyev, E. (2007). *EU policy in the South Caucasus: a view from Azerbaijan*. Brussels: Centre for European Policy Studies (CEPS), 30.

[28] Paul, A. (2015). *The Eastern partnership, the Russia-Ukraine war, and the impact on the South Caucasus*. *IAI Working Papers 14.* Rome: Istituto Affari Internazionali, 15.

[29] Giragosian, R. (2016). *Armenian national security: Drivers and determinants of a 'small state' strategy*. Edited by J. Lovitt. Tbilisi: Caucasus Institute for Peace, Democracy and Development, 14.

[30] Gomółka, K. (2017). Threats to Armenia's security in the national strategy and practice with special emphasis on external security. *Polish Political Science Yearbook*, 46 (1), 74-90.

[31] Brzezinski, Z. (1998). *The grand chessboard: American primacy and its geostrategic imperatives*. New York: Perseus Books Group, 251.

[32] Khelashvili, G. and Macfarlane, S. N. (2010). The Evolution of US Policy towards the Southern Caucasus. *Uluslararası İlişkiler*, 7 (26), 105-124.

[33] Kuchins, A. C., Mankoff, J. and Bakes, O. (2016). *Azerbaijan in a reconnecting Eurasia. Foreign economic and security Interests*. Lanham – Boulder – New York – London: Center for Strategic & International Studies, *CSIS Russia and Eurasia Program*, 44.

[34] Kuchins, A. C. and Mankoff, J. (2016). *Caucasus in the reconnecting Eurasia. U.S. policy interests and recommendations*. Lanham – Boulder – New York – London: Center for Strategic & International Studies, *CSIS Russia and Eurasia Program*, 28.

[35] Kastetter, A. (2018). *Moving forward: How Georgia can advance US strategic interests*. Tbilisi: Georgian Strategic Analysis Center, 23.

[36] Stern, J. (2006). *Russia-Ukraine gas crisis of January 2006*. Oxford: Oxford Institute for Energy Studies, 17.

[37] Kovacevic, A. (2009). *The impact of the Russia – Ukraine gas crisis in the South Eastern Europe*. Oxford: Oxford Institute for Energy Studies, 22.

[38] Chen, M.-H., Kulhánek, J. and M. Thim (2008). *Energy security in Central and Eastern Europe*. Žitná: Association for International Affairs (AMO), 114.

[39] Cohen, A. (2014). *Caspian gas, TANAP and TAP in Europe's energy security. IAI Working Papers 14*. Rome: Istituto Affari Internazionali, 17.

[40] Churchelashvili, I. (2016). The significance of Southern Gas Corridor for European energy security – myth or reality? *Journal of Social Sciences*, 5 (2), 17-22.

[41] Benashvili, G. and Asanidze, N. (2016). Economic development of the South Caucasus east – west crossroad. *The 2016 WEI International Academic Conference Proceedings*. Rome: The West East Institute, 34-44.

[42] Scholl, E. and Westphal, K. (2017). *European energy security reimagined: Mapping the risks, challenges and opportunities of changing energy geographies. SWP Research Paper*. Berlin: Stiftung Wissenschaft und Politik, 34.

[43] Azakov, S. I. (2019). *Contribution of Azerbaijan to the energy security of the European Union*. IOP Conf. Ser.: Mater. Sci. Eng., 459, 1-13.

[44] Siddi, M. (2019). The Southern Gas Corridor: Prospects and challenges for EU foreign policy. *Caucasus Analytical Digest*, 112, 8-11.

[45] Demirağ, Y. (2005). EU Policy towards South Caucasus and Turkey. *Perceptions*, Winter 2004-2005, 91-105.

[46] van den Boom, B. (2017). EU region-building in the neighbourhood: The Eastern Partnership's contribution in the South Caucasus. *EU Diplomacy Papers*, 04/2017, 23.

[47] Senger, K. (2013). The performance of South Caucasus countries (Georgia, Armenia, Azerbaijan) in terms of EU integration: The case of Deep and Comprehensive Free Trade Agreements (DCFTA). In: *EU Integration Issues - Visegrad Countries and the South Caucasus.* Edited by T. Tordinava. Tbilisi: Caucasian Institute for Economic and Social Research, 111-123.

[48] Delcour, L. and Hoffmann, K. (2018). The EU's policy in the South Caucasus. *L'Europe en Formation*, 385, 7-25.

[49] Sayan, P., Gafarli, O., Jijavadze, T., Muradyan, D., Öztarsu, M.F. and Romashov, V. (2016). Economic cooperation in the South Caucasus and the wider region: Gained losses, lost benefits. The Caucasus Edition – *Journal of Conflict Transformation*, 26.

[50] Safaryan, S. (2016). *Trade relations between Georgia and Armenia: getting close or distant?* Tbilisi: Konrad Adenauer Stiftung, 23.

[51] Oskanian, K. (2011) Turkey's global strategy: Turkey and the Caucasus. In: *IDEAS reports - special reports*. Edited by N. Kitchen. London: London School of Economics and Political Science, 23-27.

[52] Frappi, C. and Valigi, M. (2015). *Patterns for cooperation in the Southern Caucasus area: Azerbaijan, Georgia and Turkey triangular diplomacy in the shadow of energy strategy. Working Paper no. 57,* Milano: Istituto per gli Studi di Politica Internazionale (ISPI), 30.

[53] Çelikpala, M. and Veliyev, C. (2015). Azerbaijan – Georgia – Turkey: an example of successful regional cooperation. *Policy Brief,* November. Istanbul: Center for International and European Studies, 25.

[54] Austvik, O. G. and Rzayeva, G. (2016). *Turkey in the geopolitics of natural gas. M-RCBG Associate Working Paper Series No. 66.* Cambridge Mt: Mossavar-Rahmani Center, Harvard Kennedy School, 18.

[55] Suleymanov, E., Bulut, C. and Rahmanov, F. (2017). Economic and political analysis of Azerbaijan-Turkey energy relations. *Journal of Management, Economics, and Industrial Organization*, 1 (2), 24-44.

[56] Balla, E. (2013). Turkish and Iranian interests and policies in the South Caucasus. *NOREF Policy Brief* – April. Oslo: Norwegian Peacebuilding Resource Centre, 4.

[57] Weiss, A. and Zabanova, Y. (2017). *The South Caucasus and Iran in the post-sanctions era.* Berlin: Stiftung Wissenschaft und Politik, 8.

[58] Lianlei, B. (2016). Azerbaijan in the Silk Road Economic Belt: A Chinese perspective. *Caucasus International*, 6 (1), 27-39.

[59] Inan, F. and Yayloyan, D. (2017). *New economic corridors in the South Caucasus and the Chinese one belt one road*. Ankara: The Economic Policy Research Foundation of Turkey (TEPAV), 89.

[60] Hovhanesian, H. and Manasyan, H. (2014). South Caucasus – People's Republic of China Bilateral Free Trade Agreements: Why it matters. *ADB Working Paper Series on Regional Economic Integration.* Manila: Asian Development Bank, 60.

[61] Musayelyan, S. (2009). *Armenia: Building a competitive economy*. Oxford: Institute for the Study of Journalism, University of Oxford, 38.

[62] *Azerbaijan economic reforms review* (2018). Baku: Center for Analysis of Economic Reforms and communication of the Republic of Azerbaijan, 18.

[63] *Business outlook in Azerbaijan* (2019). Fourth Edition. Edited by N. Kerimov. Baku: Deloitte Azerbaijan, 40.

[64] MacFarlane, S. N. (2012). *Georgia: national security concept versus national security*. London: Chatham House, Russia and Eurasia Programme, Paper REP PP 2012/01, 28.

[65] *Georgia's long-term economic development* (2013). Tbilisi: Business Association of Georgia, 51.

[66] *Social – economic development strategy of Georgia (2014)*. Tbilisi: Government of Georgia, 68.

[67] Opitz, P. (2015). *Sustainable energy pathways in the South Caucasus: Opportunities for development and political choices*. Tbilisi: South Caucasus Regional Office of the Heinrich Boell Foundation, 96.

[68] Aslanidze, A. (2016). *The role of Energy Charter in promoting electricity cooperation in the South Caucasus*. Brussels: Energy Charter Secretariat, Knowledge Centre, 23.

[69] Papava, V., Taphladze, T. and Ulumberashvili, N. (2011). On the economic and energy cooperation in the Caucasus. *Georgian National Academy of Sciences Bull.,* 5 (1), 164-169.

[70] Karapoghosyan, E. (2019). *Armenian energy sector overview*. Yerevan: IEEJ, 21.

[71] Security of supply and solidarity (2018). *Presentation at 7th annual workshop of the Eastern Partnership Energy Regulatory Bodies in Budapest on 14-15.06.2018.* Baku: Azerbaijan Energy Regulatory Agency (AERA), 7.

[72] *Energy sector overview: Charging forward* (2019). Tbilisi: TBC Capital, 44.

[73] *2019 electricity balance of Georgia* (2020). Tbilisi: Electric Market Operator, 3.

[74] *Decennial development plan of the Georgia electricity distribution grid: 2019-2029* (2019). Tbilisi: Operator of the Georgian Distribution System JSC "Georgian State Electric System," 476 (in Georgian).

[75] Edilashvili, M. (2013). *South Caucasus united by common electricity grid.* Brussels: ENPI Info Centre, Feature No 28, 4.

[76] *In-depth review of energy efficiency policies and programmes: Georgia* (2012). Brussels: Energy Charter Secretariat, 114.

[77] *In-depth review of the energy efficiency policy of Azerbaijan* (2013). Brussels: Energy Charter Secretariat, 114.

[78] *In-depth review of the energy efficiency policy of Armenia* (2017). Brussels: Energy Charter Secretariat, 128.

[79] *The Baku-Tbilisi-Ceyhan Pipeline: oil window to the West* (2005). Edited by S. F. Starr and S. E. Cornell. Vienna: The Central Asia – Caucasus Institute, Silk Road Studies Program, 150.

[80] Socio-Economic Situation of RA, January-December 2019. *Statistical Committee of the Republic of Armenia*. Accessed on February 27, 2000. https://www.armstat.am/en/?nid=81&id=2236.

[81] *Armenia trade statistics: Exports, Imports, Products, Tariffs, GDP and related Development Indicator*. WITS. Accessed on February 27, 2020. https://wits.worldbank.org/CountryProfile/en/ARM.

[82] *Azerbaijan. Annual International Trade Statistics by Country*. Accessed on February 26, 2020. https://trendeconomy.com/data/h2/Azerbaijan/TOTAL.

[83] *Export. National Statistics Office of Georgia*. Accessed on February 29, 2020. https://www.geostat.ge/ka/modules/categories/637/eksporti.

[84] Danelia, I. (2017). Main determinants of Georgia's transit function development. *European Scientific Journal*, 31 (31), 79-91.

[85] *Doing business* (2020). Tbilisi: Ministry of Economy and Sustainable Development of Georgia, 10.

[86] *Economy profile – Georgia. Doing business 2020. Comparing business regulation in 190 economies* (2020). Washington, DC: The World Bank Group, 68.

[87] Saha, D. and Störr, A. (2017). *The creative sector in Georgia: Situation, potential and policy issues*. Berlin – Tbilisi: German Economic Team Georgia – c/o Berlin Economics, 29.

[88] Ministry of economy and sustainable development of Georgia. *Economy*. Accessed on February 15, 2020. http://www.economy.ge/?page=ecoreview&s=26.

[89] *Georgian Oil and Gas Corporation*. Accessed on February 5, 2020. http://gogc.ge/en/transporation-stats.

[90] *Yerevan airport records 3,000,000 yearly passenger flow first time ever*. Armenpress. Accessed on February 10, 2020, https://armenpress.am/eng/news/1000488.html.

[91] Air Transport. Transport in Azerbaijan. *The State Statistical Committee of the Republic of Azerbaijan.* Accessed on February 10, 2020. https://www.stat.gov.az/source/transport/?lang=en.
[92] *Azerbaijan's airports served a record number of passengers in 2019*. Accessed on February 10, 2020. http://www.rusaviainsider.com/azerbaijans-airports-served-a-record-number-of-passengers-in-2019/.
[93] Number of Passengers Served. *The Civil Aviation Authorities of Georgia.* Accessed on February 10, 2020. http://gcaa.ge/eng/regular.php.
[94] Armenia tourist arrival 2001-2019. *Trading Economics*. Accessed on March 1, 2020. https://tradingeconomics.com/armenia/tourist-arrivals.
[95] Kerimkhanov, A. *Azerbaijan welcomes over 3 million tourists in 2019*. Azernews. February 27 2020. Accessed on March 1, 2020. https://www.azernews.az/travel/160431.html.
[96] Number of international visitors to Georgia surge in 2019. *Georgian Journal*, December 31, 2019. Accessed on March 1, 2020. https://www.georgianjournal.ge/discover-georgia/36141-number-of-international-visitors-to-georgia-surge-in-2019.html.
[97] *International tourism highlines* (2019). Madrid: World Tourism Organization (UNWTO), 21.
[98] *National sustainable energy action plan of Azerbaijan* (2016). Baku: Cabinet of Ministers, 72.
[99] *WFE IOMA 2018 Derivatives Report* (2019). London: World Federation of Exchanges, 53
[100] Boneva, L., Böninghausen, B., Rousová, L. F. and Letizia, E. (2019). Derivatives transactions data and their use in central bank analysis. *ECB Economic Bulletin*, Issue 6/2019. Accessed on March 5, 2020. https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201906_01~dd0cd7f942.en.html.
[101] *OPEC monthly oil report*, 12 February 2020 (2020). Vienna: Organization of the Petroleum Exporting Countries, 102.
[102] *GFMS gold survey* (2019). London: REFINTIV, 84.

[103] *INOGATE*. Accessed on March 1, 2020. http://www.inogate.org/?lang=en.

[104] *IEA energy policies review: The European Union 2008* (2008). Paris: OECD/IEA, 217.

[105] *Shah Denize gas field development* (2017). Policy Brief, October. Tbilisi: Green Alternative, 9.

[106] Azerbaijan and the Southern Gas Corridor to Europe: implications for U.S. and European energy security (2014). *Conference Report*. Washington, DC: The Jamestown Foundation, 59.

[107] Ibrahimov, M., Aliyev, A. and Babayev, T. (2019). Evaluation of TANAP and TAP projects efficiency: "Diversification of the gas supply for the European Union's energy security – Caspian and Central Asian gas." In: *Economic and Social Development, 37th International Scientific Conference on Economic and Social Development – "Socio Economic Problems of Sustainable Development,"* edited by M. Ibrahimov, A. Aleksic and D. Dukic. Baku: Book of Proceeding, 780-786.

[108] Cohen, G. (2019). *Natural gas import and export routes in South-East Europe and Turkey. Working Paper No 26*. Athens: Institute of Energy for SE Europe, 63.

[109] Koranyi, D. (2014). *The Southern Gas Corridor: Europe's lifeline? IAI Working Papers 14.* Rome: Istituto Affari Internazionali, 11.

[110] Jarosiewicz, A. (2015). *The Southern Gas Corridor: The Azerbaijani-Turkish project becomes part of the game between Russia and the EU*. Warszawa: Centre for Eastern Studies, Ośrodek Studiów Wschodnich, 36.

[111] *Trans Anatolian Natural Gas Pipeline Project* (TANAP), Turkey. Accessed on January 31, 2020. http://www.hydrocarbons-technology.com/projects/trans-anatolian-natural-gas-pipeline-project-tanap/.

[112] Roberts, J. M. (2018). *Europe's Southern Gas Corridor: The Italian (dis)connection. Issue Brief.* Huston, Tx: Atlantic Council – Global Energy Center, 20.

[113] Kusznir, J. (2015). The Southern Gas Corridor: Initiated by the EU, completed by others? TANAP, TAP, and the redirection of the South Stream Pipeline. *Caucasus Analytical Digest*, 69, 6-10.

[114] Tsereteli, M. (2013). *Azerbaijan and Georgia: strategic partnership for stability in a volatile region*. Washington, D. C. – Stockholm: Central Asia-Caucasus Institute & Silk Road Studies Program – A Joint Transatlantic Research and Policy Center, 63.

[115] Suleymanov, E., Aras, O. N. and Hasanov, F. (2016). Economic and strategic expectations from Trans Anatolian Natural Gas Pipeline Project. *Academic Journal of Economic Studies*, 2 (4), 23–37.

[116] *Trans Adriatic Pipeline* (2017). Baar: Trans Adriatic Pipeline AG, 34.

[117] Ottaway, R. (2016). *Building the Trans Adriatic Pipeline –the European leg of the Southern Gas Corridor*. Paris: 50th IPOCA Convention, 15.

[118] Papadopouloua, D., Tourkoliasb, C. and Mirasgedisc, S. (2015). Assessing the macroeconomic effect of gas pipeline projects: The case of Trans-Adriatic Pipeline on Greece. *SPOUDAI Journal of Economics and Business*, 65 (3-4), 100-118.

[119] The largest natural gas fields in the world. *World Atlas*. Accessed on March 5, 2020. https://www.worldatlas.com/articles/the-largest-natural-gas-fields-in-the-world.html.

[120] *Trans-Caspian Gas Pipeline* (2014). Austin: The University of Texas, 8.

[121] Vashakmadze, G. (2015). *Trans-Caspian Gas Pipeline – the Project of Common Interest No 7.1.1*. Beijing: W-Stream, 9 pp.

[122] Vasánczki, L. Z. (2011). *Gas exports in Turkmenistan*. Paris and Brussels: Gouvernance européenne et géopolitique de l’énergie, 54.

[123] Coffey, L. (2019). *Time for a U.S. strategy in the Caspian. The Special Report No 216.* Washington, DC: The Heritage Foundation, 46.

[124] *Sanctions announcement on Iran. Media Note. Office of the Spokesperson*. November 20, 2018. U.S. Department of State.

Accessed on 31 December 2018. https://www.state.gov/sanctions-announcement-on-iran/.

[125] Tvalchrelidze, A. G. and Tabagari, K. (2019). American new sanction against Iran: Challenges for economic growth. *Elixir Social Studies*, 126, 52504-52513.

[126] Behravesh, M (2014). Iran's reform movement: the enduring relevance of an alternative discourse. *Digest of Middle East Studies*, 23 (2), 262-278.

[127] Tabagari, K. and Tvalchrelidze, A. G. (2018). Caucasus and world globalization – opportunities and challenges. In: *Proceedings of the III International Scientific Conference "Politics around the Caucasus. 21st October, 2017."* Tbilisi: Ivane Javakhishvili Tbilisi State University and Institute for Georgia's Neighbourhood Studies, 84-97.

In: Progress in Economics Research … ISBN: 978-1-53618-248-4
Editor: Albert Tavidze

Chapter 4

DE-RISKING AND THE LOSS OF CORRESPONDENT BANKING IN THE CARIBBEAN: CAUSES, IMPACT, AND RESPONSE

Don A. Charles*
Point Fortin, Trinidad and Tobago

ABSTRACT

In the aftermath of the 2008 global financial and the 2010-2011 Eurozone crises, several regulatory jurisdictions have strengthened their financial sector regulation, supervision, and risk management to increase the resiliency of financial institutions. More specifically, regulators are seeking to curb money laundering and the financing of terrorism with stricter anti-money laundering (AML), countering the financing of terrorism (CFT) and know-your-customer (KYC) regulations.

The compliance with AML and the CFT regulations is expensive, particularly due to the regulations differing across jurisdictions.

* Corresponding Author: Economic Research Consultant. E-mail: Dr.Don_Charles@outlook.com.

Furthermore, the high penalties that banks face for financial infractions decrease their profitability. Several global banks have responded to this new compliance risk challenge by de-risking. Although the term "de-risking" refers to the strategies adopted by a bank to reduce its risk exposure to the assets in its portfolio, in the context of this new challenge, the de-risking refers to the intentional termination of financial relationships with clients or groups of clients which may be categorized as "high risk".

Caribbean banks and financial institutions are being affected by the changing financial regulatory environment. In fact, large banks are terminating their corresponding banking relationships (CBRs) with Caribbean banks. CBRs refers to financial services in which a financial institution provides on behalf of another financial institution. CBRs includes services such as: international wire transfers; accepting of deposits on the behalf of other financial institutions; and the facilitating of payments.

The recent phenomenon raises two important research questions: 1) What is the impact of de-risking upon the Caribbean? 2) What policy measures may be adopted to address the de-risking challenge?

This chapter reviews the de-risking experience of several Caribbean countries. Several approaches have been adopted to address the de-risking challenge. In most instances, Caribbean banks have sought to find replacement correspondent banks. Other considered solutions include the utilizing of the correspondent banking relationship of domestic Central Banks, strengthening domestic regulatory and legislative framework to reduce the risk perception, and lobbying at the regional level to raise awareness of the issue.

1. INTRODUCTION

The Caribbean region, a chain of small islands to the east of Central and north of South America, are typically prone to natural disasters and vulnerable to external economic shocks. The region now faces a new threat to its economic vulnerability: the termination of Correspondent Banking Relationships (CBRs).

CBRs refers to financial services in which a financial institution provides on behalf of another financial institution. CBRs allow a correspondent foreign bank to act on the behalf of a domestic bank to conduct transactions, without the domestic bank establishing a branch in the target location. Under corresponding banking arrangements, a large bank in a developed country, would typically hold an account for a smaller bank from a developing country, and use it to facilitate transactions on the smaller bank's behalf. CBRs includes services such as international wire transfers; accepting of deposits on the behalf of other financial institutions; and the facilitating of payments. Indeed, CBRs are vital for international trade, the movement of financial capital, and remittances.

In the aftermath of the 2008 global financial and the 2010-2011 Eurozone crises, several regulatory jurisdictions have strengthened their financial sector regulation, supervision, and risk management to increase the resiliency of financial institutions. More specifically, regulators are seeking to curb money laundering and the financing of terrorism with stricter anti-money laundering (AML), countering the financing of terrorism (CFT) and know-your-customer (KYC) regulations.

Where regulated banks have failed to prevent these money laundering and financing of terrorism incidences to occur within their operations, they are charged fines by their regulators. For instance, HSBC Holdings Plc was fined $1.92 billion by the United States (US) authorities[1] for allowing possible money laundering to occur through its institution (Viswanatha and Wolf 2012; IFC 2016). Thus, there is a high cost associated with facilitating transactions with high-risk clients.

The compliance with AML and the CFT regulations is expensive, particularly due to the regulations differing across jurisdictions. Furthermore, the high penalties that banks face for financial infractions decrease their profitability.

Several global banks have responded to this new compliance risk challenge by de-risking. Although the term "de-risking" refers to the strategies adopted by a bank to reduce its risk exposure to the assets in its portfolio, in the context of this new challenge, the de-risking refers to the intentional termination of financial relationships with clients or groups of clients which may be categorized as "high risk".

The high-risk client problem is also compounded by a general information deficiency. From the perspective of domestic Caribbean banks,

---

[1] HSBC paid its fines to the US Office of the Comptroller of the Currency, the Federal Reserve, and the Treasury Department (Viswanatha and Wolf 2012).

there is often ambiguity in the criteria used by international banks to terminate CBRs. The general information asymmetry and lack of empirical data on the scale of the problem do not assist with a solution either.

This chapter seeks to explore the impact of de-risking and the loss of correspondent banking on the Caribbean region. This chapter is structured as follows. Section 2 briefly assess the factors driving global de-risking. Section 3 reviews the emerging international financial monitoring and regulation, as the changing regulatory environment marked the start of the de-risking. Section 4 examines the magnitude and scope of de-banking practices in the Caribbean. Section 5 analyses the appropriateness of the high-risk perception of the Caribbean region. Section 6 considers some policy measures which may be used to address the de-risking challenge. Section 7 concludes.

2. Factors Affecting De-Risking

The drivers of the recent global de-risking trend are multi-dimensional. To a large extent, de-risking is driven by factors related to compliance and business costs. The regulatory environment in developed countries is changing to combat money laundering, the financing of terrorism, and to some extent, tax evasion. This is resulting in an increase in compliance costs for their financial institutions. Moreover, they may be fined very higher penalties for failure to comply with new regulations. As a result, international banks are ending their CBRs in areas that they perceive as either less profitable or, more generally, detrimental to their risk tolerance (World Bank 2015; CPRI 2016; Williams 2016; Alleyne et al. 2017).

The World Bank (2015) conducted a global survey on de-risking. It was comprised of respondents from 110 jurisdictions, 20 large international banks, and 170 local/regional banks. The respondents of the survey highlighted that the lack of profitability of CBRs was a significant reason for correspondent banks ending their CBRs. Other reasons reported for the de-risking include the gradual loss of risk appetite by international banks, and changes to the regulatory environment. Table 1 provides a summary of the drivers for de-risking identified by various financial stakeholders.

3. Emerging International Financial Monitoring and Regulation

Before any policy can be adopted to address the challenge of global de-risking and termination of CBRs, the problem must first be properly understood. The problem has emerged from actions to the main stakeholders operating in the global financial industry responding to a changing environment that affects their narrow interests. Criminal regulatory authorities are responding the changing transnational criminal environment; financial authorities are responding to prevent future financial meltdowns; large banks are responding to the changing regulatory environment; and domestic and regional banks to the demands of their correspondent banks.

Table 1. Comparing drivers of termination/restriction of foreign CBRs

	Banking Authorities (%)	Large International Banks (%)	Local/Regional Banks (%)
Lack of profitability of certain foreign CBR services/products	64	80	46
Overall risk appetite	55	85	37
Changes to legal, regulatory or supervisory requirements in correspondent's jurisdiction that have implications for maintaining CBRs	48	45	31
Structural changes to correspondent	27	30	35
Concerns about money laundering/terrorist financing risks	48	95	19
Sovereign credit risk rating	7	35	15
High-risk customer base	18	75	8
Imposition of international sanctions on jurisdiction or respondent	7	90	8
Respondent's jurisdiction subject to countermeasures or identified having strategic AML/CFT deficiencies by FATF	23	75	4

Source: World Bank (2015).

The regulatory environment for international finance is influenced by the principles established by the Financial Action Task Force (FATF), the Financial Stability Board (FSB), the US' Foreign Account Tax Compliance Act (FATCA), the Organisation for Economic Cooperation and Development's (OECD's) Common Reporting Standards (CRS), and the Action Plan on Base Erosion and Profit Shifting (BEPS), and the United Kingdom's (UK's) Public Registry of Beneficial Ownership (PRBO). The changes in regulation by the aforementioned international bodies have been influencing correspondent banks, mainly in the US, and the UK to terminate their relationships with financial institutions that they deem risky.

3.1. The Financial Action Task Force

The FATF is an intergovernmental organization incorporated in 1989 on the initiative of the G7 with the mandate to develop policies to combat money laundering, terrorist financing and the financing of threats to the international financial system.[2] The FATF Recommendations present a framework of measures which countries should implement in order to counter money laundering and the financing of terrorism or related activity.

It is noteworthy that countries have diverse legal, administrative, and financial frameworks. Therefore, not all countries can take identical measures to address the aforementioned threats. Nevertheless, the FATF Recommendations are supposed to act as a guide as to what countries should seek to implement. However, certain measures are mandatory for countries to implement in order to continue banking and financial relationships with FATF member countries. They include:

[2] In 1990, the FATF Recommendations was comprised of forty recommendations to prevent the misuse of financial systems by persons laundering drug money. Later in October 2001, after the September 11th attack in the US, the FATF expanded its mandate to address the financing of terrorist activity and terrorist organizations (FATF 2017).

- Measures to identify the money laundering and financing of terrorism risks;
- Measures to develop policies to prevent money laundering, and terrorist financing;
- The application of preventive measures for the financial sector and other designated sectors;
- The delegation of responsibility to national security authorities to combat money laundering and the financing of terrorism;
- The increasing of transparency of beneficial ownership information of legal persons and arrangements; and
- The facilitation of international cooperation (FATF 2017).

3.2. The Financial Stability Board

The FSB is an international body which monitors, and makes recommendations to preserve the integrity of the global financial system. It collaborates with national financial authorities, and international standard-setting bodies, to develop strong regulatory financial sector policies.

More particularly, the FSB was established to:

- Evaluate vulnerabilities affecting the global financial system;
- Identify and review the regulatory, supervisory and related actions needed to address these vulnerabilities;
- Encourage information exchange among authorities responsible for financial stability;
- Monitor and advise on market developments, and best practices for regulatory policy;
- Strengthen contingency planning for cross-border crisis management, specifically with regard to systemically important firms
- Undertake joint exercises with the International Monetary Fund (IMF) to conduct early warning assessments

- Conduct strategic reviews of the international standard-setting bodies, and ensure that their development work is focused on priorities, and addresses gaps
- Support member jurisdictions' implementation of agreed commitments, standards and policy recommendations (FSB 2018).

3.3. The Foreign Account Tax Compliance Act

The FATCA was introduced in 2010 by the US authorities requiring all non-US financial institutions to report the foreign assets held by their US account holders to the US Department of the Treasury. Non-US banks were compelled to comply under threat of a 30% withholding penalty on all their US transactions.

The objective of the Act was to identify US citizens and residents that had financial assets overseas, and determine the size of the financial holdings. FATCA is currently used to detect assets, rather than income. It presently does not include a provision for imposing any tax. However, as US residents and citizens regardless of dual nationality, are required to self-report their non-U.S. assets to Financial Crimes Enforcement Network (FinCEN), and the Internal Revenue Service (IRS) on an annual basis. FATCA will allow detection of persons who have not self-reported, nor filed file any delinquent Report of Foreign Bank and Financial Accounts (FBAR)[3]. Subsequently, such persons may be charged penalties.

3.4. The Common Reporting Standards

The Common Reporting Standards was developed in 2014 by the OECD. The CRS is a framework that allows the automatic reporting of tax

[3] All US residents or citizens that had a financial interest in or signature authority over at least one financial account located outside of the United States, and the total value of all foreign financial accounts exceeded US $10,000 at any time during the reported calendar year must file an FBAR. If persons were late in filing an FBAR, they are required to file a delinquent FBAR (IRS 2018).

and financial information between jurisdictions. At its inception, forty-seven countries[4] tentatively agreed on the Standard for Automatic Exchange of Financial Account Information, also referred to as the CRS, allowing jurisdictions to automatically exchange that information on residents' assets and incomes. Indeed, the CRS was developed to combat tax evasion in countries. The CRS is the OECD version of FATCA.

Prior to the CRS, the exchange of financial information between countries occurred on the basis of request, and the respective authorities determined how much information would be exchanged. Under the Automatic Exchange of Information (AEoI) via the CRS, tax authorities may automatically exchange the financial information in an agreed format during certain periods, through arranged channels. The CRS expands the scope for information exchange.

It is noteworthy that the FATCA operates through bilateral agreements between the US, and respective countries. The CRS works on the basis of a Competent Authority Agreement (CAA). The CRS function on two kinds of CAA: bilateral and multilateral. A bilateral CAA is an agreement for information exchange between only two jurisdictions' tax authorities, whereas a multilateral CAA (MCAA) is comprised of multiple jurisdictions as the signatories, with each jurisdiction exchanging information with all of the MCAA signatories (PWC 2015).

3.5. Action Plan on Base Erosion and Profit Shifting

The overall effect of BEPS, and transfer pricing is the reduction in taxes paid to governments. This carries problematic to countries, as the evaded tax revenue could have been used to finance several national development objectives. Furthermore, increases the burden of taxation on the entities paying their fair share of taxes.

---

[4] All thirty four OECD countries, as well as Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Latvia, Lithuania, Malaysia, Saudi Arabia, Singapore, and South Africa agreed to the CRS.

Recognizing the potential for multinational companies to exploit taxation differentials between countries, the OECD and the G20 formed the Inclusive Framework on Base Erosion and Profit Shifting to tackle such issue.

The Inclusive Framework on Base Erosion and Profit Shifting its comprised of 108 members, and addresses tax avoidance by ensuring the implementation of the measures agreed through the BEPS Project, which targets multinational companies' aggressive tax evasion practices. In particular, the BEPS measures have four "minimum standards" are at their core: harmful tax practices, treaty abuse, country-by-country reporting and dispute resolution mechanisms (OECD 2018a).

The OECD has also developed the Action Plan on Base Erosion and Profit Shifting. The initiative is aimed at the identification of loopholes which allow multinational companies to exploit taxation differentials between countries, and subsequently, reduce their tax liability.

The Action Plan on BEPS aims to provide countries with domestic and international instruments that will better align rights to tax with economic activity. The Action Plan:

(i) identifies actions required to address BEPS;
(ii) sets timelines for the implementation of the actions; and
(iii) identifies the resources needed to administer these actions (OECD 2013).

There is also a BEPS Package[5], whereby collaborating countries are seeking to form a modern international tax framework under which profits are taxed where economic activity and value creation occur.

In addition to the Inclusive Framework on BEPS, the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes also seeks to combat tax evasion. The Global Forum on Transparency and Exchange of Information for Tax Purposes is comprised of 147 members, and endorses the implementation of the international standards on tax

[5] The BEPS package is comprised of fifteen actions which are supposed to equip governments with the domestic and international instruments required to tackle BEPS.

transparency and exchange of ownership, accounting and financial account information.

Both the Global Forum and the Inclusive Framework have installed peer reviews in place, to enable all members to assess each other's implementation of the agreed standards.

3.6. Public Registry of Beneficial Ownership

In June 2016 the UK became the first G20 country to institute a public register of the beneficial owners of companies. The register was introduced to prevent corruption and tax evasion, as it shows who really owns various UK companies (Open Ownership and Global Witness 2017). A similar drive is expected to occur in the European Union (EU), as Article 30 of the 4th EU Anti-Money Laundering Directive (4AMLD) requires all EU Member States to establish legislation to publicize beneficial ownership information for corporate and legal entities (CRO 2018).[6]

The UK also intends to introduce a new Trust Register. Trustees will be required to adhere to reporting regulations by way of an online Trusts Register. Unlike the People with Significant Control (PSC) beneficial ownership register for companies, the Trust Register will not be publicized. Rather, the information would be provided to law enforcement bodies and the UK's Financial Intelligence Unit (KPMG 2017).

The UK also intends to create a new register of beneficial ownership information for overseas legal entities. All foreign entities would be required to register beneficial ownership information at Companies House and obtain a registration number in order to purchase a long lease, or mortgage any UK property.

Surprisingly, when the proposal for a public beneficial ownership register in the British Virgin Islands (BVI) and in five other British

[6] The UK established its Public Registry of Beneficial Ownership as part of its obligations under the 4AMLD (KPMG 2017).

Overseas Territories[7] was put to the UK's House of Lords in January 2018, the majority voted against it (BVI News, Media Expressions Limited 2018). All Crown Dependencies and Overseas Territories (CDOTs) were required to have an equivalent and reciprocal PRBO mechanism in place with the UK by July 1, 2017. While all the Caribbean British Overseas Territories took the required steps to accommodate the PRBO, the rejection in the UK's House of Lords means that the information in question can only be shared with law enforcement entities, and not the public.

4. Scope of De-Risking in the Caribbean

According to the World Bank (2015), the Caribbean appears to be the region most affected by a decline of foreign CBRs.[8] Thirty-two Caribbean banks in the World Bank (2015) study reported a decline in CBRs. The US was reported as the jurisdiction where the majority of the correspondent banks terminated their nostro accounts and CBRs. This is problematic for the Caribbean, as the US is it's number one trading partner. The loss of CBRs could definitely hinder trade finance, remittances, financial development assistance, and other monetary flows, which the region relies upon.

In fact, the ICC (2015) highlights that based on responses from 482 banks across 112 countries 70% of respondents reporting declining trade finance transactions due to the loss of CBRs. Other services which have been identified as being most affected by the termination of CBRs include: check clearing, clearing and settlement, cash management services, international wire transfers and for banking authorities and local/regional banks, also trade finance.

In Belize, the de-risking phenomenon hit the country in 2015, when the Bank of America decided to end its CBR with Belize Bank (Directorate General for Foreign Trade, Belize 2017). In fact, Belize was one of the

[7] The five territories were Anguilla, Bermuda, the Cayman Islands, Montserrat, Turks & Caicos Islands (BVI News, Media Expressions Limited 2018).

[8] The World Bank (2015) survey was comprises of respondents from 110 jurisdictions, 20 large international banks, and 170 local/regional banks.

most severely impacted countries by the de-risking (Vasquez 2017). Only two of the country's nine domestic and international banks managed to retain its CBRs by the end of March 2016 (Erbenova et al. 2016). Even the Central Bank of Belize lost three of its five CBRs (IMF 2017).

Apart from the loss of CBRs, effects de-risking the banking system in Belize included:

- The increase in transaction costs;[9]
- The increase in the processing time for wire transfers;
- The decline in the growth of deposits in the banking system (IMF 2017).

It is noteworthy that in November 2013, the Caribbean Financial Action Task Force (CFATF) identified Belize and Guyana as jurisdictions with AML and CFT deficiencies. To address the deficiencies, CFATAF recommended that Belize should:

(i) Address customer due diligence deficiencies;
(ii) Institute a framework to combat the financing of terrorism;
(iii) Broaden the AML/CFT framework to non-financial businesses;
(iv) Enhance the operational independence of the Financial Intelligence Unit; and
(v) Ban dealings with shell banks.

By May 2015, the CFATAF acknowledged Belize as having made significant progress in addressing the previously identified deficiencies (Vasquez 2017).

In the Bahamas, six financial institutions lost their CBRs. Money transfer operators (MTOs) were largely affected. One domestic bank had to close its Western Union money transfer franchise in summer 2015. Although the domestic banks were able to eventually find replacement correspondent banks, the de-risking phenomenon adversely impacted banking operations in the Bahamas by lengthening cheques and deposits

[9] For instance, one of the larger banks increased its wire transfer fees from US$100 to US$300 (IMF 2017).

clearing times, and higher investment and staffing costs to comply with the enhanced scrutiny. The Central Bank of the Bahamas attempted to reduce the international perception of the Bahamas' risk by amending its AML/CFT guidelines and introducing new wire transfer regulations (IMF 2017).

In July 2015, Fidelity Bank & Trust International, a correspondent financial services company operating in the Bahamas, the Cayman Islands and the Turks and Caicos Islands, terminated its CBR with Western Union. Fidelity indicated that it decided to end its money transmission services market since it was generating too little reward for the risk involved. Western Union was forced shut down its operations in the Bahamas, Turks and Caicos Islands, and the Cayman Islands, until November 2015, where it managed to replace Fidelity with the Bank of Nova Scotia (CPRI 2016).

In mid-2014, the Cayman National Bank (CNB), which facilitated payment services for the Jamaica National Money Services (JNMS), canceled its CBR. The CNB stated that reasons for its actions were higher risks for cash transfers, and increasing costs to comply with international rules.

In the Eastern Caribbean Currency Union (ECCU), the Bank of America ended its CBRs with domestic banks, stating it was no longer aligned with the international bank's business strategy. One report notes the difficulty domestic banks in the ECCU experienced to find replacement correspondent banks.

> "A local bank was recently told, after attempting to establish a CBR in Canada for its offshore subsidiary, that currently Canadian banks were not establishing any new banking relationships in the Caribbean and that local banks should not do business with money service businesses." (Wright 2016, 9).

In Guyana, the Bank of America severed its correspondent banking ties with the country's domestic banks in 2016. At the time of the de-risking, Guyana had not yet satisfied all of the recommendations of the CFATAF (Kaieteur News 2016).

Guyana was required to pass legislation, and implement the following within its Action Plan:

(i) Criminalizing of money laundering and the financing of terrorism;
(ii) Addressing beneficial ownership; and
(iii) Enhancing the requirements for suspicious transaction reporting, international co-operation, and the freezing and confiscation of terrorist assets (CFATF 2013).

However, by March 2017, Guyana had exited the CFATAF watch list (Guyana Times 2017). By the end of October 2017, approximately 66% of the domestic banks in Guyana were unable to facilitate third-party foreign currency cheques. As a consequence, the cost of financial transactions in the banking sector increased. The Government of Guyana has drafted amendments to the Financial Institutions Act, with the objective of enhancing the supervisory capacity of the Bank of Guyana, reducing the perceived risks of the country (Press Reader 2017).

For Barbados, while there was a loss of four CBRs to the total banking sector over the 2013 to 2016 period, de-risking has not manifested as a direct threat to financial inclusion. Rather, de-risking has profoundly influenced the domestic banking system, by increasing the scrutiny from correspondent banks, and the amount of resources to manage the potential money laundering and terrorist financing (Wright and Kellman 2017).

The IMF (2017) surveyed jurisdictions losing CBRs. Table 2 displays the countries in the Caribbean region that have lost some CBRs.

4.1. Secondary Impact of De-Risking

Caribbean economies are small, and highly dependent upon international trade. Caribbean exports typically target the US, Canada, and the EU markets. Caribbean imports are also mainly sourced from the aforementioned areas. The systematic loss of CBRs in the Caribbean would reduce the ease of cross-border monetary inflows and outflows. This could directly impact on importers, as they would find difficulty in purchasing goods, and exporters, who would also experience difficulty in receiving revenues from outside the region. Definitely, the loss of CBRs would negatively affect trade finance, and may act as an increased barrier to legitimate international trade in the region.

As previously highlighted in Table 2, Belize, Guyana, Jamaica, and Suriname are the Caribbean/CARICOM countries have been the most affected by de-risking in the region.[10] Figure 1 provides an illustration of the trade flows of the aforementioned countries.

Table 2. Banks that lost correspondent banking relationships (Share of total)

	IMF (2016)	CAB (2016)
The Bahamas		
Belize		
Barbados		
Guyana		
Jamaica		
Suriname		
Trinidad and Tobago		
ECCU		
Montserrat		
Saint Vincent and the Grenadines		
Antigua and Barbuda		
Anguilla		
Dominica		
Saint Kitts and Nevis		
Saint Lucia		
Grenada		

Legend

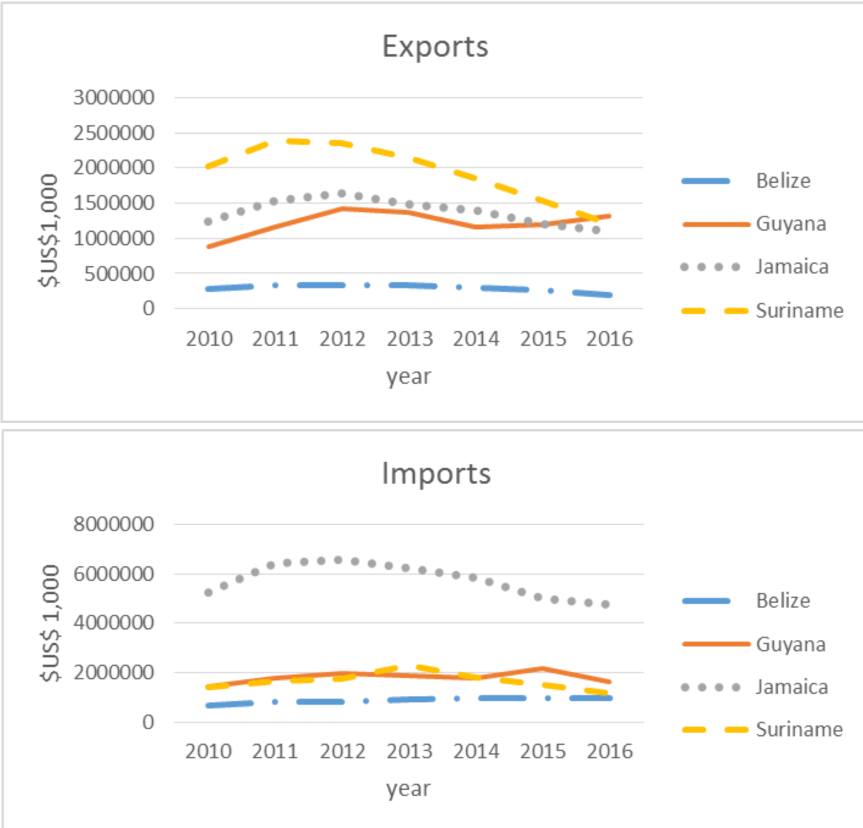
More than 75 percent

Between 25 and 75 percent

Less than 25 percent

Source: IMF (2017), based on the IMF (2016), and CAB (2016).

[10] Dominica and Montserrat have also been significantly affected by de-risking. However, they were not included in Figure 1 due to data limitations.



Source: WITS (2018).

Figure 1. Trade Flows of Selected CARICOM Countries.

As can be seen in Figure 1, Belize has experienced a continuous decline in its exports prior to its de-risking in 2015. However, from 2015 to 2016, Belize incurred a decline in its imports from US$995.560 million, to US$952.493 million. While the 5 years of annual data is insufficient to establish causality from a linear regression, it is highly likely that the de-risking challenges it experiences would have contributed to its further deterioration in its external balance. Other countries, such as Jamaica, and Suriname also experience a similar trade performance to Belize.

Increases in the difficulty to import carriers several implications. Firstly, many countries in the region are highly dependent upon food imports. Reduction in food supply due to import constraints would undoubtedly be accompanied by an increase in food prices. If prices make food less affordable to low-income groups, it could have significant negative repercussions for nutrition, health care, and poverty rates.

Secondly, with the exception of T&T, the countries are typically reliant upon diesel, and fuel oil imports for energy production and consumption. The oil price shocks of the 1970s, and the mid-2000s worsened the balance of trade position for all the Caribbean energy importing countries. If the countries experience difficulty in importing diesel, and fuel oil, it can result in energy shortages, which in turn can trigger cost-push inflation in an entire country, and further worsen a country's balance of trade.

Thirdly, the Caribbean countries are also dependent upon imports to provide medical supplies and equipment. If any import related medical supplies shortage arises, it could adversely affect the quality of health-care, and human well-being in the countries.

Decreases in export due to disruption in trade finance would result in fewer revenue inflows into the affected countries. This would affect the private sector, as well as the government. From a private sector point of view, decreased revenue inflows, or challenges to the timely receipt of revenue can result in cash-flow problems. This carries the potential to decrease the operational efficiency of the business, and may hinder the affected firms' ability to make timely payments. This can lead to delays in the payment of bills, the payment of workers, the implementation of projects, and the payment of taxes. From the government point of view, delays in the collection of taxes also affect their ability to make timely payments. The combined effect of delays in payments from both the private sector, and the public service would be a slowing down of the economy, and a decline in the multiplier effect. In other words, the disruption in trade finance could further compromise the economic growth of the CARICOM economies most severely impacted by de-risking.

Apart from the trade dimension, the Caribbean also reliant upon remittances. Remittances, which are largely personal transactions from migrants to their friends and families, are very important to sustain the standard of living of people in the Caribbean. Moreover, remittances importance to the region is also amplified since the countries have a very narrow industrial production, and export base. Remittances are often used to cover the cost of education, health care, and living expenses. Indeed, remittances act as social insurance in the Caribbean, helping to reduce the severity of poverty.

Table 3. Remittances/GDP Ratio in the Caribbean

Country Name	**1995**	**2000**	**2005**	**2010**	**2015**	**2016**
Belize	2%	3%	4%	6%	5%	6%
Dominica	5%	4%	6%	5%	10%	10%
Guyana	0%	4%	24%	16%	9%	8%
Jamaica	11%	10%	16%	15%	17%	17%
Suriname	0%	0%	0%	0%	0%	0%
Antigua and Barbuda	0.6%	2.1%	1.8%	1.8%	2.1%	2.0%
Barbados	2.7%	3.6%	2.4%	1.8%	2.4%	2.4%
Haiti	0.0%	14.6%	22.9%	22.3%	25.2%	29.4%
St Vincent & the Grenadines	4.9%	4.9%	4.1%	4.3%	5.5%	0.2%
St Lucia	3.3%	3.0%	2.8%	2.1%	1.9%	0.1%
St Kitts & Nevis	6.2%	5.8%	5.6%	6.7%	2.3%	1.1%

Source: World Bank (2018).

The data displayed in Figure 2 and Table 3 does not suggest that derisking had any impact on remittances in the region. However, if the loss CBRs has the potential to impact wire transfers, which in turn can affect remittances.

In Belize, the CARICOM Member State most affected by de-risking, the loss of CBRs has reduced wire transfer services for clients. Limited availability of foreign currency in Belize have caused some banks in Belize to ration their sale of US dollars. This has caused additional problems, including: i) the building of excess liquidity in the domestic banking system; and ii) the restricting of some multinational organizations', operating in Belize, ability to repatriate their profits (Vasquez 2017).

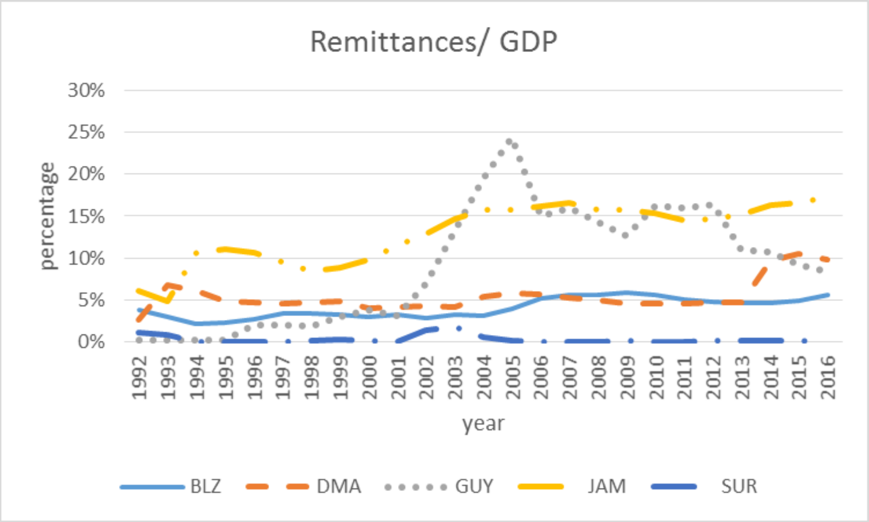


Figure 2. Remittances/GDP in Caribbean.

De--risking has encouraged domestic banks, including those with CBRs, to apply enhanced customer due diligence, particularly for clients deemed to be inherently at high risk of ML/TF. As mentioned previously, de-risking has resulted in the enhancement of CDD on money remittance firms by domestic banks. This, over time, could adversely affect the volume of remittance receipts through conventional channels.

Foreign direct investment (FDI) inflows, and financial development assistance (aid) to the region are also at risk of being negatively affected. Both flows have the ability to enhance the productive capacity of both the goods-producing, and service-producing Caribbean economies. Subsequently, the loss of CBRs could result in financial exclusion, which in turn could cut off the region from international support.

The paradox of de-risking is that it may shift financial flows to less secure avenues, which may actually encourage money laundering, tax evasion, and the financing of terrorism.

5. Applicability of Risk Factors

While the Caribbean is being de-risked and is at risk of being shut out of the global financial system, the move seems largely unjustified. The Caribbean region has complied or is in the process of complying with all the international financial standards imposed upon them.

The financial sector achievements of the Caribbean region which are consistent with international standards include:

- All the countries have passed legislation to facilitate the FATCA.
- Several Central Banks in the Caribbean such as Bahamas, Barbados, Belize, Jamaica, the ECCB, Trinidad and Tobago have issued “know-your-customer” guidelines for Licensed Financial Institutions.
- The Eastern Caribbean Central Bank (ECCB) has modeled its financial sector legislation on international standards and legislation of the more developed countries. It also regulates the domestic banks in its jurisdiction.
- Caribbean Community (CARICOM) member states have also taken legislative steps to discourage money laundering. For instance, Antigua and Barbuda, passed its Money Laundering (Prevention) Act in 1996, Barbados passed its Money Laundering (Prevention and Control) Act in 1998, Dominica passed its Money Laundering (Prevention) Act in 2000, while Saint. Kitts and Nevis implemented its Anti Money Laundering Act in 2011. In fact, in 1996, twenty-one Caribbean territories[11] collaborated to form the Caribbean Financial Action Task Force (CFATF), which was committed to combat money laundering (Maynard 1997). To current date, all the CFATF countries have passed anti-money laundering legislation.

[11] The countries include: Antigua and Barbuda, Anguilla, Aruba, Bahamas, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Colombia, Costa Rica, Dominica, Dominican Republic, Grenada, Guyana, Jamaica, Mexico, Montserrat, Netherlands Antilles, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Turks and Caicos Islands, Trinidad and Tobago, and Venezuela (Maynard 1997).

- The Caribbean British Overseas Territories took the required steps to accommodate the UK's PRBO before the July 1, 2017 deadline.

Furthermore, none of the Caribbean countries which have experienced de-risking is currently being investigated by the FATF for negligence or regulatory breach. There is no obligation for correspondent banks to provide a comprehensive justification of why they cancel their CBRs (Durner and Shetret 2015).

Moreover, one study notes

> "there is a "domino effect" when banks observe other banks terminating CBRs with a domestic bank, other correspondent banks are likely to follow suit, even without tangible proof of error on the part of the respondent bank." (CPRI 2016, 8).

It is noteworthy that several Caribbean countries[12] have Citizenship by Investment (CBI) programs. The CBI programs allow foreigners to purchase citizenship to respective Caribbean countries. This program provides funds which are crucial to the fiscal management of the countries. Unfortunately, the OECD views CBI programs as vehicles for tax avoidance (OECD 2018b; Pickard 2018).

The information asymmetry, and the domino effect of de-risking create the perception that Caribbean banks are "high risk" clients. There is a need for greater clarity on what extent to Caribbean banks need to know their customers, and conduct customer due diligence to prevent de-risking.

6. Policy Measures to Address De-Risking

In the wake of the de-risking, several Caribbean countries have adopted a number of strategies. Section 6.1 outlines some of the responses taken by the Caribbean stakeholders. Section 6.2 discusses potential policy action.

---

[12] Antigua and Barbuda, Dominica, St. Kitts and Nevis all have CBI programmes (Klein 2018).

6.1. Considered Responses

As previously mentioned, Belize was one of the countries most severely hit by de-risking. The Central Bank of Belize stepped in to assist in the provision of correspondent banking. However, the Central Bank was also de-risked. To address de-risking in Belize, the authorities are considering the following policy action:

(i) The introduction of a CBR insurance;
(ii) Collective action by banking stakeholders to concentrate the business volume to a smaller number of correspondent banks;
(iii) Payment of higher CBR service fees to make the venture more attractive to correspondent banks;
(iv) The creation of a US-licensed special purpose financial instrument to process international transactions (IMF 2017).

The banks in Belize which had their CBRs severed, managed to establish alternative arrangements. In fact, many of the banks in the Caribbean region that have been de-risked, have been able to find alternative arrangements, but with smaller US banks, or banks outside of the US.

In Trinidad and Tobago, in order to prevent de-risking, the banks have resorted to avoiding banking certain categories of clients. Private members' clubs have effectively become 'unbanked' as a large number of their accounts have been terminated. Some banks have restricted wire transfers to high-risk countries (Wright 2016).

A roundtable meeting hosted by the Central Bank of Barbados with the World Bank, the FSB, and the IMF in December 2015, to discuss the multidimensional nature of the de-risking challenge. The roundtable discussion acknowledged the Caribbean region's commitment to the international processes of financial reforms, and welcomed the FSB's four-point plan to address de-risking. The plan recommended:

(i) The further analysis of de-risking;
(ii) The clarification of the international regulatory expectations;
(iii) The capacity-building in highly affected jurisdictions; and
(iv) The strengthening of tools for correspondent banks to conduct due diligence checks (Wright 2016).

In 2016, at the 27th Intersessional Meeting of the Conference of the Heads of Government of CARICOM, a high-level ministerial advocacy group was appointed to raise greater international awareness about the threat of de-risking to the Caribbean.

6.2. Potential Responses

Information asymmetries are at the core of the de-risking problem. As previously mentioned, correspondent banks are not mandated to state their reason for de-risking. Given the Caribbean region's commitment to international financial regulation reforms, the de-risking is shrouded in speculation. It is difficult to derive a solution to the problem when the precise drivers of the problem from the perspective of international correspondent banks are not identified when the de-risking decision is taken. A coordinated regional approach is required to close the information gaps.

If AMT, CFT, and tax evasion risks are the most significant factors in any international correspondent bank decision to end its CBRs, then the Caribbean Community can collectively lobby for correspondent banks to conduct in-depth risk assessments of individual banks before terminating CBRs. The results could be forwarded to individual Caribbean banks whose financial practices raises risk concerns, and give the notice to correct the risks before terminating CBR. Furthermore, in order to ensure robustness, the risk assessments may be reviewed by international regulatory bodies, such as the FSB, and the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Although CBR is not a requirement, to prevent ad-hoc de-risking, the Caribbean Community can lobby the international regulatory bodies for the establishment of clearly defined entry, and exit rules for CBR. US banks have a Bank Secrecy Act/Anti-Money Laundering Examination Manual (BSA/AML) which provides guidelines for identifying, and controlling risks relating to money laundering, and terrorist financing. The BSA/AML Manual also includes general requirements for CBRs. With regard to the monitoring of foreign correspondent accounts, the Manual states

> "As part of ongoing due diligence, banks should periodically review their foreign correspondent accounts. Monitoring does not, in the ordinary situation, involve scrutiny of every transaction taking place within the account, but, instead, should involve a review of the account sufficient to ensure that the bank can determine whether the nature and volume of account activity is generally consistent with information regarding the purpose of the account and expected account activity and to ensure that the bank can adequately identify suspicious transactions.
>
> An effective due diligence program provides for a range of due diligence measures, based upon the bank's risk assessment of each foreign correspondent account. The starting point for an effective due diligence program, therefore, should be a stratification of the money laundering risk of each foreign correspondent account based on the bank's review of relevant risk factors (such as those identified above) to determine which accounts may require increased measures. The due diligence program should identify risk factors that would warrant the institution conducting additional scrutiny or increased monitoring of a particular account. As due diligence is an ongoing process, a bank should take measures to ensure account profiles are current and monitoring should be risk-based. Banks should consider whether risk profiles should be adjusted or suspicious activity reported when the activity is inconsistent with the profile." (FFIEC 2018, 115).

Thus, a provision in the BSA/AML Manual is made for risk assessments, but none are made to clearly outline criteria for the entry and exit of correspondent accounts. The sharing of information on objective criteria for the maintenance of CBRs to Caribbean banking stakeholders could allow the later to take the required corrective action to prevent unnecessary de-risking.

Given the dearth of secondary data about banking, and de-risking in the Caribbean, perhaps a regional information repository on the aforementioned subject can be created for the Caribbean. The Caribbean Regional Information Repository may collect the financial information from each Caribbean jurisdiction, which in turn can be shared with international correspondent banks conducting risk assessments.

Tools such as know-your-customer utilities, and legal entity identifiers may be used by the regional information repository to encourage customer due diligence. Know-your-customer utilities are electronic repositories in which banks may update and store information about their customers. A legal entity identifier is an alphanumeric code which can be assigned to legal entities engaging in financial transactions. If legal entity identifiers are used on an electronic data repository, it can be used to track the financial transactions of various legal entities.

Where deficiencies have been recognized, the Caribbean Regional Information Repository could collaborate with international and regional regulatory bodies such as the FSB, and the CFATAF to provide technical assistance.

Another option to address de-risking is for Caribbean banks to pool regional transactions through one mechanism. Since, low profitability is one of the reasons identified by the World Bank (2015) study for de-risking, the concentration of transactions can increase the profitability of CBR for an individual enterprise. This can be implemented in three ways:

(i) Caribbean banks can collectively approach a single international bank, and negotiate new CBRs;
(ii) Caribbean banks can collectively to open a bank in the US, specifically designed to facilitate the region's correspondent banking; and
(iii) Caribbean banks may purchase equity in an international bank, which in turn would be used to enable the region's correspondent banking.

While such action will not eliminate the need to comply with international financial regulations, and for strong customer due diligence, it will tackle the problem of extreme risk aversion by some correspondent banks.

Innovations in financial technology can be used to address de-risking. Bitcoin, a digital currency which was released in January 2009, can be used for wire transfers. Each bitcoin user owns a cryptocurrency wallet, which can be used to finance transactions. Bitcoin can be used to purchase currencies, goods, and services. Bitcoin operates on the blockchain interface, which is a network of computers that act as a digital ledger to record and monitor all digital currency transactions.

Bitcoin and other digital currencies may address de-risking in two respects:

(i) It can enhance the surveillance of all transactions, which increases the likelihood of detecting illicit financial transfers; and
(ii) It can allow Caribbean banks to bypass correspondent banks to facilitate wire transfers.

Bitcoin carries a number of limitations. They include:

- It is not the official legal tender for any Caribbean country. Moreover, it is highly unlikely that any Caribbean Central Bank will declare bitcoin as a legal tender, especially since the Central Bank will not be able to control its supply.
- Not every vendor will accept Bitcoin for transactions. One of the functions of money is that it must be a medium of exchange. Also, one of money's characteristics is that is must be accepted. If a currency or medium is not readily accepted, it would not be able to fulfill its exchange function.
- It is used more as a speculative asset. Bitcoin, like many other financial assets, fluctuates on a daily basis. Traders can make large speculative gains by taking the correct position on bitcoin's price movements. Some market participants may make gains by long-

term momentum trading. Although other currency pairs are traded in a similar manner, the limitation in the ease in which bitcoin can facilitate transactions makes it more analogous to a traded financial instrument, rather a monetary base.

CONCLUSION

The international regulatory environment for the financial sector is changing to combat money laundering, terrorist financing, and tax evasion threats. Caribbean banks and financial institutions have exhibited a commitment to the strengthening of the financial regulatory framework. However, several international correspondent banks have opted to cease their former correspondent banking relationships with the Caribbean banks.

De-risking threats financial exclusion of the Caribbean region. It affects trade finance, remittances, financial development assistance, and financial capital flows, all of which the region is highly dependent upon. If the de-risking is not addressed, it may compromise the quality of life in Caribbean countries.

Several approaches have been adopted to address the de-risking challenge. In most instances, Caribbean banks have sought to find replacement correspondent banks. The new correspondent banking relationships were formed with either smaller US banks, or banks outside of the US.

Other considered solutions include the utilizing of the correspondent banking relationship of domestic Central Banks, strengthening domestic regulatory and legislative framework to reduce the risk perception, and lobbying at the regional level to raise awareness of the issue.

Indeed, a regional response is required to address the problem. To prevent ad-hoc de-risking, the Caribbean stakeholders can lobby the international financial regulators for clearly defined rules to govern the entry and exit of correspondent accounts. The sharing of such information could assist Caribbean banks from taking corrective measures to prevent de-risking. This can also be enhanced if international correspondent banks perform in-depth risk assessments of individual banks before ending their correspondent banking relationships.

Given the deficiency of secondary data on de-risking and the banking sector in the region, a Caribbean Regional Information Repository could be developed to collect information. Additionally, the concentrating of correspondent banking transactions, and the utilization of digital currency can be used to address the de-risking challenge of the Caribbean.

References

Alleyne, T., Bouhga-Hagbe, J., Dowling, T., Kovtun, D., Myrvoda, A., Okwuokei, J., and Turunen, J. (2017). *Loss of Correspondent Banking Relationships in the Caribbean: Trends, Impact, and Policy Options*. IMF Working Paper. Accessed February 25, 2018. https://www.imf.org/~/media/Files/Publications/WP/2017/wp17209.ashx

Burggraf, H. (2018). *House of Lords Rejects Public Beneficial Ownership Registers for Six Overseas Territories.* Accessed February 24, 2018. http://www.internationalinvestment.net/products/house-lords-rejects-public-beneficial-ownership-registers-overseas-entities/

BVI News, Media Expressions Limited. (2018). *UK Votes Against Beneficial Ownership Register in BVI.* Accessed February 24, 2018. http://bvinews.com/new/uk-votes-against-beneficial-ownership-register-in-bvi/

CAB (Caribbean Association of Banks). (2016). *Summary of Findings: Correspondent Banking Survey*. Accessed February 25, 2018. http://cab.slu.lc/files/images/correspondent_banking/Correspondent-Banking-Survey-Summary-Report-October-2016.pdf

CFATF (Caribbean Financial Action Task Force). (2013). *CFATF Decides to Call for Counter Measures Against Belize and Guyana*. Accessed February 25, 2018. http://www.fatf-gafi.org/fr/themes/juridictions ahautrisqueetnoncooperatives/documents/cfatf-ps-nov2013.html?hf=10&b=0&s=desc(fatf_releasedate)

Central Bank of Belize. (2018). *Licensed Domestic Banks*. Accessed February 25, 2018. https://www.centralbank.org.bz/financial-system/regulated-institutions/domestic-banks

CPRI (Caribbean Policy Research Institute). (2016). *The Correspondent Banking Problem: Impact of De-Banking Practices on Caribbean Economies.* Accessed February 25, 2018. http://www.capricaribbean.com/sites/default/files/public/documents/report/the_correspondent_banking_problem.pdf

CRO (Companies Registration Office). (2018). *Beneficial Ownership – 2018.* Accessed February 24, 2018. https://www.cro.ie/Registration/Beneficial-Ownership

Directorate General for Foreign Trade, Belize. (2017). *De-risking and Belize.* Accessed February 25, 2018. https://www.dgft.gov.bz/download/de-risking-belize/

Durner, T., and Shetret, L. (2015). *Understanding Bank De-Risking and its Effect on Financial Inclusion: An Exploratory Study. Global Centre on Cooperative Security.* Accessed January 5, 2018. https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/rr-bank-de-risking-181115-en_0.pdf

Erbenova, M., Liu, Y., Kyriakos-Saad, N., López-Mejía, A., Gasha, G., Mathias, E., Norat, M., Fernando, F., and Almeida, Y. (2016). *The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action.* Accessed February 25, 2018. https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf

FATF (Financial Action Task Force). (2017). *The FATF Recommendations.* Accessed February 23, 2017. http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf

FFIEC (Federal Financial Institutions Examination Council). (2014). *Bank Secrecy Act/Anti-Money Laundering Examination Manual.* Accessed February 27, 2018. https://www.ffiec.gov/bsa_aml_infobase/documents/bsa_aml_man_2014_v2.pdf

FSB (Financial Stability Board). (2018). *About the FSB.* Accessed February 26, 2018. http://www.fsb.org/about/

Guyana Times. (2017). *Guyana Still at Risk of Correspondent Banking De-Risking – IMF*. Accessed February 25, 2018. https://guyanatimesgy.com/guyana-still-at-risk-of-correspondent-banking-de-risking-imf/

ICC (International Chamber of Commerce). (2015). *Rethinking Trade and Finance 2015 - An ICC Private Sector Development Perspective*. Accessed February 22, 2018. http://www.iccwbo.org/Products-and-Services/Trade-facilitation/ICC-Global-Survey-on-Trade-Finance/

IFC (International Finance Corporation). (2015). *De-Risking by Banks in Emerging Markets – Effects and Responses for Trade*. Accessed March 3, 2017. https://www.ifc.org/wps/wcm/connect/3dc1cc57-2ab3-4eab-8018-f93203d5a00b/EMCompass+Note+24+De-risking+and+Trade+Finance+11-15+FINAL.pdf?MOD=AJPERES

IMF (International Monetary Fund). (2016). Impact of the Withdrawal of Correspondent Banking Relationships in the ECCU. *Annex to the ECCU Staff Report.* Accessed January 22, 2018. https://www.imf.org/external/pubs/ft/scr/2016/cr16333.pdf

________. (2017). *Recent Trends in Correspondent Banking Relationships: Further Considerations.* Accessed February 23, 2018. https://www.imf.org/~/media/Files/Publications/PP/031617.ashx

IRS (Internal Revenue Service). (2018). *Report of Foreign Bank and Financial Accounts (FBAR).* Accessed February 23, 2018. https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar

Kaieteur News. (2016). *Bank of America to cut ties with Local Banks by August – says Central Bank Governor*. Accessed February 25, 2018. https://www.kaieteurnewsonline.com/2016/07/12/bank-of-america-to-cut-ties-with-local-banks-by-august-says-central-bank-governor/

Klein, M. (2018). *OECD Warns Citizenship by Investment Programs used to Circumvent Taxes*. Accessed February 25, 2018. https://www.caymancompass.com/2018/02/20/oecd-warns-citizenship-by-investment-programs-used-to-circumvent-taxes/

KPMG. (2017). *Register of Beneficial Ownership of Trusts*. Accessed February 24, 2018. https://home.kpmg.com/uk/en/home/ insights/2017/04/tmd-register-of-beneficial-ownership-of-trusts.html

Maynard, P. D. (1997). *The New Emerging Caribbean Anti Money Laundering Regime, with Special Reference to The Bahamas.* Accessed February 24, 2018. http://www.maynardlaw.com/documents/new_emerging_caribbean_anti_mone.htm#_edn2

OECD (Organisation for Economic Cooperation and Development). (2013). *Action Plan on Base Erosion and Profit Shifting*. Accessed February 23, 2018. https://www.oecd.org/ctp/BEPSActionPlan.pdf

________. (2018a). *About the Inclusive Framework on BEPS*. Accessed February 24, 2018. http://www.oecd.org/ctp/beps-about.htm

________. (2018b). *Preventing Abuse of Residence by Investment Schemes to Circumvent the CRS.* Accessed February 25, 2018. https://www.oecd.org/tax/exchange-of-tax-information/consultation-document-preventing-abuse-of-residence-by-investment-schemes.pdf

Open Ownership and Global Witness. (2017). *Learning the lessons from the UK's Public Beneficial Ownership Register.* Accessed January 22, 2018. https://www.globalwitness.org/.../Learning_the_Lessons_from_the_UKs_public_Bene...

Pickard, J. (2018). *OECD Launches Consultation on Misuse of Residence by Investment Schemes*. Accessed February 25, 2018. http://www.internationalaccountingbulletin.com/News/oecd-launches-consultation-on-misuse-of-residence-by-investment-schemes-6060903

Press Reader. (2017). *Local Banks Still Seriously Affected by De-Risking – Jordan*. Accessed February 26, 2018. https://www.pressreader.com/guyana/stabroek-news/20171128/281646780455293

PWC (PricewaterhouseCoopers). (2015). *The Common Reporting Standard.* Accessed February 23, 2018. https://www.pwc.com/id/en/publications/assets/financialservices/crs-hought-leadership.pdf

Vasquez, G. M. (2017). *Assessing the Impact of the De-risking on Remittances and Trade Finance in Belize*. Inter-American Development Bank, Working Paper. Accessed February 25, 2018. https://publications.iadb.org/bitstream/handle/11319/8702/Assessing-the-Impact-of-the-De-risking-on-Remittances-and-Trade-Finance-in-Belize.PDF?sequence=3&isAllowed=y

Viswanatha, A., and Wolf, B. (2012). HSBC to pay $1.9 billion U.S. fine in Money-Laundering Case. *Reuters Business News* December 11. Accessed March 19, 2017. http://www.reuters.com/article/us-hsbc-probe-idUSBRE8BA05M20121211

WITS (World Integrated Trade Solution). (2018). *Trade Data (UN Comtrade).* Accessed April 4, 2018. http://wits.worldbank.org/WITS/WITS/AdvanceQuery/RawTradeData/QueryDefinition.aspx?Page=RawTradeData

Williams, M. G. (2016). *De-Risking/De-Banking: The Reality Facing Caribbean Financial Institutions.* Accessed February 25, 2018. http://www.ccmf-uwi.org/files/publications/conference/2016/2_1-Williams-p.pdf

World Bank. (2015). *Withdrawal from Correspondent Banking: Where, Why, and What to do about it*. Accessed February 24, 2018. http://documents.worldbank.org/curated/en/113021467990964789/pdf/101098-revised-PUBLIC-CBR-Report-November-2015.pdf

_________. (2018). *World Bank Open Data.* Accessed March 29, 2018. https://data.worldbank.org/

Wright, A. (2016). De-*Risking and its Impact: The Caribbean Perspective. Caribbean Centre for Money and Finance Working Paper*. Accessed February 26, 2018. http://ccmf-uwi.org/files/publications/working_papers/2016TWGDR.pdf

Wright, A., and Kellman, B. (2017). *De-Risking in the Barbados Context. Inter-American Development Bank Policy Brief.* Accessed February 25, 2018. www.ceintelligence.com/content_manager/documents/download/2023

Vasquez, G. M. (2017). *Assessing the Impact of the De-risking on Remittances and Trade Finance in Belize*. Inter-American Development Bank. Accessed April 22, 2018. https://publications.iadb.org/bitstream/handle/11319/8702/Assessing-the-Impact-of-the-De-risking-on-Remittances-and-Trade-Finance-in-Belize.PDF?sequence=3&isAllowed=y

ABOUT THE AUTHOR

Don Charles holds a PhD, an MSc, and a BSc in Economics from the University of the West Indies (UWI), St. Augustine Campus. His research interests are in the areas of energy economics, international trade and value chains, climate change, and portfolio finance. He also has seventeen years experience covering economic research, industrial relations, and project management, in the public service, United Nations (UN) organizations, and in academia.

In: Progress in Economics Research … ISBN: 978-1-53618-248-4
Editor: Albert Tavidze

Chapter 5

TECHNICAL SPECIFICATION AND ITS ROLE IN PUBLIC PROCUREMENT IN KOSOVO

Safet Hoxha*

Faculty of Law, University of Prizren, Prizren, Kosovo

ABSTRACT

The importance of public procurement in spending public funds is very high in every state and society. Therefore, these procedures have a high impact not only on spending public funds but also on the development of the private sector in general.

Therefore, to achieve these goals, one of the prerequisites for sustainable procurement is a clear technical specification, whereby the public authority clarifies its needs whether for goods, works or services, and the business has a clear view of its offers including liabilities, costs and profit.

Therefore studying and analyzing technical specification is of the utmost importance for sustainable procurement. In the course of what has been said above, this chapter is constructed as a modest contribution to this issue.

* Corresponding Author's E-mail: safet_hoxha01@hotmail.com.

INTRODUCTION

The technical specification presents a detailed description of public authorities that provides detailed statements and requirements referring to the work, materials, dimensions, and standards that are subject to procurement and which will be returned, as business offers including liabilities, costs and profits. Also, clear technical specification remains an essential mechanism in the successful management of public contracts.

The purpose of the technical specifications is to give instructions and guidance to tenderers at the tendering stage about the nature of the tender they will need to submit, and to serve as the economic operators mandate during contract implementation. The technical specifications will be included in the tender documents and will become an annex of the eventual contract awarded as a result of the tender.

Specifications should reflect correctly the needs of the contracting authority and the budget estimations made for the acquisition.

Incorrect or unrealistic specifications are a common reason for many of the problems that later frequently occur during the tender and award process, such as the need for issuing amendments to the tender dossier, cancellation of tender proceedings, lodging of complaints and contract problems.

They must be drafted to permit the widest possible competition and, at the same time, present a clear statement of the required standards of workmanship, materials, performance and other factors of relevance related to products and services to be procured.

Specifications and requirements must afford equal access for candidates and tenderers[1] and not have the effect of creating unjustified obstacles to competitive tendering[2].

Thorough preparation of technical specifications is extremely important for the ultimate success of the contract implementation.

[1] Treaty of Rome, 1957, article 12.

[2] Case C-234/89 Comission V Denmark (1993) I-3353. In this case, there were two alleged violations of the Procurement Law.

Therefore, greater effort during the preparation phase will save time and money in the later stages of the project cycle.

The Directives[3] provide that the contracting authorities should define the technical specifications by reference to national standards implementing European standards, or by reference to European technical approvals, or by reference to common technical specifications.

Technical specifications must not refer to services, goods or works of a specific make or source, or process, in particular to trademarks, patents, types or a specific origin if that would favour certain service providers, suppliers, products or contractors. Such an indication is permitted, however, where it would otherwise be impossible to describe the subject of the contract with sufficient precision, but only if accompanied by the words "or equivalent."

Contrating Authorities may authorize tenderers to submit variants. Contrating Authorities must declare the minimum requirements for the fulfillment of the variants and only variants that meet the minimum requirements shall be considered. In this case the contract award criterion must be the most economically advantageous tender.

Specifications should require that all materials and other supplies that are included in the work of new, unused, and of the latest or actual models.

Samples of specifications from previous similar projects in the same country are useful in this regard.

KEY PRINCIPLES

Non-Discrimination

As mentioned above, there is a general ban on technical specifications that mention goods of a specific make or source, or of a particular process,

[3] Directive on PP, No 2004/17, and 2004/18.

and that have the effect of favouring or eliminating certain enterprises or products[4].

An exception to this general ban is allowed where the subject matter of the contract cannot otherwise be described by specifications that are sufficiently precise and intelligible to all concerned.

An exception to this general prohibition allowed when the object of the contract cannot be described in any other way from specifications that are sufficiently precise and intelligible to all parties involved. The main purpose is that the required specifications are to be related to determine a way to the achievement of the performance, but also it is needed to ensure that specifications should not lead to unreasoned difficulties.[5]

Reliance on this derogation should not, however, have discriminatory effects; to that end, the Directives require that such indications be accompanied by the words "or equivalent."

The Principle of Equivalence and Common Knowledge

In accordance with the mutual recognition principle, a contracting authority must consider on equal terms products from other member states manufactured in accordance with technical rules or standards that afford the same degree of performance and protection of the legitimate interests concerned as products manufactured in conformity with the technical specifications stipulated in the contract documents.

DRAFTING OF SPECIFICATION IN PRACTICE

The role of the procurement officer at this stage of the process is to ensure that the specification is drawn up by appropriately qualified people

[4] PP training for IPA countries, module E, pg. E-7, www.sigmaweb.org.
[5] ŠOLTES, Igor Dr. Sc. Doktorska Disertacija: "Pomen in Vloga Sistema Javnih Nročil pri Delovanju Države" Fakulteta za Družbene Vede - Univerza v Ljubljani; 2008, page 93.

in such a way that any number of economic operators can successfully tender for the requirement.

The role of specialist technical stakeholders within a contracting authority is to use their knowledge and expertise, consulting with others in the contracting authority to construct a specification that is fit for the intended purpose.

Given the technical complexity of the works contracts, the preparation of the technical specification may require the assistance of one or more external technical specialists. Each such specialist must sign a statement of confidentiality.

If a site visit is foreseen this you this must be specified in the instructions to bidders.

The tender documents must state whether the price revision is allowed. Public work contracts are usually subject to price revision. The formula for determining the price must be stated in the tender dossier.

Specifying a requirement is a fundamental and early stage in the procurement process. Simply put, if the specification is lacking in some way, what is delivered will also be lacking.

Procurement officers should ensure that the requirements are specified in a not discriminatory way; equal access should be provided to all bidders; and the preparation of the specification should not have the effect of creating unjustified obstacles to the opening of public procurement to competition.

DEFINITIONS - PUBLIC WORKS

Technical specification, in the case of public works contracts, means the totality of the technical prescriptions contained in particular in the tender documents, defining the characteristics required of a material, product or supply, which permits a material, a product or a supply to be described in a manner such that it fulfils the use for which it is intended by the contracting authority. These characteristics shall include levels of environmental performance, design for all requirements (including accessibility for disabled persons) and conformity assessment, performance, safety or dimensions, including the procedures concerning quality assurance, terminology, symbols, testing and test methods, packaging, marking and labelling and production processes and methods.

They shall also include rules relating to design and costing, the test, inspection and acceptance conditions for works and methods or techniques of construction and all other technical conditions, which the contracting authority is in a position to prescribe, under general or specific regulations, in relation to the finished works and to the materials or parts, which they involve.

WHAT DOES THE DIRECTIVE 2004/18/EC REQUIRE FROM A TECHNICAL SPECIFICATION?

"Technical Specifications should take into account accessibility criteria for disabled people."[6]

"They should not have the effect of creating unjustified obstacles to free competition."[7]

"Without prejudice to mandatory national rules (e.g., earthquake resistance requirements), they shall be formulated either. By reference to technical specifications as defined in Appendix VI and in order of preference":

- National standards transposing European Standards,
- European Technical Approvals,
- Common technical specification,
- International standards,
- Other technical reference systems established by European standardisation bodies or
- National standards, national technical approvals or national technical specifications.

[6] EU Directive No. 2004/17 (annex VI 1 (a), article 23.1).
[7] Ibid, article 23.2.

Each reference must be accompanied by the words ‘or equivalent’

a. In terms of precise performance or functional requirements
b. In terms of performance or functional requirements as stated in b) with reference to the specifications mentioned in a)
c. In terms of a combination of technical specifications and performance or functional requirements[8].

The proper description of the supplies, works or services can go well beyond purely technical aspects or the choice of European or national standard. These other aspects may be addressed in parts of the contract other than the technical specification, e.g., in the conditions of contract, or may influence the form of the contract itself.

Who will prepare the design: the contracting authority (the “contracting authority/employer”) or an “engineer” on their behalf, or the economic operator (the contractor)?

Are all materials to be provided by the contractor, or will some materials be provided by the contracting authority/employer or another economic operator chosen by them (a “nominated supplier”)?

Will the contractor have exclusive occupation of the site and undertake all of the works, or will other contractors be present carrying out parts of the works? If the latter, how are the interfaces to be defined?

Will a fully detailed technical specification be provided, or will the supplies, works or services be defined in terms of performance criteria, permitting the contractor some flexibility in the choice of equipment to be installed, if the performance criteria are met?

What will be the input of the contracting authority/employer with respect to the approval of the design?

Will they seek to approve or comment upon every detail throughout the design and construction phases, or will their involvement be limited to checking that the completed works comply with the performance specification?

---

[8] Ibid, article 23.3.

The answers to questions such as these may influence the contracting authority/employer to opt for a turnkey contract using a standard contract form such a the FIDIC “Silver Book” (under which the contractor undertakes to design and construct the works and carries most of the risk, but under which the contracting authority/employer is allowed only little involvement until the Works are almost complete).

Conversely, the contracting authority/employer may choose a form of contract that allows them much greater involvement, such as the FIDIC “Red Book” for works designed by the contracting authority/employer.

DIFFERENCES IN SPECIFYING GOODS, SERVICES AND WORKS

Goods, works and services all have different aspects to consider with regard to specification.

Specification of Goods

Goods and materials can literally be counted, touched, weighed and tested to see whether they fit, both before specification and after delivery.

If 1 000 sheets of pink A4 size, 80-gsm photocopier paper are specified in two packs of 500 sheets, then it is possible to:

1. See whether two packs have been delivered
2. Understand whether the paper has been delivered to the correct organisation and place
3. Monitor the time of delivery
4. Look at the packaging to see if it is photocopier paper
5. Count all 1 000 sheets
6. Weigh the paper to establish the gem
7. Check that the colour is pink[9]

[9] PP training for IPA countries, module E, pg. E-21, www.sigmaweb.org, www.sigmaweb.org.

The physical nature of goods means that specification and measurement can be visualised and described with less difficulty.

However, what is mentioned above refers to simple supplies and common supplies for which we have sufficient knowledge. Knowing the fact that in the public market more complex nature supplies are available, e.g., machinery, information technology equipment, various software's, electronic applications, programmes, etc., it is very difficult to draft the technical specifications.

Furthermore, these difficulties are reflected in the public procurement process, and as well impede the realization of the final aim of the public procurement, which is value for money, and satisfaction of the final buyer.

Taking into account that because of the technological development and the fact that identical supplies with different features are available in the market, drafting technical specifications has become more difficult.

In addition, recent developments in the field of e-Government, and e-Services, have shown the necessity of the development of e-procurement as a dynamic, transparent and economical system for the management of supplies in the public market.

Nevertheless, for the successful implementation of e-procurement a clear description of the contracting authority's requirement is required meaning that a clear technical specification needs to be drafted.

Because of all this development, in the EU, the E-Cl@ss has been presented, which is electronic specification of the products and spare parts.

E-Cl@ss does not only specify the product, but at the same time, it describes the functional aspect of the product, including the functional characteristics of the product.

In the past, large companies developed the technical specifications of their products, and this resulted in different description of the same specifications or with the same description of different specifications, and this resulted in the lack of buyer's confidence, uncertainty in the selection of bids, etc. Therefore the unification and standardization of specifications means that we are the buyers and we want to choose the product based on the our capabilities and our needs (our tastes).

Therefore, the e-Cl@ss provides the standardization of goods which means unification of the language we use for items. Until the end of 2012, the e-Cl@ss has classified more than 40,000 products in 16 official languages[10].

Achievements by the use of e-Cl@ss can be listed as follows:

- The use of current e-CL@ss does not invent standards;
- Can be used for every product;
- Different languages of e-CL@ss are available;
- Exchange of the specifications with other states;
- Puts the EO on equal terms;
- Creates clarity and increases security on the purchase;
- Reduces the time limit for the implementation of procurement, etc.

Whereas form the Economic operator's side, they can benefit:

- The use of a unique standard;
- Reduces the possibility of wrong bidding;
- No specifications may be added after contract specifications;
- Binding Contract is stable.

Specification of Services

A service has an intangible nature, which makes it more difficult to specify and even more difficult to measure.

The service of cleaning an office can provide an example here. The view of what is "clean" to one person may result in a complaint from another person that the office is not clean.

Services differ from goods in several ways - for example:

[10] www.paradine.at.

- Services are intangible
- Services involve the performance of activities or tasks
- Services cannot be owned like a product
- Services cannot be stored
- Samples of services cannot be seen prior to purchase
- Some services cannot be performed remotely
- Services are provided by people

These differences have implications for specifications, and to overcome the difficulties that arise, service specifications must not only lay down parameters for economic operator performance, but also act as a quantifiable basis by which the people working for the economic operator can be measured. They will cover such aspects as:

- Details of services to be provided
- Time and point of service provision
- Names of people authorised to provide the service
- Required response times, both under normal circumstances and in emergencies
- Support and back-up arrangements
- Required documentation
- Supervision and sign - off of acceptance[11]

Specification of Works

Specifying works can be time-consuming and will require the expertise of architects, surveyors and other specialists who have specific experience of the construction being undertaken. Different works - for example bridges, buildings, airports, motorways and harbours - will all present different difficulties and require different sets of expertise.

---

[11] Ibid, pg. 21.

In addition to the design of the works, specifications will need to include aspects like:

- Gaining access to the site
- Defining the site facilities available and what is being done by the contracting authority and the economic operator
- Access to the facilities of the contracting authority during the construction of the works
- The off-loading and storage facilities available
- What is required in terms of installation and commissioning, when will the handover be considered complete
- Where risk and liability starts and stops for the economic operator and the contract-ing authority
- Issues around sustainability and ongoing maintenance of the structure when it is complete[12]

Work Contracts, Specifications and Requirements Are Drawn Up in a Different Manner Depending on the Method Used

Traditional Approach

In the traditional approach, with the contracting authority in charge of detailed design, the specifications and requirements in the tender documents typically comprise:

- The location of the site,
- The scope of the works,
- Details of how each part of the works is required to be constructed (including construction drawings and specifications of materials, etc.); and

[12] PP training for IPA countries, module E, pg. E-22, www.sigmaweb.org.

- Possibly, a programme of work, e.g., if the contractor will be required to phase refurbishment work in order to allow the continuing operation of an existing facility.

Among the documents issued with the tender documents, and typically to be complemented by the tenderer in its submission (i.e., offering a price for the items concerned), are also:

- A bill of quantities: and
- A daywork schedule.

The bill of quantities must closely reflect the design worked out by the contracting authority, with item descriptions and quantities corresponding to the drawings and other specifications. The bill of quantities must also indicate the principles and methods for measurement of the works, possibly by reference to another publication specifying them. These principles also indicate, by defining what is to be measured, the basis for valuing each item in the bill of quantities, either as a "rate" or "unit price" (say, euros per cubic metre), or as a lump sum for an item which is either provided or not but is not specifically measured.

A daywork schedule for minor or contingent work may be appropriate under any form of contract. Such a schedule, to be priced by the tenderers and included in the contract, would typically comprise a time charge rate for each category of resource used (workers, equipment, etc.) and the payment due for each category of materials (possibly on a cost-plus basis).

Design-Bulid Approach

In the design build approach, the tender documents state the client's precise requirements for the completed works. These would typically include:

- The location of the site

- The definition and purpose of the works (note that it is typically the design build
- Contractor, not the contracting authority, who has the obligation to ensure that the
- Completed works are fit for the intended purpose)
- Quality and performance criteria
- Arrangements for testing
- Special obligations, such as training of operations and maintenance staff.

The specifications and requirements may well include outline drawings; however, it should then be indicated to what extent the works would have to comply with them. If at all, any design aspects should be included only after very careful consideration of the consequences, especially for the responsibilities related to such a design.

It is essential that performance requirements and other characteristics correspond to the intended purpose of the works.

The crucial element in drafting specifications and requirements for a design build contract is thus to make sure that the quality and characteristics of the works are specified in terms that are:

- Not so detailed as to reduce the contractors design responsibilities;
- Not so imprecise as to be difficult to enforce; and
- Not reliant on the future opinions of the contracting authority or his representative (which tenderers may consider impossible to forecast).

For describing its requirements in the tender under the design build approach and defining the works to be offered by tenderers, the contracting authority may work out a conceptual design. In response, tenderers would be required to work out preliminary designs, both for evaluation purposes and for incorporation as obligations under the contract. Some of these designs may need to be complemented later by more final designs (possibly in several stages, as general arrangement drawings and detailed construction drawings). The latter point may be regulated by and enforced under the terms of the contract, but the requirements for the nature and level of detail of the designs to be submitted with the tenders have to be defined in the instructions to tenderers, so that it can be determined if tenders are responsive or not in this respect.

Most specifications are normally written by employer or engineering. There is no standard specification for universal application in all sectors in all countries.

In cases of complex contracts, a “turnkey” contract or “design-build approach - and -” is more appropriate. For these cases, it is recommended bidding process with two stages (prequalification & bidding).

INFORMATIONS ON ECONOMIC OPERATORS

The contracting authority must recognise that both the contracting entity and prospective tenderers require information in order to prepare requirements and tenders, in addition to the information gathered (e.g.,) during a feasibility study, and that there are always costs to be paid for this information.

The contracting authority would typically have carried out a number of site investigations and the like in advance of tendering, at its own cost. It is normally in the best interests of all parties concerned to make their results available to tenderers, together with other such data as may be available from other studies or public sources and are in the contracting authority’s possession. Such information should be included in the tender documents. The contract may require that certain information has been submitted by the contracting authority and received by the contractor.

When the contracting authority takes responsibility for and carries out detailed design, such information is required specifically for this purpose. However, in a design build approach, tenderers will require data of similar nature, quantity and precision for carrying out their own pre-contract designs, and determine the details of the works for which a price has to be submitted. In fact, such tenderers may collectively require even more data, since they may each have a different preference, e.g., for the layout of a plant or the location of bridge piers.

In some circumstances they must be given sufficient time as well as access to the site for this purpose before and during tendering. Even if the contracting authority has carried out investigations and made their results available, the typical responsibilities of an economic operator under a design build contract mean that it will need to be able to verify the validity, precision and reliability of the data provided. This is particularly the case of turnkey projects contracts, where the economic operator takes full responsibility for the accuracy of such site data.

Contracting authorities should bear in mind that the money, which economic operators collectively find themselves obliged as tenderers to spend on pre - tender investigations, will ultimately have to be recovered from the contracting authority through the prices charged for the works actually carried out. If the required investigations or verifications are very extensive, time consuming, difficult or costly (e.g., for tunnelling or similar works), it may thus be advantageous for the contracting authority to carry them out itself and rather not use the design build approach, or to consider taking on relatively more responsibility for subsoil conditions or the like than stipulated in the standard form of contract used.

A particular reason for this is that the most qualified and experienced design build contractors may well choose not to spend any resources on pre-tender investigations (meaning that they will simply refrain from participating at all, with the effect of diminishing competition to the detriment of the contracting authority), or to raise their prices to cater for this cost and uncertainty, including the risk of having wasted the money if they are not awarded the contract (It is interesting to note that in this case, the effect may be that the lowest price tenders received could be those submitted by tenderers having spent too little resources on their own investigations and possibly underestimating real costs. The contracting authority that accepts such low tenders then runs a higher risk of getting an inadequately designed facility or suffering delays and other problems or of the contractor going bankrupt because the costs for meeting their contractual obligations may become far too high relative to the agreed price for completing the works).

Conclusions - Instructions for Writing the Specification as a Condition of the Success of the Project

1. Use simple language.
2. Avoid words or phrases that are not specific or that may lead to ambiguity, e.g.,
   - Should
   - High
   - Maybe
   - Normal
   - Reasonable
   - Approximately
   - Could
   - Possible
   - Not likely to
3. Do not use jargon.
4. Define terms, symbols and acronyms.
5. Write in layman's terms. Do not expect the specification to be read only by experts.
6. Use an attractive format. This will reflect your professionalism and encourage potential economic operators to read the specification.
7. Use a logical structure.
8. Beas concise as possible without reducing understanding.
9. Aim to define each aspect of the requirement in one or two paragraphs.
10. Do not explain the same requirement in more than one section.

11. Number each section and paragraph using a logical and consistent numbering method, representing the fifth section, sixth paragraph, third sub - paragraph.
12. Ask someone who is not familiar with the specification to read it to gauge its readability and effectiveness.
13. Discuss drafts with stakeholders, colleagues and users.

Therefore drafting of technical specifications is a procurement process that precedents the offer, namely its delivery, and consequently is made prior to the contract.

As such, a clear specification will eliminate ambiguities in interpretation between the contracting parties to the contract, the contract management of the contract will be less problematic, and the realization of the contract will result in meeting the needs of the contracting authority, and efficient management of the fixed budget.

Therefore can may conclude that the key to a successful procurement remains on the fair drafting of the technical specifications by the contracting authority.

On the contrary, non - defining a clear technical specification will result in an incorrect BoQ, and the whole process will be rigged, because it will result in the discrimination of the economic operators in the public market, high financial costs for the contracting authority, with uncertainty during the performance of the contract, etc.

The following example reflects public procurement issues arising because of incorrect specifications drawn up by the contracting authority.

References

Case C-234/89 Comission V Denmark (1993) I-3353. In this case, there were two alleged violations of the Procurement Law.

Directive on PP, No 2004/17, and 2004/18.

EU Directive No. 2004/17 (annex VI 1 (a), article 23.1). Ibid, article 23.2. Ibid, article 23.3.

PP Training for beneficiary countries of IPA, module E, pg. E-5, www.sigmaweb.org.
PP training for IPA countries, module E, pg. E-21, www.sigmaweb.org, www.sigmaweb.org.
PP training for IPA countries, module E, pg. E-7, www.sigmaweb.org.
Šoltes, Igor Dr. Sc. *Doktorska Disertacija: Pomen in Vloga Sistema Javnih Nročil pri Delovanju Države* Fakulteta za Družbene Vede -Univerza v Ljubljani [*The Importance and Role of the Public Procurement System in the Functioning of the State*, Faculty of Social Sciences, University of Ljubljana]; 2008, page 93.
Treaty of Rome, 1957, article 12.
www.paradine.at. Ibid, pg. 21.

BIOGRAPHICAL SKETCH

Safet Hoxha

Affiliation: University of Prizren.

Education: PhD of Law.

Research and Professional Experience: Law, Public Procurement, International Relations.

Publications:

1. April 2010: “Developments and Reforms in Public Pocurement System in Kosovo” (www.siteresources.worldbank.org).
2. May 2012: “Public procurement System in Kosovo” & Public Procurement activities for 2011, (www.siteresources.worldbank.org/INTECA).

3. August 2012: www.ippa.org/IPPC5, "Reforms of Public Procurment in the Western Balkans" (www.woppaa.org/PAPER-VII.2); Ilaz Duli, Safet Hoxha and Mersad Mujovic.
4. *International Public Procurement Conference* (ippc6); Dublin, Ireland August 2014: (http://www.ippc6.com/downloads/IPPC 2014_BookOfProceedings.pdf.zip).
5. "Contract Management According to the Public Procurement Law of Kosovo" Mr. Safet Hoxha, President of the Public Procurement Regulatory Commission-Kosovo, Mr. Ilaz Duli, Board Member of the Public Procurement Regulatory Commission-Kosovo (http://pubdocs.worldbank.org/en/631441468498299263/12th-PRIMO-Astana-Forum-Report.pdf).
6. Public Procurement in the Security Sector in EU, Montenegro and Kosovo Safet Hoxha, Academic *Journal of Business, Administration, Law and Social Sciences*, Vol. 3 No. 3 November 2017, IIPCCL Publishing, Graz-Austria (http://iipccl.org/wp-content/uploads/2017/11/Pages-from-175-185.pdf).
7. *Reforms of Public Procurement in the Western Balkans Ilaz Duli, Safet Hoxha and Mersad Mujovic* (http://www.ippa.org/images/PROCEEDINGS/IPPC5/Part7/PAPER7-2.pdf).
8. Designing a public procurement compliance and performance monitoring system in Kosovo WB Project Kosovo - IDF Grant No. TF013655 Enhancing the Implementation of Public Procurement Project Mr. Safet Hoxha, President of PPRC - Kosovo Mr. Ilaz Duli, Board Member of PPRC - Kosovo (https://www.worldbank.org/content/dam/Worldbank/Event/ECA/public-procurement-forum10-eca/tr-procurement-kosovo.pdf).
9. *Rules and Operational Guidelines for Public Procurement* (https://krpp.rksgov.net/krpp/PageFiles/File/STRforms2016/English/A01%20Rules%20and%20Operational%20Guidelines%20for%20Public%20Procurement.pdf).
10. Professionalization of Public Procurement Dr. Sc. Safet Hoxha, President of PPRC - Kosovo May, 2016 Astana - Kazakhstan

(http://pubdocs.worldbank.org/en/786051462430185379/KOSOVO-Presentation.pdf).

11. Hoti Hamdi, Safet Hoxha, and Mustafa Gara: “Foreing Direct Investment in Kosovo” *International Sctientific and Research Journal Diskutime*, no 9, January 2013 www.diskutime.org ISSN PRINT 1857-825X, ISSN online: 1857-8543.
12. http://eprints.ugd.edu.mk/19553/7/15.1.pdf%20Bugarija%202016.pdf.

In: Progress in Economics Research … ISBN: 978-1-53618-248-4
Editor: Albert Tavidze

Chapter 6

THE EUROPEAN UNION IN A LABYRINTH OF TRANSITION FROM THE TERRITORIAL INTO A MARKET STATE

Pavle Jakovac*[*], *Goran Kutnjak and Dejan Miljenovic
Faculty of Economics and Business,
University of Rijeka, Rijeka, Croatia

ABSTRACT

The world is changing rapidly. Many distinguished economists were convinced that the international Pareto optimum, particularly relevant for the enlargement of the European Union (EU), was quite a realistic achievement only if EU follows the dictate of a strong radical free market reform. "Laissez-faire" was considered as a magic solution for every economic issue within the EU. However, we believe that the EU is becoming a perfect case in point to illustrate the labyrinth of transition from a "territorial" (nation) state into a "market" state on the basis of profound globalization process and functional integration of the global economy. Dialectic of globalization suggests that the extant economic theory becomes virtual and unsuitable for the process of globalization.

[*] Corresponding Author's E-mail: pavle.jakovac@efri.hr.

We raise the following questions which we are not able to answer just by using the existent (neoclassical) economic theory and policy: whose GDP should be optimized in a global economy? Whose employment level should be addressed: that of territorial or the market state? Who is the main economic subject in the upcoming market state: (multi/transnational) corporations or individual (non-sovereign) states deprived of their economic resources during privatization? How this new stage in the world (capitalist) development is going to look like? Since we have (partly) stepped in the next stage of capitalist development, we propose the term "mega-capitalism" which totally differs from Friedman's and neoliberal understanding of economic processes and Fukuyama's end of history. Should the EU join mega-capitalism as a unique state or as bunch of (currently 28) integrated national states? Should the EU maximize its own GDP or GDP of individual member states? The same question is pertinent for the level of employment, social justice etc. Is the EU becoming or should it become (only) a region within the unified global state? These are the questions that need to be answered as soon as possible for the sake of the citizens of the EU and we will try to tackle these questions within this chapter.

Keywords: EU, globalization, dialectics, territorial state, market state, mega-capitalism

INTRODUCTORY REMARKS: QUO VADIS EUROPEAN UNION?

The former president of France, Nicolas Sarkozy, back in 2011 gave his remarks regarding the future of the EU (federal core vs. confederal outer band). His comments were, at the same time, worrying, intriguing and far-fetched. But, was he mistaken? We think not. In the context of "widening and deepening of the EU", this has become our reality.

On the subject regarding the so-called multi-speed Europe (or two-speed Europe[1]), Sarkozy stated (The Economist, 2011): "You cannot make

[1] The term "multi-speed Europe" or "two-speed Europe" is used to describe the idea that different parts of the EU should integrate at different levels and pace depending on the political situation in each individual country. It represents a form of the so-called differentiated integration and it is closely linked with the terms "variable geometry Europe" and "Europe à la carte". For more explanation, see https://eur-lex.europa.eu/summary/glossary/multispeed_europe.html.

a single currency without economic convergence and economic integration. It', s impossible. But on the contrary, one cannot plead for federalism and at the same time for the enlargement of Europe. It's impossible. There's a contradiction. We are 27. We will obviously have to open up to the Balkans. We will be 32, 33 or 34. I imagine that nobody thinks that federalism (total integration) is possible at 33, 34, 35 countries. So what one we do? To begin with, frankly, the single currency is a wonderful idea, but it was strange to create it without asking oneself the question of its governance, and without asking oneself about economic convergence. Honestly, it', s nice to have a vision, but there are details that are missing: we made a currency, but we kept fiscal systems and economic systems that not only were not converging, but were diverging. And not only did we make a single currency without convergence, but we tried to undo the rules of the pact. It cannot work. There will not be a single currency without greater economic integration and convergence. That is certain. And that is where we are going. Must one have the same rules for the 27?[2] No. Absolutely not. In the end, clearly, there will be two European gears: one gear towards more integration in the euro zone[3] and a gear that is more confederal in the European Union."

The Treaty of Maastricht (1992) and the Stability and Growth Pact (1997) have saddled Europe with such an institutional framework which heavily relies on the neoliberal/neoclassical economic theory. As long as both politicians and economists were convinced (i.e., were true believers) in the free market ideology (and everything that goes with it), endless prosperity should be on the horizon (Stojanov, 2015). Many distinguished economists were convinced that international Pareto optimum, relevant for EU enlargement process, is quite a realistic achievement just if one (country or region) follows the dictate of strong/radical free market reform. Therefore, the creation of a unique economic market (economic union)

---

[2] As of July 1st, 2013 there are 28 member states of the EU were Croatia was the last one to join. There are several candidate countries (Albania, Montenegro, North Macedonia, Serbia and Turkey) while two potential candidates are Kosovo and Bosnia and Herzegovina.

[3] The term „eurozone" or „euro area" is used to describe a monetary union of 19 (out of 28) EU member states which have adopted the euro (€) as their common currency and sole legal tender.

within Europe, without political unionization, was quite feasible and had a promising future with "laissez-faire" being considered as a magical solution for every economic issue within the EU (with no possibility of a crisis). The experiment of creating monetary union (1999) without having a political union promised success in time of fine-weather conditions that prevailed until the appearance of 2007-2008 economic crisis. However, since 2007, the global financial crisis has raised questions about the validity of the majority of determinants of the neoclassical economic doctrine.

We believe that the future and destiny of the EU is inseparable from globalization dynamics (and crisis as an integral part of globalization processes) regardless of individual member state desires to preserve both economic and political sovereignty, so in this chapter we try to round up the challenges facing EU's functionality.

DECEPTION NO. 1: PARETO, SAY AND PROSPERITY

The elementary textbook from Microeconomics teaches us that when the marginal rate of substitution in consumption between goods (X) and (Y) equals the marginal rate of transformation between goods (X) and (Y), an economy reaches the state of equilibrium. At that moment, the economy enjoys the privilege of general equilibrium with both microeconomic and macroeconomic efficiencies and properties of a general equilibrium being reached: efficiency in consumption, efficiency in production, efficiency in allocation of resources with maximized both producers and consumers surplus (Salvatore, 2003). In other words, the Pareto optimum is reached: the economy is at the level of full employment and there is no deficit or surplus in the balance of payments. Consequently, when aggregate supply and aggregate demand are equalized, there is no room for inflation.

According to theory of comparative advantage (which we consider to be a component part of the neoclassical economic model) and Say', s law, two countries with common tastes and consumer preferences and with the same technology may enjoy benefits of open foreign trade. They can enlarge "common" GDP by means of international division of labor and by international specialization in production. Specialization in production in both countries reaches optimum/equilibrium when marginal rate of transformation between goods (X) and (Y) equalizes with the prices of good (X) and good (Y). At that very moment both countries enjoy full economic equilibrium. The logic of perfect competition, treating two countries as one country (or one country with two regions) and suggesting that both countries (or regions) are functioning as „connected dishes“ may enlarge the well-being of both (all) countries importing lower priced foreign goods, and therefore bringing social indifference curve to higher position in comparison with the pre-trade levels.

Under the condition of international Pareto Optimum, free foreign trade contributes for both countries (global world) with the following effects: optimal allocation of resources world-wide, optimal and enlarged consumers surplus without endangering the producers surplus (win-win situation), equalization of prices and wages in both countries (world-wide), convergence of GDP growth rates in both (all) countries engaged in foreign trade. All of these optimums are achieved together with full employment in both countries (world-wide), price stability (world-wide) and equilibrium in the balance of payments (Stojanov nad Jakovac, 2012).

If we take into account the above mentioned achievements (effects), it looks as though the neoclassical paradigm firmly suggests all countries theoretically, and transition countries even practically, not to disturb the automatic mechanism of market forces. The paradigm pleads for abstaining from all of possible sorts of social (state) intervention into the market as well as for entrepreneurial animal and rational spirit. However, since 2007, the global financial crisis has raised questions about the validity of the majority of determinants of the neoclassical economic doctrine. The "invisible hand" disappeared and the so-called visible hand of prudent and concurrently frightened state was in the town again (Stojanov, Kandzija and Mudric, 2008).

DECEPTION NO. 2: CONVERGENCE

Neoclassical and "the old view of growth assumed that where capital is scarce, it has a high return. There was a natural possibility about this: when you give a machine to a worker who previously did not have one, it has a big productivity effect. Together with the assumption of constant return to scale, and the existence of unalterable factors such as labour supply, the assumption of diminishing returns has a sharp prediction. During the transition to a new steady state, growth in capital-scarce countries will be high because of the high returns to capital. Consequently, poor countries should catch up fairly rapidly with rich countries. Growth is high when capital per worker is low and declines as capital per worker rises. Growth stops when the rate of return to capital is just equal to the discount rate" (Easterly, 1998). Similar views on growth, development and catching up process are expressed by Maddison (2001): "If the world consists only of two groups of countries (developed and developing countries), the pattern of world development could be interpreted as a clear demonstration of the possibilities for conditional convergence suggested by neoclassical growth theory. This supposes that countries with low incomes have "opportunities" of backwardness, and should be able to attain faster growth than more prosperous economies operating much nearer to the technical frontiers." However, Maddison (2001) points out a very crucial observation and fact never before mentioned, but possibly hidden in the neoclassical paradigm, about exogenously given technology and capital. Maddison concludes that "this potential can be only realized if such countries are successful in mobilizing and allocating resources efficiently, improving their human and physical capital to assimilate and adopt appropriate technology. The resurgent Asian countries were successful in seizing these opportunities. All other regions of the world (the rest of Asia, Latin America, Eastern Europe and former USSR, Africa) have not. Their relative position has deteriorated sharply since 1973."

Fisher (1987) in "Economic Growth and Economic Policy" shares Maddison', s conclusion pointing to the role of technical progress as one of the main determinates of economic growth of a country, and of a developing country in particular. "The modest long-run rates of growth of the industrial economies and lessons learned from that growth are not necessarily relevant to the LDC's. The prime reason is that those countries are far from the technological frontiers; technical progress could play a significant role in their future growth without any major technological breakthrough taking place. A quick look at the evidence is not supportive of the hypothesis. Except for Japan, most of the countries currently in the ranks of the industrial market economies have been among the high income countries for at least a century."

World-wide experience with economic growth of different developing countries lagging more and more behind the developed ones the more they apply the neoclassical economic prescription, has led Vanek (2004) to conclude the following regarding the theory of comparative advantage: "The point of departure of my paper is that the traditional theory of comparative advantage on which modern globalization is based is incorrect and not applicable to the present day conditions of world trading. Instead, I propose a theory of destructive trade which explains much better what happens in world trading today. Destructive trade leads to a world where a minority of the rich dominates a majority of the poor and what is worse, the situation tends to grow ever worse, the rich becoming relatively richer and the poor poorer. Technically, the situation is explosive."

Discussion on the convergence between LDC's and developed countries in terms of the role of free trade and the role of capital flows can hardly escape the Lucas paradox. This paradox is reflected in the fact that capital does not flow into poor countries where capital is scarce, against the neoclassical view that the return on capital accumulation should be higher where capital is rare. Lucas concludes that the neoclassical paradigm should be abandoned, while Reinhart and Rogoff conclude that the risk premium due to bad behavior is the main culprit (Cohen in Stiglitz – Serra, 2008). Cohen points out that the capital/output ration is, in general, the highest among poor countries: This can be coined as an anti-Lucas paradox. "The intuition that we offer is that poor countries, lacking other inputs such is infrastructure, use physical capital as a substitute for the scarcity of those missing inputs."

At this moment it seems useful to get an insight into the critics of the neoclassical economic paradigm and the theory of comparative advantage provided by Stiglitz and Charlton (2005), Horvat (1995), Rodrik (1999), Panic (2003), Pitelis (1998), Adelman (2001). It is not a surprise that Adelman (2001) introduced the term "KISS" ("keep it simple, stupid") in her "Fallacies in Development Theory and their Implications for Policy". She writes: "I shall argue that the discipline of economics has enshrined the "keep it simple and stupid" principle as an overarching tenet, imbibed in graduate school that can be violated only at the violator's peril. This principle demands simple explanation and universally valid propositions. It has led to three major fallacies, with significant deleterious consequences for both theory and policy: single-cause theories of underdevelopment; a single-figure-of-merit criterion for development; and the portrayal of development as a log-linear process." Historical and simultaneously challenging evidence corroborated with plenty of examples of developmental experiences of many countries throughout the history, and in favor of thesis by Adelman, Stiglitz, Horvat, Pitelis, Easterly, etc., can be found in the book by Angus Maddison (2001) titled "The World Economy".

We might conclude this part of the paper by asking the following question: how the poorer member countries of the EU can catch up with the rich ones? And, if they can't, what will the future of the EU look like?

Real-World Complication(s): Dialectic of Globalization

There are many definitions of globalization. All of them are more or less confined to the country', s integration into the international division of labor and integration of production factors in international scale. Bhagwati (2004) defined economic globalization as "the integration of national economies into the international economy through trade, foreign direct investment (FDI), short-term capital movements, international mobility of workers and aid workers in general, and international technology flows".

Anne Krueger (2000) defined economic globalization in the simplest possible manner as “a phenomenon by which economic agents in any part of the world are much more affected by events elsewhere in the world than before”. We claim that this and similar definitions of globalization are technical and superficial and do not reflect the dynamics of capital. We are most partial to our own political-economic definition, which says that globalization is a process of the privatization of world’, s economic resources done by large capital centres, which is very often virtual and hybrid and expressed through exponential expansion of derivatives which in the last two decades (according to Reuters, article posted on May 28, 2008) reached a fascinating amount of 457 trillion Euros. And, if privatization represents a political process with economic consequences, we dialectically can conclude that globalization is a process of transforming “territorial” (national) state into global corporate/market state as a new stage in the development of capitalism which precedes to post-capitalist society, as it was seen by Marx (Capital), Keynes (Economic possibilities of our grandchildren) or Hilferding (Financial capital). Observed under the conditions of contemporary globalization, the global economic crisis is a consequence of the centralization of capital on a global scale, which is now occurring under the conditions of an imperfect global market structure. Through such a process, world production relations eventually will be harmonized with the world (global) production forces.

The basic economic entities of our time are becoming transnational corporations (TNCs) as the entities which reflect globalization process. The basic microeconomic principle of their behaviour is the principle of increasing returns and diminishing costs! The transnationalization and globalization of the world economy lead to the formation of a global market whose main characteristic is imperfect competition with the prevailing oligopolistic market morphology. In an oligopolistic global market, large corporations become both “price makers” and “rule makers.” While the existing microeconomic theory helps to understand how transnational corporations do business, macroeconomic theory of the global economy is not even on the horizon. Consequently, under the conditions of globalization, small and medium developed countries can hardly have their own strategy of economic development while TNCs significantly influence the formation of macroeconomic and development policies of those countries (in the rest of the world) that are (becoming) addicted to FDI.

In addition, one might wonder whether any of the assumptions of the (virtual) neoclassical economic theory are valid in such emerging global world. If not, then neoclassicism during the time of global economy deserves to go into the dustbin of history. Again, the global economy does not have a theoretical construct as seen from the so-called macro plan. What is optimized in a global economy? Is it GDP? Who's GDP should be optimized: global GDP or GDP related to individual non-sovereign states that have deprived themselves of their resources during privatization and now have nothing to manage? What about employment? What about optimal allocation of resources at macro-level or what about general equilibrium? Stojanov and Jakovac (2013), ask the same questions even for the EU as a potential federation of member states.

CONFUSED ECONOMIC SCIENCE

Globalization provokes a number of issues related to the process of economic development and its effects on both the host country and the capital exporting country. For example, an American transnational corporation produces a product in China, while exporting capital from USA, and then imports the goods from China back to USA. From the point of the standard balance of payments statistics this transaction is clean and clear. However, from the angle of property rights (especially capital) policy and economic issues, it seems to be much vaguer on how to treat such a transaction. Does the USA import its own goods produced by its own capital and knowledge, or does it import Chinese goods? The FDI and TNCs in the global economy provoke confusion between "territorial" state and "market" state.

The balance of payments issue, at first glance, is perhaps only the first step in opening the Pandora's Box which will have to be opened and studied by the new economists. Once opened, the Pandora's Box of globalization will have a profound impact on relations between the "territorial" and "market" state as well as on the relations between virtual neoclassicism and real corporatization of the world.

Stojanov and Jakovac (2016) argue that "during the 1980s and 1990s, monetarism provided an impetus for the development of huge TNCs and financial institutions. They became the main actors in the world economy and initiated the transition process from the territorial (national) states into a global market state. Today, the institutions of global governance are inadequate and/or incapable of dealing with the globalization dynamics and the issues globalization brings to the forefront." Therefore, the present conomic science, which reflects national economic interests has to be transformed into a new macroeconomic theory which reflects the interests of transnational mega-corporations, financial and trade institutions as the new core subjects in the present stage of the development of capitalism (i.e., mega-capitalism). If not, the neoclassical economic theory (and its offspring economic schools) will become (if not already) increasingly irrelevant and even counterproductive.

A Look into the Future

The EU is a economic union but not a complete one and it certainly is not a political union. In times of fair-weather conditions the EU may function well on behalf of both its citizens and national state members. However, in bad-weather conditions (i.e., economic crisis), members of the EU might need to (and they did) resort to Keynesian type of economic policy. However, Keynesian type of economic policy might not be effective without proper management of monetary and fiscal policy. Such an effective Keynesian policy seems far from reality on the EU level. Applied nationally, such an economic policy might contribute to economic divergence between members and might dilute the efforts necessary for achievement of political union in the (near) future. On top of that, the reality of so-called mega-regions contributes to economic divergence between richer and poorer parts of EU even more.

From the current point of view, the EU looks like a classical example of an entity situated in a labyrinth of transition from the territorial state to the so-called market state. The EU is a mix of everything: Scandinavian countries with well developed welfare policies and emphasized social component, corporatist states such as Germany, France and Netherlands plus the whole bunch of new members which try to emulate free market liberalism. Taken altogether only one conclusion seems pertinent at this moment and that is that the EU is in the midst of an economic policy fog (with no Pareto optimum, no Say's law, no prosperity for everyone, no convergence between unequally developed countries, no joint fiscal policy, no joint tax policy, no joint industrial policy, no joint social policy and a lot of national interests) likewise the global economy and the whole economic science.

If nothing changes (i.e., ceteris paribus), one can say the EU is more prone towards the syndrome of balkanization[4] than to efficient political union. If nothing changes, we will (continue) to see nationalistic intrigues, economic meltdown(s) and (further) division(s). If nothing changes, the EU's founding countries will no longer have the courage to portray their union of European states as a political, economic and historical success story. If nothing changes, the union will fall apart back into its separate member states. Brexit is currently in the spotlight while several other possible „exits” (due to rising euroscepticism) are around the corner: Czexit (Czech Republic), Nexit (Netherlands), Frexit (France) together with rising nationalism in Poland (Jaroslaw Kaczynski) and Hungary (Viktor Orban). Also with Putin, Erdogan and Trump at the gates, it doesn't get any easier for the EU. If nothing changes, especially nowadays regardig the refugee problem, the end result is/will be an erosion of

[4] Balkanization has unfortunately become a global term with negative connotations such as political instability, insecurity and fragmentation, isolation and ghettoization. The term came into common use in the immediate aftermath of the First World War and refers to the division of the Balkan peninsula into a number of smaller states that arose from the collapse of the Austro-Hungarian Empire and the Ottoman Empire. It is a geopolitical term used to describe division of a multinational state into smaller ethnically homogeneous entities. The term also is used to refer to ethnic conflict within multiethnic states.

solidarity within the EU.[5] If nothing changes, the EU, in its current form, will perish.

Therefore, the EU politicians face a great problem of how to reconcile: a) different interests between nations which need an efficient economic and developmental policy, and b) big (multi/transnational) companies having their own profit making motive and demanding stateless economic space. These are direct challenges for the EU's functionality, its internal cohesion and the ability of institutions to resist external shocks and harmonize flows on the common market.

ACKNOWLEDGMENTS

We are very grateful for the critical remarks made by the reviewer that have significantly improved the depth of theoretical analysis of this chapter. We are especially grateful for the everlasting encouragement and comments of distinguished professor Dragoljub Stojanov who retired in 2016. We thank him for sharing his concepts, ideas, materials, unpublished and draft papers as well as for his support to pursue investigating topics similar to the one presented in these chapters. The usual disclaimer applies and the views expressed in this chapter are the sole responsibility of the authors.

This chapter (research) is a part of the scientific project entitled Investments in Research and Development and Competitiveness of the Republic of Croatia and the Western Balkan Countries financed by University of Rijeka - Faculty of Economics and Business.

[5] The Dublin Regulation (Regulation No. 604/2013), which states that refugees must remain in the country where they first set foot on EU soil, primarily protects Germany and the rich countries in the north and puts huge pressure on the Mediterranean countries instead. (Re)introducing border checks (i.e., Belgium, France, Austria, Denmark, Norway and Sweden and setting up razor wire fences (i.e., Hungary, Slovenia), invokes ghosts of the past (i.e., Iron Curtain).

REFERENCES

Adelman, I., (2001). Fallacies in Development Theory and Their Implications for Policy, in: *Frontiers of Development Economics*, ed. Meier, G., Stiglitz, J., The World Bank & Oxford University Press, Washington D.C. & Oxford.

Bhagwati, J. (2004). *In Defense of Globalization*. Oxford: Oxford University Press.

Easterly, W. (1998). Economic Policies, Economic Shock and Economic Growth, in: *New Theories in Growth and Development*, ed. Coricelli, F., di Matteo, M., Hahn, F., Macmillan Press.

Fisher, S. (1987). Economic Growth and Economic Policy, in: *Growth Oriented Adjustment Programs*, ed. Corbo, V., Goldstein, M., Khan, M., IMF, Washington.

Horvat, B. (1995). *Theory of International Trade*. Macmillan Press.

Krueger, A. (2000). Conflicting Demands on the International Monetary Fund. *American Economic Review*, 90(2) 38-42.

Maddison, A. (2001). *The World Economy*. OECD.

Panic, M. (2003). *Globalization and National Economic Welfare*. Palgrave.

Pitelis, C. (1998). Productivity, Competitiveness and convergence in the European Economy: Supply-side Considerations. *Contributions to Political Economy*, 17(1) 1-20.

Reuters. (2008). *More derivatives trading platforms likely*. http://www.reuters.com./article/2008/05/28/markets-derivatives-idUSL2831477720080528.

Rodrik, D. (1999). *The New Global Economy and Developing Countries: Making Openness Work*. ODC, Washington, D.C.

Salvatore, D. (2003). *Microeconomics: Theory and Application*. Oxford: Oxford University Press.

Stiglitz, J., Charlton, A. (2005). *Fair Trade for All: How Trade Can Promote Development*. Oxford: Oxford University Press.

Stiglitz, J., Serra, N. (2008). *The Washington Consensus Reconsidered*. Oxford: Oxford University Press.

Stojanov, D., Kandzija, V., Mudric, S. (2008). *Pareto, Institutional Setting and Bosnia and Herzegovina Transition Failure*, paper presented at the 10th bi-annual EACES conference held at Higher School of Economics in Moscow, August 28-30, 2008.

Stojanov, D., Jakovac, P. (2012). Quo Vadis Economics? The End of the Epoch of Neoclassical Economic Paradigm? *Economics and Finance Review*, 6(2) 22-30.

Stojanov, D., Jakovac, P. (2013). Economics science in the trap of globalization [Ekonomska znanost u zamci globalizacije]. *Economic Review/Ekonomski pregled*, 64(5) 447-473.

Stojanov, D. (2015). The scope, challenges and perspective of Croatian development policy in the context of the EU destiny. *Ekonomija/ Economics*, 22(1) 78-88.

Stojanov, D., Jakovac, P. (2016). Dialectics of globalization and the future of capitalism, in: *Globalization: economic, political and social issues*, ed. Gonzales, B., Nova Science Publishers, New York.

The Economist (2011). *The future of the EU: Two-speed Europe, or two Europes?*, https://www.economist.com/charlemagne/2011/11/10/two-speed-europe-or-two-europes.

Vanek, J. (2004). *Globalization, Destructive Trade and Remedies Through Cooperation*, paper presented at the 11th conference of the international association for the economics of participation (IAFEP) held at Catholic University of Brussels, July 4-6, 2002.

https://eur-lex.europa.eu/summary/glossary/multispeed_europe.html.

Reviewed by Mario Pecaric, Faculty of Economics, Business and Tourism, University of Split, Split, Croatia.

CONTENTS OF EARLIER VOLUMES

Progress in Economics Research. Volume 43

Progress in Economics Research. Volume 42

Progress in Economics Research. Volume 41

Progress in Economics Research. Volume 40

Progress in Economics Research. Volume 39

Progress in Economics Research. Volume 38

INDEX

D

E

F

L

M

N

O

P

T

U

V

W