The Economic Potential of a Larger Europe

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Preface

Klaus Liebscher, Josef Christl, Peter Mooslechner and Doris Ritzberger-Grünwald

2004 saw the completion of the fifth EU enlargement since 1972 as eight Central and Eastern European countries and two Mediterranean islands became members of the European Union (EU). This was an unprecedented event in EU history, both with respect to the number of countries and the number of citizens newly integrated into the EU at one go. Enormous, ongoing political and institutional efforts have paved the way for this development that was all but inconceivable 15 years ago.

Mirroring this process, a wide range of economic questions have emerged. Some are fundamental ones, mainly related with the transition process as such. Others have a clear link to the macroeconomic policy framework set up by the old EU member states. Several questions have been solved in the meantime; privatization, for instance, is no longer a major issue. But at the same time new challenges have appeared on the horizon, reflecting different adjustment speeds across sectors, a lack of macroeconomic policy coordination or newly arising conflicts of interest.

Right from the beginning of the transformation process, the Oesterreichische Nationalbank (OeNB) has closely followed issues on Central and Eastern Europe that were perceived as important from a central banker's view. Austria's historical links and its geographical situation may have been the first incentives to do this. Nowadays economic considerations prevail, as trade relations, foreign direct investment (FDI) patterns, and developments in financial markets, especially the banking sector, clearly signal that Austrian firms were quick to take advantage of this opportunity to expand into neighbouring countries. As a result, Austrian companies now hold above-average market shares, which makes it necessary from an analytical, and advisable from a supervisory point of view to keep following developments in this region closely.

This book contains contributions made to the East–West Conference that the OeNB organized together with the Joint Vienna Institute (JVI) in November 2003. The conference focused on several topics of proven relevance for a successful transition process. High-ranking representatives from international institutions and well-known academics shared their views and contributed their expertise in these areas.

To single out a few topics, a discussion of human capital and capacity building challenges highlights the labour market issues involved. In this area the gap between the supply and demand of well-trained people has narrowed only slowly, even when elder generations are excluded from the sample. Hand in hand with the ongoing up-grading of the labour force nominal wages are catching up, making the task of keeping wage increases in line with productivity even more difficult. However, compared with the levels prevailing in the old EU member states, unit labour costs will remain much lower for quite a while, so that these countries will hold their position in the international division of labour and still attract FDI in the foreseeable future. Interestingly, FDI is not spread evenly across Central and Eastern European countries and, vice versa, not all Western industrialized countries have become engaged in the region. Instead one can find a clustering behaviour of different sectors and industries. Moreover, FDI flows have declined recently, indicating that the big-ticket investments have been made and that the big companies are passing on the baton to smaller and medium-sized companies. From a macroeconomic viewpoint this increases ongoing worries about the existing current account deficits.

A discussion of fiscal policy issues underlines the necessity of coordinating macroeconomic policies at a national level. Recent experiences have impressively shown how broken public sector commitments can disturb market expectations and result in capital outflows and speculative behaviour. It has to be kept in mind that while offering opportunities, newly liberalized capital markets also create risks if accompanied by unsound and incredible macroeconomic policies. Yet, overall, there is firm evidence that financial markets in Central and Eastern Europe have performed well. The Austrian banking sector, which has become a major player in many of these countries, has contributed to this development, and Austrian banks generate a significant share of their earnings in this region. Given that the variety of financial products is still limited in the acceding countries, these markets offer a lot of potential. At the same time, the lack of liquidity, which reflects the smallness of these countries, is difficult to overcome.

Monetary integration is perhaps the most interesting part of the ongoing transition process. This statement reflects not only a biased central banker's view. The adoption of the euro has also become a major issue in the current political debate in many Central and Eastern European countries. Without any doubt, by adopting a common currency, a country gives up one of its strongest policy tools, thus limiting future possibilities to adjust competitiveness. The success of this undertaking will depend on responsible decision-making and a thorough process of economic analysis. To answer the related questions about how to optimally time Exchange Rate Mechanism (ERM) II entry and which exchange rate may be adequate is not an easy task. Given that the newly acceded countries are still on a catching up route and that those decisions are hence embedded in an even more complex target function, they can hardly be compared with the challenges created by the first round of monetary integration.

Yet the debate about the euro is not limited to such economic issues because first, the relation between a nation and its currency tends to be an emotional one, widely used in the electoral process, and second the euro appears to be a symbol for successful integration. As the economic facts and analyses call for caution, the countries should carefully weigh the pros and cons of taking this final step. At any rate they would be well advised to wait until it became clear that EU enlargement did not cause a major external shock.

To sum it up, this book tries to give insights into past, current and coming issues related with the EU enlargement process. Joining the European Union is only one of several goals, many of which have been reached but some of which are yet to be met. Nevertheless, the process of catching up has not yet been completed and issues of convergence, driven by different base lines, deviating cyclical positions or asymmetric shocks, will continue to appear on the European agenda.

Executive summary

Stephan Barisitz

The East–West Conference 2003, hosted by the Oesterreichische Nationalbank (OeNB) and the Joint Vienna Institute (JVI), took place from 2–4 November and covered the topic 'The Economic Potential of a Larger Europe – Keys to Success'. Recalling conference topics of previous years in his introductory remarks to the 2003 event, OeNB Governor Klaus Liebscher pointed out how, mirroring the evolution of the transformation process, the conference focus had shifted over time from purely transition-related issues to a more global perspective and a more horizontal approach: to investigating issues such as human capital formation and capacity building, financial stability, a suitable policy mix or structural reform needs.

The eve of EU enlargement being an opportune time to revisit, those were the very issues that the East–West Conference 2003 was designed to re-address. Consequently, accounts of capacity building initiatives, assessments of financial market and trade integration, and evaluations of policies for an enlarged EU – in particular of structural policies for an enlarged euro area – are also the key topics of this book. The contributors to this book look at these issues from two complementary perspectives. Some investigate the importance of these factors for the success of the past integration process within the EU as well as for the ongoing transition process in EU accession countries. Others take a forward-oriented approach and address the challenges of a wider and deeper Europe, in particular with a view to monetary integration and the challenges on the road to the euro.

Part I goes straight into a central issue, the strengthening of the European economy and of European integration. IMF Managing Director Horst Köhler discusses the challenges for turning a larger Europe also into a stronger Europe. He emphasizes the need for structural reforms to tackle labour market problems in Western Europe, and to correct fiscal imbalances, underdeveloped financial sectors, institutional and legal frameworks in the Central European and the Baltic countries – to ensure that this region can continue to be a focus of investment and job creation in Europe. At the same time, it will be important for Europe to embrace the opportunities of globalization while maintaining its own identity, and to continue to foster the process of integration. Cross-border issues, such as the enforcement of international standards and codes, may increasingly feature among the activities of the IMF in a larger Europe.

Charles Wyplosz, Professor at the Graduate Institute of International Studies, Geneva, deals with 'The challenges of a wider and deeper Europe'. Two broad sets of issues are addressed. First, the question is raised whether we need further deepening of the European Union. The provision of economic and non-economic public goods can be either centralized (thus implying further deepening) or decentralized. The theory of fiscal federalism is applied to compare the potential benefits of centralized and decentralized solutions. The analysis demonstrates that the process of centralization is nearly complete for a majority of economic public goods (such as trade liberalization and the common currency). The remaining areas are characterized by questionable benefits and/or potentially high costs of centralization (for example research, financial market supervision, taxes and public spending, labour market institutions). By contrast, the process of centralization of non-economic public goods (for example internal and external security, foreign policy and justice) has just started. On the one hand, these areas are characterized by strong national preferences, implying high costs of centralization. On the other hand, the process of economic integration may justify a certain degree of coordination, but a reform of EU institutions may be necessary to ensure adequate political authority and accountability. Another issue is whether the eastward enlargement of the EU could run counter to further deepening in selected areas. Little evidence for this hypothesis is found and the necessity to reform decision-making procedures in a wider EU is stressed.

Key issues for capacity building are the subject of Part II. European Bank for Reconstruction and Development (EBRD) President Jean Lemierre in his contribution stresses that the process of transition has not yet been concluded. Looking ahead, the first priority is to reform the banking sector to improve its capacity to sufficiently finance the real economy. Second, to be competitive, it is crucial to invest in infrastructure and education. However, to pave the way for these improvements and to attract investors, the judiciary systems need to be adjusted. Relationships with neighbouring countries beyond EU borders should be tightened, and the concept of a 'Wider Europe' is worthy of strong support. Challenges ahead include the relationship between Russia and the EU and the European integration of the South-East of the continent.

World Trade Organization (WTO) Deputy Director-General Kipkorir Aly Azad Rana elaborates on the fruitful cooperation between the WTO and the JVI, and underlines that the World Trade Organization's new approach to building strategic relations and capacity can best be achieved through training centres and regional centres of excellence. The WTO very much appreciates that, almost without exception, the Central and Eastern European countries have expressed their interest in full WTO membership. Effective integration into the European Union and the world economy as a whole will require further reductions in trade barriers, the elimination of inefficient policies, stable and sound macroeconomic conditions, fiscal and monetary policies, and coherence in policy making.

Part III deals with human capital and capacity building, experiences and lessons for the future. In his contribution, Valeriy Pyatnytskiy, Ukrainian First Deputy Minister of Economy and European Integration, graduate of the JVI's Comprehensive Course, provides first-hand information on his JVI experience. He also focuses on recent developments in his country: Ukraine's key priority now is accession to the WTO, which can be seen as a powerful incentive for further economic reform. Josef Tošovský shares his experience as both a recipient of technical assistance which he organized for his staff in his former position as Governor of Česká národní banka, and as a provider of technical cooperation in his current function as Chairman of the BIS Financial Stability Institute, whose principal aim is to upgrade knowledge in financial market regulation and supervision.

Frannie Léautier, Vice President of the World Bank Institute, deals with the questions of how the World Bank has responded to the capacity-building challenge and of how to scale up measures for capacity enhancement in order to achieve sustained, measurable results. Saleh Nsouli, Deputy Director of the IMF Institute, takes stock of the activities of the International Monetary Fund (IMF) and the JVI, focusing in particular on why institutions are important, how needs have evolved, what the IMF's unique model of capacity building is and how the JVI has contributed to institution building. Last but not least, Raymond Torres, Head of the Employment Analysis and Policy Division at the OECD Directorate for Employment, Labour and Social Affairs, discusses the importance of human capital investment in today's economies. Adequate policies are needed not just to ensure initial education, but also to create an environment conducive to lifelong learning.

The role of FDI and trade integration in the catching-up process is analysed in Part IV. Alena Zemplinerová, Senior Researcher at the CERGE-EI and the Charles University, Prague, focuses on the importance of foreign-owned companies in the catching-up process. She shows that in the case of the Czech Republic, FDI has proven to be welfare enhancing. Many indicators point to a higher productivity of foreign-owned enterprises compared to domestic firms. The long-run commitment of a strategic investor and the competitive environment of the economy prove to be key factors for success; investment incentives by the government also play a role, but are often overrated. Jarko Fidrmuc, Economist in the Foreign Research Division of the OeNB, and Martin Djablik, Comenius University in Bratislava, analyse the importance of FDI for intra-industry trade between the EU and the acceding countries. The redirection of trade from former Central and Eastern European markets to EU countries was accompanied by an improvement in the commodity trade structures, thereby increasing the welfare gains of integration for consumers. FDI plays an important role in improving the trade structures of these countries. Slovenia and Hungary seem to be the most integrated acceding countries in this respect.

Boris Vujčić, Deputy Governor of Hrvatska narodna banka (Croatian National Bank), and Vedran Šošić, Economist in the Research Department of the Croatian National Bank, elaborate on trade integration in South-East Europe and the trade potential of Croatia. Apart from Croatia, they focus on Albania, Bosnia and Herzegovina, Macedonia and Serbia and Montenegro – most of which are successor countries to the former Socialist Yugoslavia. They arrive at the interesting finding that despite past tensions and conflicts, Croatian trade with the above-mentioned group of countries has greatly exceeded its potential according to all estimates. One of the major reasons appears to be that all these countries used to be 'trade isolated', being neither candidates for EU accession nor Central European Free Trade Agreement (CEFTA) members in the 1990s. Their exclusion from trade integration with the rest of the world thus had substantial repercussions. Once trade liberalization with the rest of the world was launched, the trade bias started to fade.

Part V focuses on the road to monetary union in Europe. In his contribution 'The accession economies' rocky road to the euro', Professor Barry Eichengreen (University of California, Berkeley) sets out to analyse the major challenges acceding countries face during the run-up to euro adoption. Alternative exchange rate regimes are discussed, such as currency boards, unilateral euroization, free floating and fixed exchange rate regimes. With a currency board pegged to the euro, monetary policy is virtually identical to what it would be after euro adoption. Free floating is hardly possible because floating would probably mean heavily managed floating, which limits monetary policy to a large extent. As to narrow band regimes, theory teaches that they stabilize the exchange rate only in the presence of perfect credibility. But in practice, because of possible capital flow reversals, such regimes are prone to crisis, as the collapse of ERM in 1992–93 demonstrated. Against this background, Barry Eichengreen advocates early euro adoption. Therefore, whether or not acceding countries could adopt the euro should be judged on inflation and fiscal policy, without considering a narrow ERM II band as proposed by EU Economic Commissioner Solbes early in 2003. In this context, the real challenge for some of the acceding countries is indeed fiscal adjustment. The Czech Republic, Hungary, Poland and Slovakia, dubbed the 'big four', have recorded large budget deficits in the past and are expected to do so in 2003. By contrast, the Baltic States and Slovenia have balanced fiscal policies. The 'big four' are running large welfare systems, which are difficult to reform, and fiscal control may be more complicated in bigger countries. More generally, successful fiscal consolidation should come through expenditure reduction and not tax increases because even painful budgetary cuts could turn out to be expansionary by giving a fillip to long-term economic growth.

A concise panel discussion among high-ranking representatives of the central banks of the ten acceding countries deals with ERM II – the next steps to be taken. In his prologue to the discussion Peter Mooslechner, Director of the Economic Analysis and Research Section of the Oesterreichische Nationalbank, focuses on ERM II as a milestone on the road to the euro. To make the way into the euro a successful one, the new member states need to make substantial adjustments to their economic policies: the challenges range from macroeconomic imbalances to questions like overall competitiveness and monetary stability. On the way it seems to be very likely that some flexibility or adjustment of exchange rates might still be needed. At the same time, unjustified volatility of exchange rates should be avoided as much as possible and the existing European economic policy framework, including ERM II, can and should be used as a tool in this respect.

The account of the panel discussion, compiled by Zoltan Walko, Economist at the OeNB's Foreign Research Division, witnesses partly sceptical positions of acceding countries' central bankers toward ERM II. The Deputy Governor of the Estonian central bank, Märten Ross, stresses the advantages of ERM II, which he primarily pinpoints as greater credibility as compared to unilateral exchange rate pegs. The Deputy Governor of the Hungarian central bank, György Szapáry, regards participation in ERM II as positive, too. He principally agrees with using the narrow bands as an orientation point in the assessment of exchange rate stability, but at the same time advocates some degree of flexibility in the interpretation. More critical tones come from Adam Czyżewski, Director of the Macroeconomic and Structural Analysis Department of Narodowy Bank Polski, and Oldřich Dědek, Vice Governor of the Czech monetary authority. Both highlight the success they have achieved by their policies of direct inflation targeting during the past few years and express concern that participation in ERM II could constrain the manoeuvring room for such policies. Therefore they intend to limit the duration of participation in the mechanism to the necessary minimum of two years. Correspondingly, entry into ERM II should take place only when it can be realistically expected that the other Maastricht criteria can be fulfilled within two years.

On the question of whether to adapt the current exchange rate regimes before or upon entry into ERM II, Ramune Vilija Zabuliene, Deputy Chairperson of the Board of Lietuvos Bankas, does not see the need for significant action, apart from an agreement on the central rate. Lithuania intends to maintain the narrow fluctuation bands within ERM II as a unilateral obligation. George Thoma, Senior Manager and Head of the Economic Research and Statistics Division of the Central Bank of Cyprus, stresses that Cyprus has been operating an exchange rate regime which has shadowed ERM II for several years without significant tension. Therefore, he also regards an agreement on the central rate as the only necessity. The Governor of Banka Slovenije, Mitja Gaspari, underlines that the expected decline in Slovenian inflation in 2004 should allow further interest rate adjustments. Thus, the current policy of step-by-step depreciation of the currency can be abolished before ERM II entry. Malta will also have to change its regime and replace the present currency basket with the euro as an anchor, as the Governor of the Central Bank of Malta, Michael Bonello, explains. None of the participants perceives any important risk in connection with adjustments in exchange rate regimes that may be necessary.

Given the limited role of interest rate policy within the framework of ERM II, all central bank representatives agree upon the necessity of price stability-oriented exchange rate, fiscal and wage policies. Moreover, the importance of structural reforms and of increased labour market efficiency to fight inflation is underlined. The representatives emphasize that necessary reforms to eliminate economic imbalances should be pursued as soon as possible. This should guarantee that participation in ERM II is smooth and that it is not endangered by asymmetric shocks. Views are mixed as to whether ERM II would work as a 'discipline multiplier': while György Szapáry regards ERM II as an instrument to foster discipline, Oldřich Dědek is rather sceptical and questions the ability of such an external factor to replace the lack of fiscal discipline. Finally, the central bank representatives see little evidence for potential risks of asymmetric shocks upon and after EU entry. EU accession has been planned for quite a long period and is very much anticipated by all economic agents. Still, the rather large necessary fiscal consolidation measures may lead to asymmetric shocks in some countries because of their short-term negative effects on GDP growth. Although the representatives see their currencies as shock absorbers, they do not object to giving up their currencies (in a medium-term perspective).

Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB and former Vice Governor of the Oesterreichische Nationalbank, in her chapter 'On the threshold of the 2004 EU enlargement' explains the key elements that will guide the ECB approach in the area of prospective monetary integration. First, the basic interest of the euro area is to ensure that monetary integration will be a smooth process in line with Treaty (the Treaty establishing the European Community) provisions. Second, there is no single path to the euro that would suit all acceding countries, and the ECB does not discourage any particular strategy, provided that it conforms with the institutional set-up in place. Third, new member states will have to fulfil the convergence criteria in a sustainable manner to qualify for full participation in EMU, whereby the equal treatment principle will continue to govern the application of the criteria. Monetary integration would be facilitated by a successful EU accession process that should reduce the growth differential between the new member countries and the euro area. The cumulative long-term effects of enlargement should be moderately positive for current member countries and significantly positive for the new member countries, due to the full integration into the Internal Market, the decrease in the risk premia and the net transfers from the EU budget. However, the total size of these growth effects and even more so their dynamic profile are quite unclear.

Corporate governance, financial markets and the optimal role of the state constitute the focus of Part VI. In his remarks on good governance and sound finances Josef Christl, Member of the Governing Board of the Oesterreichische Nationalbank, emphasizes the strong economic ties that have been established between the euro area and the acceding countries. Austrian companies, in particular Austrian banks, have made use of the business opportunities which have opened up in the transition process. They have not only benefited from the emergence of new markets but have, in return, also contributed to the economic changes in Central and Eastern Europe. The importance of the Stability and Growth Pact and of complying with fiscal policy rules is highlighted. Abolishing agreed-on rules could not only destabilize expectations of economic agents but also result in a severe loss of credibility. The provisions of the Stability and Growth Pact and the Maastricht Treaty will likely constitute an important challenge for Central and Eastern European countries to master in the years to come.

Khaled Sherif, Sector Manager for Finance and Private Sector Development for Europe and Central Asia of the World Bank, shares his views on the costs and fiscal impact of state-owned banks. The experiences with state banks are reviewed, the problems that exist today are described, and the main findings highlighted: first, continued state ownership of the banking sector entails high economic costs; second, delaying banking sector reform and privatization only adds to the costs; and third, most remaining state-owned banks should be treated as resolution cases, that is, if they carry large burdens of non-performing assets, they should be wound up.

Stephan Barisitz, Economist at the Foreign Research Division of the OeNB, gives a country study presentation on 'The Romanian banking sector: progress, problems and prospects'. Many features of Romanian banking are comparable to those of Croatian banking: the sector is small with a low level of financial intermediation, and foreign-owned credit institutions play a large role. Despite tangible reform progress, the Romanian financial sector also faces many challenges, such as banks' insufficient risk analysis and management capacities, a partial currency mismatch between deposits and credits, weak corporate governance, continuing limited contract enforcement and corruption.

Part VII is devoted to the issue of stabilizing expectations – macroeconomic and structural policies in an enlarged euro area. Fabrizio Coricelli, Professor at the University of Siena, contributes a chapter entitled 'Fiscal discipline and the adoption of the euro for new members of the European Union'. The chapter points out several issues that question the efficiency of existing fiscal rules in the European Union in the light of the upcoming enlargement, such as the fact that existing rules have the property of reinforcing a procyclical stance during bad times and that they provide little incentive for surpluses during good times. One implication of the chapter is that it is of great importance that fiscal discipline be strengthened in accession countries but also that new fiscal rules are needed for such countries since they usually display much higher volatility of economic activity, making it much harder to comply with the 3 per cent deficit ceiling.

'Fiscal convergence before entering EMU' is Luca Onorante's contribution. The economist at the European Central Bank (ECB) applies a game-theoretical approach to investigate the interaction of monetary, fiscal and wage policies and their effects on prices in a monetary union hit by economic shocks. A model is developed which focuses on wage dynamics, fiscal and monetary activism and their consequences for inflation and which highlights some relevant problems central to the current policy debate. The chapter concludes that the beginning of EMU is a structural break that needs to be modelled explicitly and that fiscal rules may help in the process of convergence but are more optimal after EMU entry than before.

Gabriel Moser and Wolfgang Pointer, both Economists at the Foreign Research Division of the OeNB, and Johann Scharler, Economist at the Economic Analysis Division of the OeNB, analyse the issue 'International risk sharing in Europe: has anything changed?' The subject of the chapter is a test of whether the process of European integration has increased the extent of risk sharing among European countries, which is equivalent to asking how integrated European financial markets are. This is an important question, since as long as international financial markets provide insurance against regional shocks, asymmetric shocks might not be so problematic. The results imply that risk sharing does not appear to have improved among European countries. Moreover, a few countries even feature indicators of declining risk sharing over time.

Part VIII, finally, is devoted to an issue transcending economics: Economic and Monetary Union – a leading indicator for political union? Johan Verhaeven, Head of Unit, Transition Issues Related to EMU, European Commission, focuses on 'European integration and *finalité politique*'. He points out that in certain policy areas (trade, agriculture, monetary policy, exchange rate), the EU already embodies a kind of political union. The EU comprises quasi-federal elements (Parliament, Commission, primacy of European law over national law) and inter-governmental components (Council, small size of the budget). The fact that EU integration embodies a mostly functional step-by-step process and that there is no clear *finalité politique* yet may constitute the basis for its success so far. What is the way forward? With more and more member states, enhanced cooperation through variable geometry may reconcile problems.

Gerda Falkner, Head of the Department of Political Science of the Institute for Advanced Studies, Vienna, demonstrates in her contribution 'The European Union and social policy' that in some fields, like social policy, there can be slow but steady processes that at least partly move decision-making from the country level to the EU level. On the other hand, actual compliance with EU directives is often problematic. Fritz Breuss, Professor at the Vienna University of Economics and Business Administration, is sceptical about some economic aspects of further integration. In his opinion, the Stability and Growth Pact has not 'passed the test', given the delaying of decisions. The economic integration of a bloc of poor countries with a bloc of rich countries could lead to setbacks on interest rate policy and the goal of a European business cycle.

EU enlargement in 2004 – a time to revisit transition challenges

Klaus Liebscher

The OeNB's East–West Conference 2003, on which this book is based, looks back at an impressive history. The first OeNB seminar focusing explicitly on the transition economies in Central and Eastern Europe took place in October 1989, not long after the opening of the iron curtain. Since 1995 the conference has been an established annual event, serving as an international forum in which leading experts from government and international organizations, central and commercial banks as well as universities and research institutes discuss questions related to the transition process and to EU enlargement.

Previous conferences dealt with all the major topics relevant for European integration and enlargement: the restructuring of the banking system, financial crises, the convergence progress, regulatory aspects of transition and other structural challenges, the quest for an adequate policy mix and the challenges of transition in general. The range of topics is, however, not just impressive because of its broad coverage, it also reflects the evolution of the transformation process. Some of the earlier conference topics, as for example the regulatory aspects of transition or issues related to institution building, have lost importance over recent years, given the successful completion of the major transition steps in these areas.

At the same time, we have also seen the focus shift from purely transition-related topics toward a more global perspective and a more horizontal approach to specific topics. The most recent conferences proved especially rewarding owing to the exchange of views and research cooperation among experts from transition and industrialized countries.

On several occasions, the Oesterreichische Nationalbank co-organized the conference with other institutions, such as the IMF, the Institute of International Economics, the Banca d'Italia or The Vienna Institute for International Economic Studies. The conference of 2003 (like that of 2000) was co-hosted by the Joint Vienna Institute (JVI), the Vienna-based provider of training in transition issues for central bankers, government officials and private sector representatives from countries in Central and Eastern Europe and from former republics of the Soviet Union.

The JVI, launched in 1992 by five international organizations and the Austrian authorities to respond rapidly to the large demand from economies in transition for training in market economics and the free enterprise system, and the OeNB look back at a long history of cooperation. The Austrian authorities have recently provided the JVI with a new building that meets the technology and accommodation requirements of a modern training facility. This new location, which has been in use since May 2003, will guarantee continuity in training for the years to come. We are especially pleased that we had the opportunity to combine the official opening with the 2003 East–West Conference.

About 15 years after the first seminar in the spirit of the East–West Conference, we stand at a point where the most important step of EU enlargement, one major focus of the conference series, is only a few months ahead. In May 2004, ten countries will join the European Union. This enlargement round is not only the most important one to date in terms of scale, diversity and economic growth potential, but also – as Commissioner Verheugen once put it – the best prepared in the history of the European Union.

The challenges facing Europe in the coming years and decades are manifold, complex and exciting. It is these challenges, tasks and prospects that the East–West Conference series is designed to address. We are convinced that the conference has played a significant role in providing a forum for discussion among experts and politicians from Western Europe and the current and future acceding countries, especially in times when the enlargement project that we are facing now still sounded like an overly visionary project.

With the most important wave of enlargement about to become reality, I believe that this is the opportune time to revisit. Consequently, the topic of the 2003 conference 'The Economic Potential of a Larger Europe – Keys to Success' was meant to cover the most important topics of previous East–West Conferences, including issues such as human capital formation, financial stability, the specification of a suitable policy mix or structural reforms – topics that are key to a successful transition process and therefore also to the provision of a prosperous growth environment within a larger Europe.

On the eve of the upcoming EU enlargement, we looked at these increasingly relevant topics from two perspectives. On the one hand, we investigated the importance of the before-mentioned factors for the success of the past integration process within the European Union as well as for the ongoing transition process in the current group of acceding countries. On the other hand, we also took a forward-oriented approach and addressed the challenges ahead. In this respect, not only did we focus on the South-Eastern European countries that are already on the accession track, but also debated the role the European Union and the Eurosystem can play in fostering the cooperation with and in promoting reforms in the countries as summarized under the 'Wider Europe' strategy of the European Commission – Russia, the Ukraine, Moldavia, Belarus and the Southern Mediterranean region.

While the formal enlargement of the European Union is scheduled for May 2004, an 'enlarged Europe' has already become reality for all of us in many respects. Preparations for the final step have been progressing steadily and I can imagine that many representatives from the acceding countries feel as if they were part of the European Union already. To mention just one example: delegates from the acceding countries have observer status in all European System of Central Banks (ESCB) and EU committees and thus closely follow the discussions about the future challenges of economic and monetary policy.

We appreciate the medium-term prospect of a number of new members joining the euro area. Of course, they will have to fulfil the same conditions for EMU accession as earlier members did, which are: European Union membership, participation in ERM II for at least two years without severe tensions and sustainable compliance with the Maastricht criteria. These are sensible and sound milestones on the route to full monetary integration.

As to the single monetary policy, sticking to the primary objective of maintaining price stability remains a key factor for the credibility of both EMU and the euro. By maintaining price stability, monetary policy makers optimally contribute to enhancing the long-term prospects for economic growth and thus also employment in the euro area. Even though the short-term nominal interest rates are at the lowest level in 50 years, inflationary expectations are in line with our definition of price stability. At this juncture, it may, however, be particularly warranted to stress that monetary policy cannot by itself generate lasting and sustainable growth and employment in the euro area. To stimulate the economy and employment, economic policy makers are called upon to devise adequate structural measures that tackle the fundamental weaknesses and set off pressing adjustments.

Whereas EMU entails a common monetary policy for all of its members, fiscal policy continues to be formulated and executed at the national level. Fiscal policy must be part of a comprehensive and growth-oriented strategy that focuses on improving the structure of public expenditures. Besides, we must continue to credibly meet the provisions of the Stability and Growth Pact, which is crucial for the smooth functioning of EMU. Let me emphasize that in a monetary union we need fiscal policy rules to prevent one country's unsound fiscal policy from negatively impacting on other members of the monetary union. What is more, our complying with the Stability and Growth Pact not only favours other countries but also future generations, which is particularly important in those countries where population ageing is a significant phenomenon. Against the grain of some critics of the Stability and Growth Pact, I am strongly convinced that the Pact is sufficiently flexible to support budgetary discipline also in economically difficult times. Without the Stability and Growth Pact, EMU would – in my opinion – suffer from a 'design flaw'.

Let me conclude with expressing my conviction that the enlargement of the European Union and the economic and monetary integration of the acceding countries will not only strengthen the role of the European Union as a global player in the long term, but also make a sustainable contribution to stability, peace and welfare in Europe.

PART I

Reconciling policies for Europe

1. Toward a stronger Europe in the global economy

Horst Köhler[1]

1. THE GLOBAL ECONOMY

The global economic outlook is improving. Led by the United States, prospects for a recovery are firming in the advanced economies. This is good news for emerging market and developing country economies as well, which have also benefited from a supportive financial market environment. But we know that risks remain. Chief among these risks is the excessive dependence of the world economy on growth in the United States and the resulting global current account imbalances. Resolving these imbalances in an orderly manner must be the primary objective of international economic policy. And this requires a cooperative approach involving all major countries and regions:

- In the United States, significant monetary and fiscal stimulus is in the pipeline. But while fiscal policy has provided short-term support to the economy, going forward it will be critical to restore medium-term fiscal balance.
- In the euro area, indications of an economic recovery are still more tentative. But there are increasing signs of returning confidence and it is encouraging that several euro area economies have initiated long-overdue structural reforms, buoying expectations.
- In Japan, recent data point to a much hoped-for firming of the short-term economic outlook. And structural reforms in the corporate and financial sectors must continue to be pursued vigorously to raise longer-term growth prospects.
- In emerging market economies, sound economic policies and structural reforms are bearing fruit in several countries. But vulnerabilities bear watching, particularly as a result of persistent high levels of public debt. Current favourable financing conditions must be seized as an opportunity to reduce these vulnerabilities. And where reserve accumulation has been rapid and current account surpluses large,

allowing greater exchange rate flexibility would be helpful, both domestically and globally.

2. POLICY PRIORITIES FOR A LARGER AND STRONGER EUROPE

Against this global background, what should the policy priorities for Europe be? On the threshold of the enlargement of the EU, the destinies of all the European economies are becoming ever more intertwined. I am confident that enlargement will bring significant benefits for old and new members alike, not least through the expansion of the internal market. Moreover, for the accession countries, closer political and economic integration within Europe offers new sources of capital and technology. And for the existing EU, the new members will bring fresh perspectives and provide welcome impetus to competition. But while convergence and the dynamism of its new young market economies will boost economic performance in the accession countries for some time to come, the medium-term challenge that all European countries face is the same: how to remain competitive in the global economy, how to continue to improve the standard of living for their populations, and how to ensure that the benefits from growth are spread as widely as possible.

There is no need for undue pessimism. Europe continues to possess significant economic strengths, including good public infrastructure, a well-educated and trained work force, and high domestic saving rates coupled with financial systems that are capable of channelling resources to productive investment. And in numerous areas, European companies remain world leaders, competing on quality and innovation. But globalization and the accelerated integration of world markets requires always remaining in motion: that is, the economic and political ability to adapt to constant change. New growth hubs are emerging in Asia, where growth has outpaced Europe by 5 percentage points per year over the past decade – and according to the IMF's *World Economic Outlook* will continue to do so in the coming years. And I expect the United States to return to strong growth, driven not least by a remarkable capacity for technological innovation. Therefore, in my view a larger Europe must also become a stronger Europe, which is outward-looking and capable of competing successfully in the global economy.

In Western Europe, there has been no lack of debate on what needs to be done. The EU's Lisbon Agenda correctly identifies the key challenges: how to improve incentives to work, how to foster innovation through better education and training systems, and how to encourage the cutting-edge research and development needed to remain competitive. Meeting these challenges requires tackling the root causes of anaemic growth through a vigorous acceleration of structural reforms. These relate especially to the labour market, which is also at the core of Western Europe's deep-seated fiscal problems. Different countries and regions maintain differing approaches to labour markets, and rightly so. But benefits systems in many European countries are too generous and taxes too high to expect vibrant, employment-rich growth over the medium term. I welcome the new reform momentum which is evident in Germany's Agenda 2010 and in the initiation of reforms in a number of other countries, including the welcome progress on pension reform in France, Italy and Austria. But there is no doubt that reforms will need to be deepened and broadened if they are to deliver the expected dividends for growth and employment over the medium term.

The Central European and Baltic countries poised for EU accession can rightfully look back to significant economic achievements over the past decade. Macroeconomic stabilization has been followed by comprehensive economic restructuring, which is creating increasingly competitive economies, not least thanks to continued high inflows of foreign direct investment. But this is not the time to relax. Large current account and fiscal imbalances in many countries illustrate their remaining vulnerabilities, and in most countries the medium- and long-term pressures on public resources as a result of ageing populations rival those in Western Europe. Financial sectors also remain underdeveloped in many countries, and institutional frameworks, especially predictable and well-enforced legal and regulatory systems, still fall short of international best practice. Tackling these issues decisively will ensure that Central Europe and the Baltics can continue to be centres of investment and job creation in Europe for many years to come.

As Europe becomes larger, it will be critical that it does not retreat behind its expanded borders. Over the past half-century, building the European Union has brought peace and unprecedented prosperity to the people of Western Europe. I am confident that enlargement – which will create an economic area of some 450 million people accounting for well over a quarter of world GDP – holds tremendous promise for both the current and the new members of the EU. But ensuring that the future of Europe is as bright as its recent past will require an outward-looking strategy, embracing the opportunities of globalization while maintaining the European identity. For the Balkans, a clear perspective of – and commitment to – future EU membership is a key to lasting stability and promoting prosperity. The Stability and Association Agreements with the Western Balkans are already providing momentum and a sense of direction to policy makers and the public. But the EU can help in many other ways: I support the recent 'Wider Europe' initiative of the EU, which offers a prospect of closer economic ties for the EU's new Eastern neighbours over the medium term, including improved market access to the exports from its new neighbours. I also hope that the EU's reform of its agricultural policy – a key element for a successful conclusion of the WTO Doha Round – will help in boosting trade with this region.

3. THE ROLE OF THE IMF IN A LARGER EUROPE

The IMF's role in Europe is evolving in tandem with Europe's further economic integration. Our focus is increasingly on cross-border issues as much as on the policies of individual countries.

- In our ongoing surveillance, we will continue to focus on the key issues facing Europe, including establishing appropriate medium-term fiscal frameworks, bringing long-run considerations – notably population ageing – to bear on current fiscal plans, and implementing structural reforms needed to raise its long-term growth potential. And for the new members, in the run-up to membership of the euro area, the conduct of monetary and exchange rate policy will likely pose some difficult challenges. The appropriate strategy and timing of the adoption of the euro is likely to differ according to individual country circumstances. But achieving durable macroeconomic stability is surely a prerequisite. I look forward to an in-depth debate of this question.
- Of equal importance, especially in the new and prospective members of the EU, will be our work on transparency and international standards and codes. Meeting international standards of best practice is a critical building block in strengthening business confidence and fostering investment and job creation. A key focus of our financial sector assessment programme will remain on financial sector reforms, particularly to improve risk assessment and financial supervision. Fiscal transparency, including the role of audit agencies in strengthening governance of public finances and reducing corruption, will also continue to be an important part of our work in many countries. And improving the quality and transparency in the dissemination of economic data remains key to strengthening domestic economic management and promoting our members' integration in international financial markets. In all these areas, we will continue our fruitful collaboration with the European Commission, the European Central Bank, and the EBRD.

I am optimistic that a larger Europe can also be a stronger Europe. The progressive economic integration of the countries of Central and Eastern Europe and the Baltics into the European Union is now bringing better jobs and long-awaited improvements in living standards to increasing parts of the population throughout the region. But globalization forces constant adaptation and change, as the spread of information, innovation and technical progress expands opportunities and markets for all countries. In 1950, Robert Schuman, one of the founding fathers of a united Europe, said that Europe will not be made in one fell swoop or according to a single plan. It will be built through concrete achievements of de facto solidarity. Now, at the beginning of the 21st century, it is again with concrete steps that a larger Europe can build its own future and be a force for prosperity world-wide.

NOTE

1. Managing Director of the International Monetary Fund.

REFERENCE

Schuman, Robert (1950), Declaration of 9 May 1950, http://europa.eu.int/abc/symbols/9-may/decl_en.htm.

2. The challenges of a wider and deeper Europe

Charles Wyplosz[1]

1. INTRODUCTION

In just a few years, Europe will have deeply transformed itself. With the launch of the euro in 1999, it has become much deeper. With the accession of ten new members in 2004, it is becoming much wider. It is no wonder, therefore, that an unprecedented Convention has been convened to mull over the changes required to adapt our institutions to the new configuration. The Convention's proposals are not driven by a powerful vision but by a thick web of compromises, within the Convention itself, and between the Convention and the national governments that will now decide what to do with them. To some, these proposals represent a significant step forward, to others they display Europe's tendency to crystallize current disagreements into perennial arrangements.

It is tempting, indeed, to feel that Europe is not rising up to its challenges. Where is the vision of the founding fathers? It is time to remember Jean Monnet who, in the darkest hours of World War II, declared in August 1943: 'There will be no peace in Europe, if the states are reconstituted on the basis of national sovereignty . . . The countries of Europe are too small to guarantee their peoples the necessary prosperity and social development.'[2]

The subsequent 60 years have not fulfilled his vision, but Jean Monnet would not be disappointed, for he was a patient man with a method: 'Concrete and resolute action on a limited but decisive point, which provokes a fundamental change on this point and progressively modifies the actual terms of the problem as a whole.' (Memorandum of 3 May 1950).[3]

Jean Monnet's pragmatist method lives on, under the name of functionalism. EMU and enlargement have already changed 'the terms of the problem as a whole'. And so has the Convention, and so will the Inter-Governmental Conference (IGC), despite all the shortcomings that we can envision. Impatient euro-enthusiasts must coexist with frightened eurosceptics; we sit in the uncomfortable and imperfect middle, but the middle itself moves, albeit slowly. As an economist, I can see a trend, and large fluctuations around the trend. And, true to the state of knowledge in macroeconomics, I can better explain and foresee the trend than the cyclical fluctuations. My purpose in this chapter is to apply the methods of economic analysis to interpret the current political debate. I will start by recalling some general principles from the theory of fiscal federalism and then use them to argue that Europe needs to get deeper, with increasing emphasis on non-economic issues. I will then examine whether enlargement makes deepening more difficult, and provide an assessment of the draft treaty proposed by the Convention. Before concluding, I will draw attention to the conflict between large and small countries.

2. TASK ALLOCATION IN THE EUROPEAN UNION: PRINCIPLES

Do we need further deepening? This is a highly controversial issue, with strongly held views on each side. I will argue that these opposite views are (usually) correct but unbalanced. They fail to recognize that costs and benefits from further deepening are often finely balanced. To see that, we need a method of analysis.

The EU is not a federation but it must still deal with the same basic question that federal states face: how to decide to which level particular tasks should be assigned? This question is more delicate than in a federal state because any transfer of sovereignty calls into question the Nation-State, the deep, intimate way in which every citizen nowadays defines his identity. It was not always that way. Not so long ago, different people from different nationalities could co-exist within a state for generations. Baghdad, for instance, was home to Arabs, Jews, Turks, Persians, Kurds, Russians, and many more. Vienna was at its political and cultural peak when its inhabitants were coming from all over Central Europe and the Balkans. Our prism has changed over the last couple of centuries, but it may change yet again. This is why such an enduring construction as a constitution should be designed with enough flexibility to accommodate the current attachment to the Nation-State while preserving the possibility of a slow evolution towards an overarching European identity. The principles of fiscal federalism are a good starting point when trying to think which public goods ought to remain in national hands and which ones can be shared at the European level.[4]

In a nutshell, fiscal federalism observes that centralization involves both benefits and costs, which have to be assessed and balanced. Centralization provides benefits when it exploits existing economies of scale or scope and when spillovers occur. The benefits come in the form of enhanced effectiveness. The costs result from information asymmetries and heterogeneity. If it is costly for the centre to be well informed about local conditions, effectiveness calls for decentralization. If preferences significantly differ across localities, decentralization is required to deliver the best adapted public goods. Good economics is two-handed, it reveals trade-offs.

3. THE CHALLENGES OF DEEPENING

A number of countries and citizens are happy to have a wider but not deeper EU. They observe that deepening has progressed far enough. Their view is that, even before enlargement, we had reached equilibrium between the gains in efficiency and the costs of heterogeneity and asymmetric information. When this is presented as a blanket statement, I do not agree. I think that in some areas, we may have gone too far while in others we have a long way to go. Let me try and convince you that some deepening is needed. We need to deal with public goods, one by one, and with an open mind. In this respect, I will distinguish public goods of an economic nature (the single market, money, and so on) from non-economic public goods (security, diplomacy, education, and so on).

3.1 Economic Public Goods

Much of the integration process so far has concerned economic public goods. The process of centralization is now almost complete. We do have an economic and monetary union and it works, for good reasons.

Trade can be seen as a public good. It clearly displays increasing returns to scale and scope. It enlarges the set of producers and consumers, and many of the traded goods are produced with increasing return technologies. Local conditions matter little since it is the relative competitive advantage that matters, although transitory adjustment costs, if concentrated geographically, call for some form of Pareto transfers. Pareto transfers, however, are rarely observed in practice, which justifies some concern and transitory arrangements. Likewise, preference heterogeneities are limited, but not altogether absent as we learn from cases like beer purity laws or artistic creation. All in all, though, the case for centralizing trade is overwhelming and it is logical that this is where European integration started, and why the Common Market has come to be seen as a spectacular success.

Money too is a public good that displays strongly increasing returns to scale. Monetary policy is a serious source of spillovers, which used to be called beggar-thy-neighbour. The Optimum Currency Area literature, on the other hand, brings up the role of heterogeneous preferences that come with low labour mobility and undiversified or limited trade openness. The case for centralizing monetary policy is less strong than in the case of trade, and this is why it has taken longer for the single currency to be adopted, and why it has not been adopted everywhere.

Financial market supervision is a public good for which information asymmetries are important enough to deter centralization. But, with the single currency, the potential for returns to scale and spillovers has greatly increased. For example, in the case of a banking or financial crisis, the systemic risk is now increasingly pan-European. As financial integration deepens, the trade-off is shifting in favour of centralization. We are not there, yet.

Much of public spending (education, justice, police, public transports, and so on) is strictly local and, quite possibly, subject to decreasing returns, with few spillovers. Local preferences and information asymmetries are important; just think of agriculture support. There is little room, therefore, for Europe-wide public spending. The exception may be public infrastructures, especially in transports, where returns to scale and spillovers are present. In this area, some partial centralization could be warranted. Elsewhere, as with the Common Agricultural Policy and the regional funds, we should retrench.

Since taxes are primarily justified by the need to finance public spending, the same conclusion applies. There is much debate on tax spillovers, these days, with fears of a race to the bottom and calls for harmonization, which is close but not equivalent to centralization. So far at least, there is no evidence that such a race has happened, except maybe for the taxation of capital.[5] On the other side, high tax levels in Europe point to an opposite spillover, the collusion of Leviathan governments. This potential collusion makes tax competition desirable. All in all, the case remains open.

Finally, the discussion about labour market institutions mirrors that about taxes. The same fears about a race to the social bottom lead to demands for harmonization. Yet, years of economic research have associated high unemployment with misguided regulation of the labour markets. In the face of strenuous resistance to reform in a number of countries, competition among regulatory systems seems the only hope of reducing unemployment.

Summarizing, I have noted that the provision of economic public goods has now reached a degree of centralization that is close to optimal, but not quite there yet. The Common Market and the single currency operate well, yet not perfectly well. Some of the remaining tasks include closing loopholes in the Common Market (for example state aids) and in the monetary union (for example financial regulation and supervision) or cases of excessive centralization (for example the Common Agricultural Policy and the Stability and Growth Pact, for which information asymmetries and preference heterogeneity have proven deep enough to reconsider existing arrangements).

3.2 Non-economic Public Goods

The provision of non-economic public goods takes us closer to the idea of a political union. Centralization has been limited so far, largely because of the presence of important information asymmetries and real or supposed heterogeneous preferences that reflect nationalistic sentiments. This where the next frontier of European integration lies, and indeed the Lisbon strategy represents a first attempt to deal with this challenge. The objective of making Europe 'the most dynamic, knowledge-based economy in the world by 2010' is clearly unrealistic but the intention to prevent the technology gap with the US from increasing further and, eventually to close it, is commendable. How is this supposed to come about? The strategy emphasizes social inclusion and the functioning of labour markets, environment protection and higher education and research. Because these are areas where information asymmetries and preference heterogeneities are generally high, the Lisbon strategy does not rely on centralization, but on the 'open method of coordination'. The approach consists in comparing national experiments, trying to identify best practices, and exerting peer pressure on national governments so that they move towards these best practices. The open method of coordination can be seen as a waffle that attempts to square the circle, inviting joint action in areas where, I have argued earlier, competition is the proper response. The absence of any obligation, while fully justified on most issues, means that the strategy is unlikely to deliver concrete decisions. Yet, peer pressure may be helpful in providing national governments with much-needed incentives to confront powerful interest groups. Let me consider three areas where deepening is needed now, with or without enlargement.

In areas like justice or education, returns to scale are non-existent and spillovers limited while heterogeneity is large, reflecting long-held national traditions and cultures. In most federal countries, where heterogeneity is less pronounced than across European countries, these public goods are decentralized. There is no general case for centralization in justice and education. The exceptions include commercial law, which is associated with trade; higher education, which is related to research; and deep defining values such as the death penalty ban.

The case of internal security is different. The free mobility of people inside the EU 'modifies the actual terms of the problem', to adopt Jean Monnet's terms. The true borders are now between the EU and the rest of the world. This is a form of spillover, which opens up the possibility of free-riding. The creation of a unique border police corps would greatly enhance the effectiveness with which the public good is delivered, but resistance is stiff. It is partly justified by information asymmetries, but the defence of special interests also weighs heavily, a theme that will become recurrent. National corps fear that they will lose some influence and authority, they appeal to heterogeneities of preferences: are we sure, they say, that a European corps will protect us as well as our own?

Much the same applies to external security. Defence is subject to rising returns, and spillovers are very large in a geographically compact area. A European army is certain to be more efficient than the puzzle that we now have. This is why one of Jean Monnet's first 'concrete and resolute actions' was to propose the European Defense Community, which was vetoed by his own – and my – country. Since then, very little progress has been achieved. To be sure, true preference heterogeneities exist, yet the case for centralization is strong. Vested interests are powerful, we do have a military–industrial complex.

3.2.1 Higher education and research

Higher education and research are central to the Lisbon strategy. Europe badly trails behind the US, and suffers from the most wasteful brain drains: many of the best teachers and researchers, trained at high costs by the free public systems of Europe, are imported free of charge by the US universities and research centres.

An analogy can be helpful, here. For the production of goods and services, the Common Market has finally put to an end the time-honoured practice of nurturing national champions, an ill-conceived implication of the mostly invalid infant-industry argument. This applies to the production of knowledge as well.

The Bologna process, which aims at standardizing university curricula, is an early acknowledgement of the need to 'do something'. Its main advantage is to increase competition by raising the mobility of students. But, with few exceptions, universities are state-owned and therefore quite insensitive to competition, much like subsidized national industrial champions. If the EU is ever to challenge the US in higher education, much more will have to be done, and powerful entrenched local interests will have to be confronted. Similarly, research funding remains largely national, supporting national champions that often fail to compete with the world's leaders in their fields. Some resources have been transferred to the EU level but the procedure emphasizes the development of networks. In economic terms, these networks are no different from cartels that link together, and protect, uncompetitive national champions. Here again, we need Europe-wide competition among research centres and among funding sources.

3.2.2 Internal security

The four freedoms imply that internal security is no longer enforceable at the national level. For most criminal activities, the real border is the EU border. The current arrangement is clearly inefficient, prone to free-riding. Why should, say, the Greek authorities devote large resources to policing their borders if they have reasons to believe that most crime will take place elsewhere in the EU? Cooperation exists, but it is unlikely to be adequate.

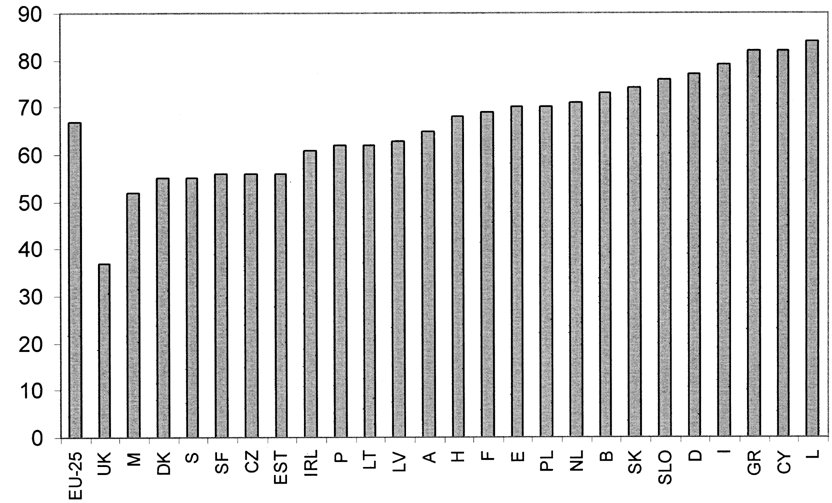
3.2.3 External security and foreign affairs

I combine external security and foreign affairs in this section to be brief, and because these two public goods are deeply linked. Here, as the Iraq war reminded us, increasing returns are massive. No European country alone can weigh much in world affairs while a united Europe can be a decisive voice. This seems to be well understood by most Europeans: 67 per cent of the citizens of the future EU-25 are in favour of a common foreign policy, and 75 per cent in favour of a common defence (Figures 2.1 and 2.2). Yet, preference heterogeneities are very sizeable, which is undoubtedly one reason why no centralization is in sight. Another reason may be the fact that the relevant national administrations are loath to see their prerogatives clipped.

3.3 Executive Powers, Democratic Accountability and Legitimacy: The State of Play

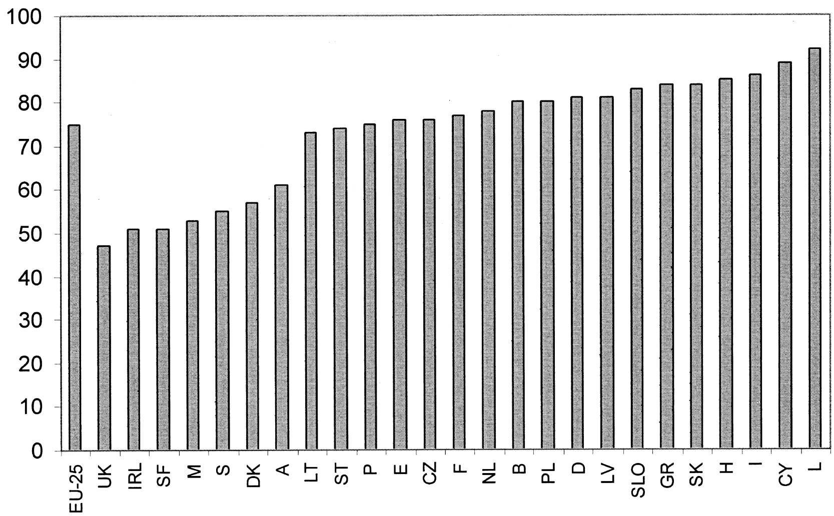
Heeding rational criteria to decide on task allocation would open a Pandora's box. The delivery of non-economic public goods requires an executive with adequate political authority and subject to democratic oversight. Currently, we have two institutions that enjoy executive powers, the European Commission and the Eurosystem; and two legislative bodies, the Council and the European Parliament.

The European Commission is a hybrid, combining legislative and executive powers and subject to the kind of limited democratic accountability that typically applies to bureaucracies. As Guardian of the Treaty, it is meant to be non-political and indeed it brings together Commissioners that are not jointly supported by any majority, either in the Council or in the European Parliament. Two of them, the Competition Commissioner and the Trade Commissioner, enjoy true executive powers, a consequence of the existence of a Common Market. The other Commissioners currently act as bureaucrats acting on mandates from the Council. The two 'executive Commissioners' are not subject to democratic accountability, however. At the cost of limited legitimacy, this is acceptable since their tasks are precisely defined and largely technical. Open-ended tasks like foreign policy or internal security, however, require the ability to make political decisions, which can only be legitimate if they are supported by a political majority.



Source: *Eurobarometer* EB59, July 2003.

Figure 2.1 Percentage favouring a common foreign policy



Source: *Eurobarometer* EB59, July 2003.

Figure 2.2 Percentage favouring a common foreign defence

As a non-elected body with executive powers, the Eurosystem is a bureaucracy. It is given a precise and narrow task defined as price stability and 'without prejudice to the objective of price stability . . . to support the general economic policies in the Community'. It is nominally accountable to the European Parliament, but the Parliament has limited control power.[6] The result is a widespread perception of a 'democratic deficit'.

The Council decides on proposals submitted by the Commission. Decisions fall in either of two categories: unanimity, which gives each country a veto right; or qualified majority, with weights that tend to over-represent the smaller countries but with a required majority threshold that gives de facto veto powers to the large countries. I return to this question later; here I just wish to note that the Council is legitimate (it is based on legitimate governments) but that its democratic accountability depends on the importance voters confer to European issues at times of national, not European, elections. A rough rule of thumb is that this importance is inversely proportional to country size.

The European Parliament's powers have increased with co-decision, a process that subjects some decisions to the joint approval of the Council and of the Parliament. In theory, the Parliament should be fully legitimate and the main source of democratic accountability in the EU. In practice, the fact that elections to the Parliament are conducted at the national level, and are mostly determined by domestic political issues, undermines the Parliament's legitimacy. The Parliament is also divided along both party and national lines, with the result that its decisions are not always easy to understand by the citizens.

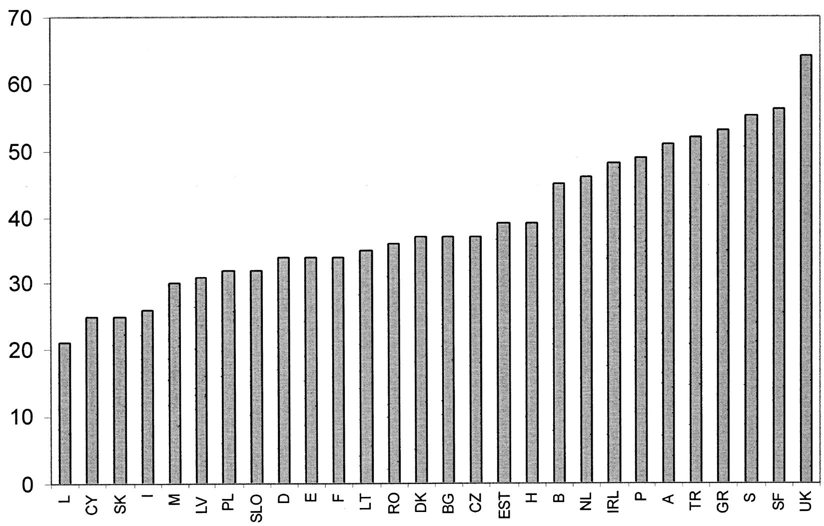
4. ENLARGEMENT VERSUS DEEPENING?

The enlargement to 25 members in 2004, with several more countries likely to join over the next decade, changes the nature of the EU. The Nice Summit has demonstrated the inability of current institutions to carry out existing tasks, making it clear that, independently of any further deepening, enlargement requires a serious overhaul. The Convention has drafted a Constitutional Treaty under negotiation within the Inter-Governmental Conference.

4.1 Is Enlargement the Problem?

Enlargement would make further deepening difficult if the new countries were to increase heterogeneities within the new EU more than they raise the returns to scale and scope. Of course, it is too early to know how the new members will act once inside the union. One limited piece of information can be gleaned from the surveys reported in *Eurobarometer*. A key question is: 'In the near future, do you see yourself as (1) Italian; (2) Italian and European; (3) European and Italian; (4) European only', and similarly in every country. Figure 2.3 shows the percentages of citizens who chose the first answer, those who mainly 'feel national'. Among the citizens of the current EU member countries, 40 per cent chose the first answer and 44 per cent the second. Among the ten acceding countries, the corresponding returns are 33 per cent and 54 per cent. Averages, of course, hide large differences across countries, and this is what matters for heterogeneity. The standard deviation of the percentages that chose the first answer is 12.1 per cent for the sample of current members, and it drops to 11.2 per cent when the ten acceding countries are added. I am not prepared to argue that the EU-25 will be less heterogeneous than the EU-15, but I am pleasantly surprised by this result.

I am not prepared either to conclude that decision-making will be as easy – or rather not harder – after enlargement. Quite to the contrary, Baldwin et al. (2001) show that, at unchanged distribution of preferences, the various (current, past and future) decision-making procedures become more unwieldy as the number of members rises. Thus the good news (no more diversity) is turned into bad news (more difficult decision-making)



Source: *Eurobarometer* EB59, July 2003.

Figure 2.3 Percentage of citizens 'feeling national' because of the voting procedures. The direct implication is that a wide Europe cannot be run as the initial EU-6. It is not enlargement itself that threatens deepening but the arcane decision-making process.

4.2 The Draft Treaty[7]

The Convention's draft treaty represents some progress concerning decision-making in the Council, the structure of the Commission and democratic accountability. It is not as successful concerning the task allocation process and ignores the Eurosystem.[8]

4.2.1 Decision-making

The Council decides either by unanimity or by qualified majority. Under both rules, Baldwin et al. (2001) show that decision-making becomes more unwieldy as the number of members rises. The reason is that, with qualified majority voting, the number of coalitions that can block a decision quickly increases as the number of voters rises. Unanimous decision-making, of course, makes things much worse; individual countries can exercise their veto rights for good (true disagreement) or bad (strategic behaviour, for example holding-up for unrelated purposes) reasons.

Moving more items to qualified majority voting, a frequently-heard suggestion, would raise effectiveness if qualified majority voting were efficient. The Nice decision has considerably degraded the situation. The Convention's proposal – a majority of nations and 60 per cent of the population – would significantly help. Baldwin and Widgrén (2003) show that, with this proposal, the Council's decision process will not be more unwieldy than it used to be in the EU-6.

The draft treaty offers an interesting solution to the problem of a Commission whose size expands endogenously. The Commission's size does not affect decision-making since matters are settled by majority voting. Where size matters is with regard to administrative efficiency: surely it makes little sense to equate the number of functions with the number of member countries. By capping the number of voting Commissioners to 15, the Convention's proposal safeguards the Commission's ability to act as the EU's executive body. Resistance to this proposal is strong but misguided. It is based on a representation argument, which applies to legislative bodies, not to an executive, unless Commissioners are seen as representing their countries. They are officially forbidden to do so, but practice seems different; this deviation not only violates the letter and the spirit of the Commission's mission, it may also derail the Convention's proposal.

Executive power requires democratic accountability. I have argued that the allocation of open-ended tasks, such as internal and external security or foreign affairs, further requires a politicization of the Commission. The draft treaty makes good progress by proposing that the President be elected by the European Parliament. The fact that the Parliament is allowed to pass a binding censure motion would lead to the required degree of politicization if the Parliament itself were operating along majority lines. This is not an issue that the Convention has tackled, a missed opportunity.[9]

The draft also proposes creating the position of Union Minister for Foreign Affairs, to also serve as Commission Vice-President, who would be appointed and dismissed by the European Council, on qualified majority. While this makes the position of this Minister more fragile, a step needed to reassure the Eurosceptics, it may serve as a blueprint for other open-ended executive tasks.

Finally, by reinforcing the EU Parliament, the extension of co-decision improves the democratic accountability of the EU, as does the proposal that national parliaments be consulted when the principle of subsidiarity is involved.

Yet the Convention has failed to go to the end of its logic. The proposed rotation that ensures that, over time, each country has its own European Commissioner, stands in contradiction with the current principle, reaffirmed by the draft treaty, that Commissioners do not represent their countries. The same contradiction concerns the Eurosystem. The Governing Council is the executive body and its members are formally forbidden from receiving instructions from their governments or any other public body. Yet, the one country-one person-one vote rotation rule proposed by the Eurosystem stands in sharp contradiction with both its executive nature and the no-representation rule.[10] The Convention has let this proposal stand, maybe to justify its own misguided proposal for the Commission. The Convention has not even revisited the consensus decision practice in the Eurosystem, in fact suggesting the same rule for the European Council. Consensus is a weak form of unanimity which is either highly inefficient if rigorously applied, or a source of manipulation and opaqueness.

4.2.2 Task allocation

The draft treaty makes more limited progress on the crucially important task allocation process. Where a method is needed, the draft treaty provides lists of exclusive and shared competence. This means that future transfers of competences in either direction will require treaty revisions, in effect freezing current preferences.

The problem is not just that centralizing new tasks will be difficult, it is that there is no procedure for *de*centralizing currently centralized tasks.

This is not an omission. The view that European integration is a one-way process is deeply ingrained. The *acquis communautaire* is considered sacrosanct. This is doubly inefficient. First, it means that earlier centralization moves which are no longer needed, or which were mistaken in the first place, cannot be reversed. Second, the irremediable nature of sovereignty transfers unnecessarily raises the stakes. A centralization decision that can be experimented with, and possibly reversed, is easier to agree to than a permanent one.

The treatment of foreign and security policy is puzzling. The draft treaty seems to design this area as a shared competence: 'The Union's competence in matters of common foreign and security policy shall cover all areas of foreign policy and all questions relating to the Union's security, including the progressive framing of a common defence policy, which might lead to a common defence.' (Article I-15-1). Yet this area is not listed as a shared competence, and further articles clearly describe a gradual process. As often in controversial matters, ambiguity is the way to reach an agreement, but it is also an assured source of difficulties later on. Instead of establishing a procedure for moving tasks between the central and national levels, the Constitution has produced a list that will be difficult to change.

5. THE REPRESENTATION PROBLEM

Both centralization of tasks and increased effectiveness in voting procedures come at the expense of national sovereignty. This is why the Convention's proposals for revamping the Council and the Commission face serious opposition. Another reason is that they increase the power of the large countries.[11]

As the EU expands, the relationship between the larger and smaller countries becomes more conflicting. The reason goes beyond sheer arithmetic. Enlargement means dilution, for large and small countries alike. This increases the room for a subset of countries to get together and influence decisions, not at the time of voting but upstream, when proposals are being mooted. For this influence to work, two conditions must be met: (1) there should be few countries involved for obvious effectiveness reasons; (2) these countries should still represent a significant share of votes to insure formal approval, if only by blocking alternative proposals. Dilution intensifies the incentives for the larger countries to attempt masterminding decisions, and makes it increasingly less acceptable. This is why deepening is becoming more difficult with widening.

The problem lies with democratic control, more precisely its representation aspect. Any democracy must balance the need for effectiveness and the concern that minority views are taken on board when they are strongly held. As a democratic arrangement, the EU is badly structured to combine effectiveness and representation. Effectiveness would call for a transfer of power to a central institution; representation calls for powerful counterweights. Federal countries achieve the required balance by combining a central government with a bicameral parliament, with one chamber representing the population and the other chamber representing the constituent entities. Since the EU is not a federation, this natural solution is ruled out. What we have instead, is implicit leadership by some large countries – with several unstable possible coalitions – and veto rights through unanimity decisions. Both features are highly undesirable.

It is likely that preference heterogeneity regarding the areas where deepening is needed cuts across national public opinions. The debate should therefore move from the inter-governmental forum to become truly political. This may be Europe's most delicate challenge.

To start with, we do not currently have true pan-European parties. The groupings at the European Parliament do not have such status and, even if they would be given adequate status, the incentive would be for them to remain under the shadow of national parties. These national parties may share the same name but they remain far apart on European and other issues. There are two key reasons for that. The first one is that elections to the European Parliament are conducted at the national level among domestic parties. Inevitably, these elections reflect domestic politics: at best, lip service is paid to European issues. The second reason is that the make-up of the European Parliament does not determine the political orientation of European institutions: neither the Council, nor the Commission need a political majority in the European Parliament, in fact both are essentially non-partisan.

Closely related is the issue of democratic accountability. The result of the Swedish referendum on the euro may reflect national fondness for the krona. More likely, it is a manifestation of displeasure with the perception of 'Brussels dictates'. The Swedish tradition of open government is in many ways unique, but the complexity of European affairs also irritates less sensitive public opinions.

As long as we do not see changes here, national politics will dominate Europe and the representation problem will remain acute. It will continue to plague decision-making in the Council, but also the composition of the Commission and even the way the Eurosystem operates.

6. CONCLUSION

All of this may seem hopeless, but it is not. The process of European integration is unique in the world. Many regions are looking at Europe as a model, but they are intimidated by our ability to transfer significant components of national sovereignty to the central levels. Thanks to Jean Monnet and his colleagues, 50 years ago Europe decided to shed centuries of animosity and wars, most likely for good. They were pragmatic and picked the easy-to-reach fruits first. Our generation benefits every day from this process, but it also finds it hard to pick the far-away fruits.

Deep down, it is the Nation-State that is under siege. It remains the term of reference for most citizens, but its power of attraction is clearly on a declining trend. The trend is very slow, of course, and it is measured in terms of generations, not years. What is also needed is that the European institutions become seen as considerably more democratic and more mindful of national sensitivities. This is our challenge, it requires patience and dedication.

NOTES

1. Graduate Institute of International Studies and CEPR. This chapter draws on Berglöf et al. (2003). I am grateful to Barry Eichengreen and Guido Tabellini for comments and suggestions.
2. http://www.jef-europe.net/federalism/archives/000938.html.
3. http://www.jef-europe.net/federalism/archives/000938.html.
4. On fiscal federalism, see Oates (1999). On an application to Europe, see Berglöf et al. (2003).
5. See Krogstrup (2002) and the review therein.
6. The EU Parliament cannot enforce its will, either directly or indirectly (through dismissal or change of mandate/delegation). It can only issue opinions on what the Eurosystem does.
7. This text was written in early December 2003. The IGC's decisions are not known yet and may change some of the conclusions.
8. For an interesting evaluation of the draft treaty, see Tabellini (2003).
9. More generally, the Convention has not considered whether the right model for Europe is a presidential or a parliamentary democracy. Berglöf et al. (2003) argue that the presidential model is better suited for a large, heterogeneous grouping.
10. The Eurosystem has proposed a rotation system which would cap the number of voters to 21. This proposal is flawed for two main reasons. First, the size of the Governing Council will increase with each new member state, limiting the ability to prepare policy decisions effectively. Limiting the number of voters is not needed for effectiveness in majority voting, and the limit is far too high for 'implicit consensus'. Second, the rotation formula establishes a direct link between voting rights and country size, which further contradicts the principle that Governors sit as qualified individuals and not as country representatives.

11. This is clearly the case for the Council's voting procedure (Baldwin and Widgrén, 2003) and for the Commission composition (since it is highly likely that the large countries will each have a Commissioner).

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PART II

Key issues for capacity building

3. Capacity building challenges in the run-up to EU enlargement and beyond

Jean Lemierre[1]

Looking ahead, the major challenge for the EU acceding countries is that transition has not yet been completed. To quote an example from previous enlargement rounds, Spain and Portugal took another ten years after their accession to the EU to make further reforms and to adapt their economies and their societies. The main challenges the new EU members states now face include, apart from implementing the *acquis communautaire*, reining in the fiscal deficit, making structural reforms – and responding to the pressure of the people, who want a reward for the extraordinary efforts they have made already over the past ten years of transformation. They have been very good, they have done a lot. But they want rewards, and they will get some. Those measures and measures taken to enhance competitiveness mean costs, in the fields of environment, education, and so on; so the acceding countries will continue to be under pressure. Finally, unemployment can come and it is coming. In many countries in Central Europe and for the same reasons, transition has thus been both destruction and creation. So what is the answer?

The way forward will be to boost the private sector. Against this background, the first priority will be to reform the banking sector, to improve its capacity to finance the real economy sufficiently. The level of financial banking intermediation in central Europe is still very low, much lower than in the other countries of the EU. The financial sector continues to be underbanked. The financial markets are small, and their capacity to attract capital, except probably in Hungary, is still limited. That is the reason why, at the EBRD, we try to increase financing possibilities and to promote equity financing. In particular, there is an unmet need to finance medium-size companies, which are the backbone of the economies of Austria, Switzerland, Italy and Germany. They will also be key to the success of Central Europe, but they have yet to emerge and expand. A lot has to be done there. And we have to be more focused.

Second, to be competitive you need to invest in infrastructure. Here, too, there is a pressure from the people, for instance with regard to the quality of drinking water, or of urban transport systems. These are fundamental needs, but they will be impossible to finance in their entirety from the budget. What is important is to involve the private sector to take risks and provide financing, and the capacity to develop innovative schemes while keeping tariffs from rising too high.

However, to pave the way for improvements and to attract investors, the legal system needs to be reformed, and education efforts must be enhanced. The crucial thing about education is that it is a question of generations: if you do not pay sufficient attention to education and research, you will lose competitiveness over time. Of course, education is a matter of costs and budgets year after year, so the important thing is not to lose momentum and to look at the longer term.

Considering that the EU is going to allocate EUR 22 billion from structural funds, regional cohesion funds, and so on to Central Europe in the coming years it is essential to make sure that these funds will be absorbed efficiently. To allocate good people to public service, to make the best use of their skills and to keep training them, is going to be crucial not only at the level of the state but also at the level of the regions and the municipalities – to make sure that there are highly qualified people in place who are able to prepare, manage and monitor the projects which are going to be financed mainly by EU funds and other funds coming from the state or from the EIB or from the EBRD. So, implementation capacity and absorption capacity will be a key concern for the next years.

Finally, following the next enlargement round in 2004, Romania and Bulgaria should be joining a few years later, and Croatia and other countries are willing to join as well. Yet the future is not only the enlarged EU but a 'wider Europe'. The broader question of how to improve relationships with the neighbours beyond the EU's borders is certainly a very interesting challenge. Expectations are high, and tensions are there. But among other things, the EU integration process has been an extraordinary driving force for progress and reform, and this momentum should be used in the neighbouring countries, and the leaders of these countries agree on this.

There is probably a need for a more structured approach by the EU Commission, and this is exactly where the concept comes into play of a 'wider Europe' which they have created and try to develop. But at the same time this is a challenge for investors and policy makers in both the private and the public sectors, who are called upon to find ways to improve the dialogue on many issues. In this context, the Balkans stand to play a larger role. The Board of the EBRD has incidentally decided to propose to hold its annual meeting in 2005 in Belgrade, as a clear symbol of focusing on the

Balkans, to promote this type of regional approach and modernization. Of course there is also a need to build on the relationship between the EU and Russia. Here, a host of issues, including energy partnerships, investment, trade and WTO accession for Russia, are going to be on the table over the next years. Yet all these issues will give more value to the enlargement of the EU and will be the next step towards the goal all of us have pursued over recent years.

NOTE

1. European Bank for Reconstruction and Development (EBRD).

4. Partnerships for capacity building – a necessity rather than an option

Kipkorir Aly Azad Rana[1]

Among training institutions, the Joint Vienna Institute (JVI) has built a tradition in, and a solid reputation for dealing with issues of direct concern to Central and Eastern European countries. This is most valued not only by beneficiaries, the academic community and policy makers, but equally by such organizations as the World Trade Organization (WTO), which is an active supporter of the JVI.

A key objective of the WTO, as one of the JVI's main sponsors, has been to strengthen existing partnership arrangements with the Joint Vienna Institute and I am glad to note that the Secretariat is progressing well in this main endeavour. In 2003, the WTO nearly doubled the number of activities held at the JVI and it has been agreed to further expand the scope of activities in 2004. Among other things, enhanced partnership with the JVI is an important component of the WTO's new approach of outsourcing to, and building strategic relations with training institutions – and with their students. After all, the JVI can claim credit to have trained a remarkable number of specialists in the short period of its existence: more than 12 000 participants at the time of writing.

Building capacity is one of the WTO's main goals in delivering technical assistance and training programmes, and, in our view, can best be achieved through 'decentralizing' those activities and bringing them closer to the region. Moreover, results can be improved by enlisting local experts and tapping local resources to carry out the activities. Thus, we are increasingly moving into that direction and building relations with such well-recognized institutes as the JVI to complement our more traditional relations with other international organizations and regional development banks (including the EBRD, the Asian Development Bank and the Arab Monetary Fund, just to mention a few).

In a way, our efforts are geared towards building regional 'centres of excellence', and it is of crucial importance to identify the right training centres for this purpose. Given its track record, the JVI will continue to be one of our main partners for training activities in the region. We are confident that our collaborative efforts will help integrate transition economies into the multilateral trading system and raise the overall levels of knowledge, skills and capacities to address trade-related issues effectively. As a case in point, a WTO seminar hosted by the JVI in December 2003 was geared towards strengthening relations with the academic community, which is a fundamental part of our newly developed University Programme featuring in the WTO's Technical Assistance and Training Plan for 2004.

Over time, the WTO has acquired a significant amount of experience with building institutional relations with training centres in other regions, and these relations are increasingly bearing fruit. I am referring particularly to the regional trade policy courses held annually in Kenya since 2002, with considerable success. These courses were of a three-month duration and focused on English-speaking African countries. The way these programmes were designed enhanced the ownership of the programmes and heavily involved the beneficiaries. In return, the WTO contributes to building sustainable programmes, which will gradually be taken over by the beneficiaries and partners themselves. Considerable efforts, in terms of both financial and human resources, are thus undertaken to organize capacity building programmes in the field.

In addition, the WTO Secretariat attaches the highest importance to cooperating with the regional development banks, as they add new dimensions to the programmes that the WTO conducts in the region. Not only do most regional development banks have well-established relations with governments and the private sector in the region; often they can also generate the necessary institutional funding, as well as private-sector funding, to get projects off the ground or to support them and thus enhance effective assistance in the field.

Moreover, the WTO Secretariat does not have the size or the capacity to follow up on its technical assistance programmes in the field, with the possible exception of the Integrated Framework (IF; undertaken in partnership with the World Bank, the International Monetary Fund (IMF), United Nations Development Programme (UNDP), United Nations Conference on Trade and Development (UNCTAD) and the International Trade Centre (ITC) and the Joint Integrated Technical Assistance Programme (JITAP; a multi-country, multi-agency capacity-building programme implemented by the WTO, UNCTAD and ITC). What this means is that partnerships for capacity building are a necessity, not just an option, and everybody is a net gainer in the process.

Many of the JVI's alumni have moved on to hold ministerial positions in their countries, or have become leading academics at universities and think tanks, or experts in the private sector. We have a unique mix of personalities that we like to interact with, and to exchange ideas and experiences with. Enhancing cooperation with each of these partners can only improve the quality of our activities and joint programmes and reinforce the sustainability of our actions.

Furthermore, I am convinced that the interaction on issues relating to capacity building between all stakeholders is essential in advancing the WTO negotiation process. Let me briefly recall that at the Doha Ministerial Meeting held in Qatar in December 2001, the WTO committed itself to fully integrate technical assistance and training for capacity building into all aspects of our work. Since then and in implementing its mandate, the Secretariat has taken a very proactive stance, developing programmes geared towards capacity building and interacting with any organization that can offer technical expertise.

The Cancun Ministerial Meeting held in September 2003 regrettably did not yield the expected results, but what it showed for sure is a stronger participation of developing Members, both in the preparatory process leading up to the Ministerial Conference as well as in the discussions at Cancun. As I see it, our duty at the Secretariat is to continue to assist Members both to expand their capacities to participate in the system effectively and to strengthen their collective efforts to put the process of negotiations back on track. Technical assistance and capacity building will continue to be an integral part of this process and the WTO Secretariat will continue to turn to its partners for support.

I believe that developing countries, transition economies, newly-acceded countries or those that are currently seeking accession to the WTO cannot but benefit from a fuller integration into the multilateral trading system. While many countries are developing closer economic and trade relations at the regional level, including in Central and Eastern Europe, it should be kept in mind that such closer trade and economic integration must go hand in hand with international commitments, as these are the ones that are legally binding and enforceable. While multilateralism and regionalism do not always make for the easiest of relationships, regional trade integration can be directly beneficial for multilateral trade liberalization, as has been proven many times, provided certain conditions are met. Of course, this being said, it should always be kept in mind that the WTO multilateral trade rules are the only ones to be applied unconditionally and on a most-favoured-nation basis, thus providing global benefits.

Several countries in Central and Eastern Europe have faced and many continue to face remarkable challenges. It is only over a decade ago that many of them followed economic policies and systems that were far removed from what classical international trade theory tells us to do. Economic policies were rarely based on the application of fundamental market considerations, and more often than not guided by irrational decisions and plans, leading to inefficiencies and the incapacity to respond adequately to new market challenges.

As a result of history and in one stroke, these systems had to be abandoned and replaced with an entirely new one, based on the application of market principles. Almost without exception, the transition countries joined or initiated the process to become a WTO Member or expressed their interest to do so. You would probably agree with me that the process leading to full WTO membership is not easy, often quite painful and requiring major adjustments. In most countries it has meant radically altering legal infrastructures, domestic laws and regulations, institutional frameworks, decision-making procedures and relations with the outside world. Accepting the WTO's rules of the game may or may not have generated immediate and tangible economic benefits, but it has invariably affected economic policy making in fundamental ways. This has been a major challenge, and countries have taken up these challenges with vigour and determination and I would like to commend them for their efforts.

Today, many countries in the region are facing a new challenge, namely the perspective of joining the European Union. I have no doubt that their accession to the EU will bring further improvements to their ability to implement their international commitments. At the same time, an effective integration into both the European Union and the world economy as a whole will require further reductions in trade barriers, the elimination of inefficient policies, stable and sound macroeconomic settings, fiscal and monetary policies, and coherence in policy making. In other words, it is not just trade that matters. Trade is part of a policy framework, which should be addressed in a coherent fashion, in its entirety. I am convinced that these countries will yet again face this challenge with determination and vigour and I wish them good luck.

NOTE

1. Deputy Director-General, World Trade Organization, Geneva, Switzerland.

PART III

Human capital and capacity building – experiences and lessons for the future

5. JVI and WTO – beacons for navigating the waters of transition

Valeriy T. Pyatnytskiy[1]

When Ukraine first appeared on the map of Europe in 1991, it was typically referred to as 'one of the former Soviet Union republics'. Then it was labelled 'a CIS country'. Only recently has it been recognized as 'a newly independent country in Eastern Europe'. A similar change in attitudes and values has evolved in the country itself, as has been clearly reflected in economic developments, and, most importantly, asserted itself in the hearts and minds of the people of Ukraine. The changing mentality of (first and foremost) decision-makers is a significant factor of market reform in Ukraine, if not the most significant one. And sowing the seeds for such change is basically what training institutions like the Joint Vienna Institute (JVI) – launched in 1992 to provide a forum for the training of officials from former centrally-planned economies in transition to market-based systems – do for all transition economies.

These days Ukraine looks forward to finally getting involved as a peer in global development processes. In this context, the goal of joining the World Trade Organization (WTO) and the world trading system governed by the WTO is viewed as an extremely important step in the right direction. What is even more important, WTO accession happens to be a kind of beacon for navigating the waters of transition and thus a major prerequisite for the success of our ongoing internal reforms. No matter what foreign economic and political orientation we may choose, the compass is within our country and its needle will turn any direction, depending on how sound our domestic economic transformation is. And that is why we see WTO accession primarily as a strong incentive for pushing ahead with domestic economic reform. Of the top ten benefits the global trading system offers, as defined by the WTO, we would actually rank the tenth benefit – 'the system encourages good government' – highest from the perspective of our present needs.

Since I have mentioned the key role that the WTO plays in our domestic structural transformation, let me also draw your attention to the importance this organization has on the global scale. The influence of business and trade on both national political interests and foreign policy keeps growing. The performance of transnational corporations and capital flows entail political consequences, and individual countries are not able to cope adequately with these consequences on their own. With the annual volume of trade in goods between the EU and the USA totalling nearly half a trillion US dollars, and with half of US foreign investment going to Europe and more than half of European investment going into the USA, what if not trade defines American and European relations, and what if not trade will in the long run define global relations? To quote Ulrike Guerot, a German expert: 'with a certain degree of exaggeration one can come up with the following idea: NATO that served as a transatlantic bridge for a long time is being substituted by WTO'.[2]

If we extrapolate this tendency to other aspects of international life, unilateralism will, with a high degree of probability, have to give way to multilateralism. To my mind, the recent transformational developments, painful at times, in all international organizations and conglomerations, from the UN and the WTO to the Commonwealth of Independent States (CIS) and the EU, should be viewed not as an event of crisis but as the movement to the next level in the endless spiral of evolution – to the place where law rules the day and not force, where all aspects of international life are regulated by democratic multilateral procedures applied equally to all countries regardless of their size. I cannot predict how long it will take to get there, but I am quite sure that we will reach this goal through trade, by boosting world trade and cross-border economic links as much as possible – there is no other way. Brad DeLong, Professor of Economics at the University of California, Berkeley, labelled this process a 'neoliberal crusade for development', stating that 'this strategy may not be a winner, but it is a strategy of last resort'.[3]

Both Ukraine and Russia, another accession country, are heatedly debating the expediency of accession, with lots of arguments against it. I am neither trying to put a halo on the WTO, nor do I consider the mere fact of Ukraine's accession as a tool to resolve all the problems it is facing. But is there any viable alternative? Prior to the EU referendum in the Czech Republic, incidentally, one could find billboards reading 'Say Yes!' and 'Is there any other way?' placed side by side. That is exactly the question I would like to pose to all those, both inside and outside Ukraine, who are trying to intimidate my country with the negative consequences of WTO accession. We fully recognize them, but there is just no other way to become an equal player in the world trading system, and to get a say in setting the rules of the game.

Ukraine faces new tasks and challenges while building up its capacities for democratic society and market economy. In order to be able to benefit from the advantages provided by WTO membership and the status of a next-door neighbour of the 'wider Europe', in order to preserve beneficial relations with the CIS countries and, at the same time, not to get stuck in the past by losing the momentum of development gained, Ukraine needs extraordinary people, experts with a broad scope of knowledge and even broader perspectives. With all these tasks in mind, we have been establishing appropriate educational institutions in Ukraine, for instance the Foreign Trade Academy and the National Academy of Public Management. Here, we see the JVI as a model, and a number of former JVI graduates, myself included, teach at these new institutions. In this respect, the JVI, being quite unique in what it is doing, could become a nucleus around which a whole network of respective training centres could be formed in the transition economies, and it could serve as a kind of nursery that provides such centres with tutors.

NOTES

1. First Deputy Minister of Economy and European Integration of Ukraine.
2. Ulrike Guerot (2000).
3. DeLong (2001).

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6. Capacity building initiatives – a personal account from the giving and receiving end

Josef Tošovský[1]

I would like to share my experience with capacity building from two perspectives: first, as a former governor of a central bank in a transition economy – that is from the receiving end of technical assistance. Second, from the giving end, as the current head of the Financial Stability Institute (FSI), which among other activities helps to upgrade skills and knowledge, and to build capacity in the area of financial regulation and supervision.

Allow me to start with the first perspective and a personal recollection of some historical developments. At the beginning of 1990, shortly after the 'velvet revolution' in the Czech Republic, a very small group of newly appointed government officials started to prepare economic reforms. In long discussions and meetings, we worked out proposals for very radical and fast structural economic changes. We soon realized that a swift transition from a centrally planned economy to a market economy, and the political change from a totalitarian regime to a democratic system, would not be without difficulties.

We faced two basic kinds of problems. First, the structure of education and the mix of skills in a command economy did not match the needs of a market economy. Second, life under a socialist regime had shaped people's quality of life, mentality and morals. These problems also undermined the ability of the central bank to fulfil its main task at the time, namely to rebuild the central bank, the banking system and the financial infrastructure. Realizing these constraints, one decision among others I made, which may seem trivial, was to promote foreign language learning. Yet especially the knowledge of English was essential for accessing foreign literature, attending meetings with international experts, participating in international seminars and simply being able to receive technical assistance.

We were reaping the benefits of this decision within a few years' time. The quality of our staff was improving. I experienced this in meetings with my colleagues, in their papers, back-to-office reports and so on. These positive changes led also to changes in managerial positions and a gradual upgrading of the quality of the staff of the central bank and consequently its reputation.

During this important period, governments, international financial institutions and central banks of most developed countries played a very important role in human capacity building, and specifically the Joint Vienna Institute (JVI) played and continues to play an important role in the area of central banking, monetary policy and financial markets.

Now that the economic and financial landscape has undergone significant transformation over the last 14 years, the further need for the JVI may be questioned by some, especially Central and Eastern Europe countries, several of which will soon become EU members. My response would be the following: it is possible to implement some systemic measures 'overnight', for example to liberalize prices and foreign trade or to move to a more realistic exchange rate. But to prepare and gather all the necessary components of an institutional framework for a well-functioning market economy is a gradual, long-term process. Capacity building, technical assistance and training are essential tools in this respect, and the JVI will certainly continue to play an important role in this process.

Moving to my second perspective as chairman of the Financial Stability Institute (FSI), let me start with a few words on the FSI. Established by The Bank for International Settlements (BIS) jointly with the Basel Committee on Banking Supervision, the FSI assists financial sector supervisors globally in disseminating sound supervisory standards. Its work is concentrated on banking and insurance sector supervisory issues. High quality, up-to-date information is required for financial sector supervisors to keep pace with dramatic innovations in financial markets, the progressive shift to risk-focused supervision, and increasingly complex capital requirements. The FSI meets this demand through its intensive programme of disseminating standards and best practices and providing assistance on a wide range of important supervisory matters. In particular, the FSI designs and delivers seminars and regional workshops for financial sector supervisors around the world. These events also serve the important purpose of fostering cross-border supervisory contacts and cooperation.

An important new project initiated in 2003 was FSI Connect, an on-line information resource tool for banking supervisors. This programme will offer courses over the Internet on a wide range of topics of interest to financial sector supervisors. FSI Connect will be a valuable tool for all levels of expertise: for the senior-level supervisor, who needs to remain current on supervisory topics that are constantly changing; for the technical expert, who needs to be up to date on the latest developments and for the more junior supervisor, who will have the opportunity to become familiar with the essential elements of sound supervisory practices. We anticipate that the initial tutorials will be available by mid-2004 and will cover various risk management topics as well as the revised Basel Capital Accord. FSI Connect is viewed as a strong complement to the FSI's existing activities and will enable the FSI to reach out to a wider audience of financial sector supervisors globally.

Finally, I would like to say that the BIS has been cooperating with the JVI since its inception. The FSI is ready to continue its cooperation with the JVI and I would like to make a clear commitment here that we plan to have approximately two events per year at the JVI in the future.

NOTE

1. Chairman, BIS Financial Stability Institute, Basel.

7. Meeting the challenges of enhancing capacity for development

Frannie A. Léautier[1]

1. A NEW CONSENSUS ON CAPACITY FOR DEVELOPMENT

Despite substantial attention and financial support from the development community over a long period of time, capacity remains a binding constraint to development, especially in Africa. Among the reasons for lack of progress in capacity are (a) shifting definitions of the term 'capacity' and hence shifting attention on its components, leading to a lack of coherence in results over time (see Appendix 1 on the multiple definitions of capacity enhancement); and (b) poor coordination and lack of harmonization of policies and practices among development partners in the provision of support for capacity development (see Appendix 2 for a summary of donor perspectives on pooling technical assistance). For the purposes of this chapter, we use an operational definition of capacity that allows us to focus on the key issues that will lead to substantial results going forward.

What is capacity for development? It is the ability of individuals, institutions and whole societies to solve problems, make informed choices, order their priorities and plan their futures – as well as to implement programmes and projects, and sustain them.

With respect to individuals, this definition captures their educational attainment levels, their access to information, and their inclusion in decision-making. For institutions, this includes the incentives structure within the planning and decision-making systems; effectiveness of public decision-making, including transparency and accountability; institutional features that offer information to citizens, connecting them and communicating with them; and the way in which institutions adapt to new ideas by complementing and building on what exists but also by encouraging innovation. And finally at the societal level this includes the components of culture, norms and codes of conduct that are embedded in formal or informal institutions. The media play a key role in ensuring accountability, transparency and access to information and giving voice to different audiences. Also central is the role played by research institutions and think tanks.

So defined, the capacity for development is at the heart of the international consensus on achieving the Millennium Development Goals (MDGs). By setting specific development and time targets, the MDGs have helped to more directly link these efforts to the achievement of tangible results in people's lives. Thus an understanding of the sources of current weaknesses, as well as of how incentives change behaviour, is critical to addressing capacity challenges. Enhancing these critical abilities, as well as their effective and timely use, has been widely acknowledged as the key element in advancing a country's development strategy.

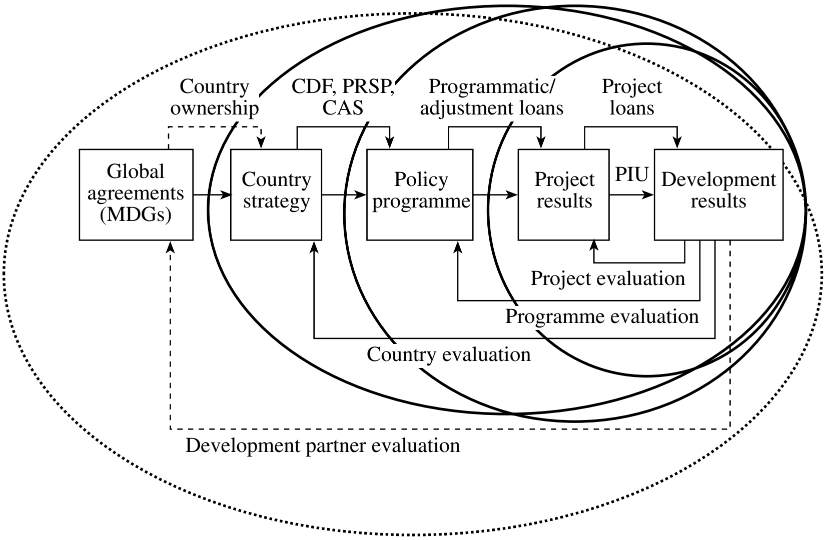
2. THE GLOBAL CHALLENGE

2.1 Recognizing the Need for Enhancing Capacity on Both the Demand and Supply Sides of the Challenge

A 1993 United Nations Development Programme (UNDP) report[2] observed that 'in few areas of policy are the costs of inaction or misguided action more far reaching'. A year later, the Conference on Technical Cooperation co-sponsored by the Organisation for Economic Co-operation and Development/Development Assistance Committee (OECD/DAC), UNDP and the World Bank, addressed the elusive goal of sustainable capacity development through technical assistance reform. A 1996 report of the Operations Evaluation Department of the World Bank (OED) noted that from free-standing technical assistance provided in the form of bank loans and credits during FY1970–95 and FY1991–95, Sub-Saharan Africa had received a share of 20 and 32 per cent, respectively – with disappointing outcomes, which the report attributed to governance problems and weak management on the part of both technical assistance providers and recipients.

The World Bank's assistance in enhancing client capacity has grown and evolved over the years, in tandem with the evolution of the development paradigm and the emergence of a consensus on both the meaning of 'capacity for development' and the requisites for achieving results. From the 1950s to the early 1970s, the Bank's concern with client capacity centred on engineering skills, which were critical to Bank-financed projects to develop physical infrastructure. By the mid-1970s, capacity-building objectives had begun to include human resources and national policies and institutions.

In the late 1990s, the introduction of the Comprehensive Development Framework/Poverty Reduction Strategy Paper (CDF/PRSP) approach emphasized the key role of borrower ownership and leadership in national



Notes:
CAS: Country Assistance Strategies, CDF: Comprehensive Development Framework, MDGs: Millennium Development Goals, PIU: Project Implementation Unit, PRSP: Poverty Reduction Strategy Paper.
Figure developed by author for presentation at the Strategic Implementation Forum, The World Bank, January 2003.

Source: World Bank Institute internal presentation.

Figure 7.1 Evolution of capacity-building needs

development. This approach moved the issue of borrower capacity and needs (see Figure 7.1) toward the centre of the development effectiveness discussions, and made it particularly relevant to low-income countries (in which capacity is typically deficient or highly uneven). A 2002 management review of the PRSP, an instrument adopted mainly in Africa, further underlined the lack of capacity and the inability to use existing capacity effectively, as the key factors in limiting the preparation, implementation, monitoring and evaluation of PRSPs. In this perspective, the presence or absence of gaps in capacity was seen as rooted in the political economy of the affected countries.

Capacity concerns have been expressed consistently and on a number of occasions: at the 2001 meeting in Doha, the question of trade-capacity building engaged further discussions on the knowledge and skills that countries need to exercise effectively prior to and upon accession to the World Trade Organization (WTO). These include the severe supply-side constraints that countries – mainly in Africa, the Caribbean and the

Pacific – are facing, including those related to infrastructure, transport logistics and customs, but also the policies that need to be implemented for effective benefits in the current trading system.

At the conclusion of the 2002 Monterrey Financing for Development Conference in Mexico, it was agreed that without scaled-up capacity for human, organizational and societal change, the development impact would be minimal.[3] The question of the partnership between developed and developing countries required specific capabilities in both groups of countries. In Johannesburg in 2002, the call for institutions that will allow the world to achieve sustainable development was the issue.

The emerging global consensus on capacity for development brings together a number of strands and assumptions. It includes the following key principles:

- Go beyond individual skills building: while skills are embedded in organizations and individuals, it is institutional incentives (the 'rules of the game') which ultimately shape their retention and utilization, the scalability and sustainability of any efforts to nurture capacity on a national scale;
- Recognize the need for harmonization: supply-driven approaches, often characterizing the capacity-building inputs from donor agencies, are not by themselves sustainable in nurturing pre-packaged solutions for capacity enhancement, and too often use practices that are not harmonized (an analysis done by the World Bank's CDF Secretariat found that this is the least harmonized of all development aid categories);
- Focus on country demand: demand-led approaches – those which emphasize country ownership, local participation and a focus on results (capacity for what and for whom) are more pragmatic and achievable as they give voice to key stakeholders, and institute more transparent processes;
- Develop evidence-based processes that build on transparency and accountability of decision-makers and allow policy formulation and implementation that is sensitive to political dimensions of reform, helping to develop an accepted culture of evidence-based processes of policy formulation and implementation; and
- Pay attention to time horizons for results: it is critical to be aware of the timeframe in which change will take place (keeping in mind the need for political commitment and consensus) as well as the timeframe within which achieving such results is realistic. For donors that means staying the course and supporting longer-horizon activities linked to short-term results.

An approach conducive to the achievement of demonstrable results, and therefore emerging from both supply- and demand-side considerations, requires a partnership between developed and developing countries, drawing on specific capabilities of the two groups of countries. Developing countries would be expected to have governance systems in place, ensuring accountability and transparency. Also needed would be a detailed poverty strategy; the ability to shape and implement that strategy; the ability to manage the achievement of development outcomes and to focus on the attainment of concrete results by the acquisition and use of skills and systems to collect and process relevant data. This includes systems of monitoring and evaluation and statistical capability, as well as independent think tanks and research-based reporting.

Developed countries were called upon (in 2002 at the Monterrey conference and in Johannesburg, South Africa) to act in ways that would enable the international community to achieve the goals of sustainable development. This reflected a growing recognition that donor practices can play a facilitating role or, through policies and procedures that are too diverse, burden and delay the emergence of national capacities. Hence the call for collective action institutions to facilitate the necessary choices and trade-offs across locations and generations, as well as to adopt policies which promote inclusion, diversity and integration.

3. CHALLENGES FOR THE WORLD BANK

3.1 The World Bank is Taking a Leading Role in Implementation for Results and Focusing on Using Various Modalities for Scaling Up Measures for Capacity Enhancement

While much has been written and debated, especially since 2002, about the importance of capacity building and how to enhance it, a watershed was reached in January 2003, when the Implementation Forum of the World Bank Group identified capacity enhancement in client countries as a key factor in increasing development effectiveness.

Factors that contributed to success in capacity building are viewed as essentially the same as those that contribute to good development assistance: (a) good strategic positioning based on sound analytic work, (b) ownership, (c) attention to quality at entry, (d) supervision and results in providing Bank support; and perhaps most important, (e) a willingness to stay the course.

The evidence indicates that workmanship quality issues are crucial in that we would need to subject 'capacity enhancement' to the same quality filters as our other strategic goals. The review further suggests that effective donor coordination is even more important on this score than on other issues, possibly because of the large number of donors that are usually involved in capacity building and the potentially perverse mix of accessible grant funding, diverse roles of external consultants, and conflicting agendas.

3.2 The World Bank Has Made Use of a Number of Instruments to Move Capacity Enhancement into Operations' Mainstream

- Project components in loans and grants, such as the work the World Bank has been doing in strengthening the highway sector in China, which over a ten-year period has led to a transformation of the procurement, planning, and highway maintenance systems in the country. This includes products such as policy adjustment loans, poverty reduction strategy credits, structural adjustment loans, sector investment loans, learning and innovation loans, adjustable programme loans, community-driven development loans, and sector-wide adjustment programmes (SWAps);
- Self-standing technical assistance, including the Reimbursable Technical Assistance instrument mostly in use in the Middle East and North African (MENA) region, but also including trust-funded activities, bilateral aid components that support capacity building (such as the UK Department of International Development's [DFID] support in China), and all the technical capacity-building work in trade (which was about USD 400 million in FY2002);
- Analytical and advisory services with capacity enhancement as an objective, which includes products such as participatory economic and sector work (ESW), Institutional Development Facility (IDF) grants, and diagnostic work such as investment climate assessments (ICAs), knowledge assessment methodology (KAM), and integrated framework (IF) diagnostics, to name a few;
- Learning activities including client training activities, scholarship programmes, workshops, clinics, seminars, global dialogues, research work done jointly with clients, field visits, and institutional twinning arrangements; and
- Creating self-sustaining networks to expand knowledge sharing, such as the work done by the Global Development Learning Network (GDLN), the Development Gateway, the research networks supported under the Global Development Network (GDN), Communities of Practice such as the Regulators Network, and support to the African Economic Research Consortium (AERC) and the African Capacity Building Foundation (ACBF).

4. THE WORLD BANK'S CAPACITY ENHANCEMENT BUSINESS MODEL

The basic elements in the Bank's business model for capacity enhancement are geared toward regional approaches (such as the Nile Basin Initiative) and country-level approaches; they are based on the Poverty Reduction Strategy Paper (PRSP) and rely on the poverty-reduction support credit (PRSC) as the lending instrument to further Country Assistance Strategies' (CAS) objectives in low-income countries. Other elements include focused policy notes for middle-income countries (MICs), and the support framework for low-income countries (LICUS).

4.1 Regional Strategies

Mounting strategies for capacity enhancement requires taking stock of the lessons of experience within both national and regional contexts and incorporating into their design allowances for known constraints, bottlenecks and gaps, as well as resources and institutional assets. The plans elaborated for such a strategy in Africa are a case in point.[4]

The approach relies on analytical work and diagnostic indicators, with a focus on political economy, to guide realistic actions for enhancing capacity. Both demand- and supply-side measures are considered in order to overcome the binding constraint of 'state capacity'. The report implies that donors may need to rethink how to structure and harmonize technical cooperation and for countries to take ownership of their own capacity-enhancement strategies. The approach acknowledges that countries with differing levels of national consensus for change, varying capacity for their leaderships to demonstrate political will and commitment, and differences in their implementation capacity, have as a result varying levels of baseline resources. This range of different starting points suggests different strategic perspectives:

- In countries with *strong baseline characteristics* (for example, Tanzania, Ethiopia, Burkina Faso) the focus can be on incentives to attract and retain capacity; on strategic restructuring at the level of specific organizations; and on providing programmatic finance for qualifying capacity-enhancement plans, implemented at the lowest possible level;
- Countries where the *bureaucracy is weak or unresponsive* (for instance, Mozambique, Madagascar) may require a more narrow set of interventions, focusing on expenditure accountability, quick-win reforms in support of the service delivery objectives contained in the

PRSP; and support for intervention opportunities that shift resources and accountability downwards; and

- *Borderline and countries under stress* (for example, Malawi, and Republic of the Congo) would focus on expenditure reporting and transparency, islands of opportunity that help articulate demand and create some measure of accountability.

Such strategies call for intensified analytical work to diagnose and monitor country-specific contexts, and work with selected country teams to build capacity as one of the organizing principles of Country Assistance Strategies (CAS). This approach acknowledges the role a learning and knowledge infrastructure can play in enhancing capacity by tapping into both global and indigenous knowledge.

4.2 Customizing Capacity-enhancement Products

A better understanding of the kind of services that can be made available to clients, and in what contexts, also helps better gauge the scope and breadth of the task at hand. The findings from the Africa Capacity Building Initiative indicate that we can move toward a customized approach that recognizes differential starting points:

- Middle-income countries generally would have in place strong starting points on a number of dimensions. This leaves room for the Bank to work with them on a number of issues such as incentives and motivation systems; participatory processes that allow clients to bring in the private sector, the research community, non-governmental organizations (NGOs), and the public sector to improve the buy-in for reform; strengthening the organizational capacity at specific points such as a ministry, a department or agency within a ministry, or local government and community levels; supporting programmatic finance instruments to back changes such as civil service pay, monitoring and evaluation systems including data and statistical capacity, and trade capacity building; and helping countries with complex research and policy questions.
- PRSP countries generally would have good political commitment and a good degree of consensus and ownership, partly because of the instrument and process of getting to a PRSP. They would, however, have weak bureaucracy or administrative capacity that needs to be strengthened. In these countries the capacity-building entry points could include expenditure and revenue systems, addressing questions such as efficiency, transparency and accountability; service delivery

modalities to show rapid results; long-term investment in skills building and access to knowledge of what works (which seems to be one of the strong points of the South-to-South Learning approaches that are embedded in the PRSP process); and help in specific strategic institutions that work in the area of enforcement and accountability, as well as those that lead to prioritization and choice.

- Low Income Countries Under Stress (LICUS) would typically have weak political commitment, very little degree of consensus and severe gaps in administrative capacity. The shocks that these countries go through and opportunities for peace or breakthroughs present the main entry points for interventions. A sample of interventions for enhancing capacity could include focusing on improving the expenditure management and revenue collection systems with activities to improve reporting, transparency and allocation systems; creating the demand for good governance by working with communities, the media and NGOs; looking to get quick results on services by working with the private sector, faith-based institutions or communities, and working in areas that are politically feasible; and tapping into external capacity (for example, working with diasporas and using incentives for repatriation), as well as tapping into the coordination potential from donor harmonization.

4.3 The World Bank Institute's Capacity-enhancement Response

Beginning in FY2002, the World Bank Institute (WBI) embarked on a new strategic direction, moving from a training institute specialized in thematic training offerings to a capacity-building institute with a wider array of products and services, and becoming much more closely integrated with the rest of the World Bank Group, to deliver demand-driven products and services at the country level. WBI has been given the mandate, as an operational vice-presidency, to champion the Bank's capacity-enhancement agenda.

To that end, it has (a) restructured its functional units and management structure to achieve closer alignment with the Bank's regional operations, research and policy groups, and to be more responsive to client demands; (b) aligned the content of its thematic learning programmes closely with the Bank's strategy of investing in people and promoting broad-based growth (a process that is ongoing, as Bank priorities evolve and become more closely aligned with internationally agreed development goals); and (c) introduced new products and services to support country clients and Bank teams in designing and implementing capacity-enhancement strategies and activities.

By redirecting its efforts, the WBI's business model now rests on three operational goals: (a) *greater impact* of products and services through closer alignment with country operations and customization of its products to country needs, as well as the dynamic effect of networking various stakeholders at the country level; (b) *greater reach*, through partnerships and technology (including video and Internet use, web-based e-learning, and digital radio), to a wide range of stakeholders at national, regional and local levels including the executive branch, legislative branch, private sector, research communities, and civil society; and (c) *greater effectiveness* by focusing on results through better measurement and monitoring of results, and efficient use of resources.

In delivering on this mission, the main business lines of the WBI now include:

- Capacity-enhancement support services such as advice to client countries and Bank teams on the design of capacity-enhancement interventions at the country level;
- Thematic learning programmes including courses, seminars and communities of practice using face-to-face, distance learning and blended approaches;
- Web-based learning products such as on-line dialogues, a capacity-enhancement website (at www.worldbank.org/capacity), and the Capacity Enhancement Advisory Service desk (reached via e-mail at capacity@worldbank.org);
- Diagnostic tools such as governance diagnostics and indicators, capacity-enhancement needs assessments (CENAs) and knowledge assessments; and
- Evaluation and certification programmes including evaluation of learning programmes for clients and Bank staff.

For planning purposes, the WBI is using a new programming tool, the Country Program Brief (CPB) to ensure multi-year financial allocation for its country programmes. The CPB reflects country priorities and describes how the WBI will contribute to the broader Bank effort in a specific country; it also serves as an internal instrument for allocating resources for delivery in that country. The CPB is prepared in close collaboration with the Bank's country team and is formally adopted only after endorsement by the team. Altogether, 18 Country Program Briefs (CPBs) were approved in FY2003.

The use of priority client country categories (MIC, PRSP and LICUS) to better define levels of need, provides the WBI with greater flexibility than in the past for adapting its offerings to specific needs. As a result of this approach, the WBI has begun to acquire the nimbleness required for supporting operations, exemplified in the following synopsis of capacity-enhancement activities for FY2003:

- Leadership development: at the request of the President of Madagascar, a four-day learning retreat was organized for the incoming and relatively inexperienced members of the Government of Madagascar, a meeting aimed at fostering an intensive South-to-South exchange focused on improving the investment climate and governance. That event brought together senior experienced policy practitioners at national and local levels from Asia, Eastern Europe, Africa and Latin America. The WBI expects to broker similar events in other countries.
- Knowledge adaptation: in 2002, the WBI delivered just-in-time knowledge transfer to Ethiopia, in support of its information and communication technology-driven capacity-building strategy. A multipdisciplinary mission reviewed Government plans for ICT use in schools and district government. This was followed by a Video-Based Learning Event carried out using the Global Development Learning Network (GDLN) with practitioners involved in similar projects in Barbados, Jamaica, Canada and Jordan, in which Ethiopian counterparts were brought together with representatives of ministries of education, media and telecommunications to discuss capacity-building implications in their projects, and to exchange first-hand experiences.
- Self-sustaining networks: in the MENA region, the WBI managed the evolution of the Mediterranean Development Forum, which now includes new and more diverse partners, toward providing a platform for discussing policy issues between local think tanks, civil society organizations, and policy makers. This promises to be a useful forum to tackle the new regional challenges and opportunities in the post-Iraq war period. The Dubai meetings were instrumental in building on this initiative to strengthen partnerships and focus them on the emerging issues of the MENA region.
- Opportunistic support post-conflict: in the context of partnership in the Bank-wide LICUS Initiative, WBI co-sponsored a seminar series and reached out to diasporas. It has been especially active in two LICUS countries: Sudan and Somalia. In Sudan, the WBI is the major Bank partner to Operations in the design and implementation of the Reengagement Strategy. Capacity enhancement is at the core of the strategy, and the WBI is taking the lead in developing a multi-donor Country Capacity Enhancement Strategy. Based on progress in these areas, training programmes were delivered (a) in planning and management of public resources for the Government of Southern

Sudan, and (b) in orientation, policy design and analysis in preparation for an interim poverty reduction strategy paper (I-PRSP). In Somalia, the WBI is responding to capacity-enhancement needs in specific priority sectors, such as economic planning.

- Trade capacity building: the WBI provided a substantial response to the challenge of capacity enhancement for trade. Prior to Cancun, the WBI had focused on delivering trade capacity building (TCB) support in client countries to strengthen institutions, skills and knowledge to: (a) formulate and implement sound trade policies; and (b) participate effectively in regional and international institutions and negotiations – currently the Doha negotiations. TCB lending approvals have doubled in recent years, with learning programme growth concentrated in low-income East Asia and Pacific (EAP) and African countries. In the last two years the WBI increased its deliverables in TCB from 17 to 26 and increased the number of staffers working on trade from one in FY2001 to six in FY2003. We expect learning events to expand 26 per cent in FY2004 as regional preparations for Doha negotiations continue; we also expect increases in WTO accession training and other specialized country programmes at the country level.

4.4 What is the Role of Partnerships such as the Joint Vienna Institute?

Over the FY2000–03 period, the World Bank Institute has steadily expanded its reach for building capacity in client countries. This has been accomplished primarily through learning events and other products, with offerings increasing by some 22 per cent from 587 in FY2001 to 715 in FY2003. Participants attending these events have similarly increased by 21 per cent from 48 000 in FY2001 to 58 000 in FY2003. Training days went up from 209 000 to 238 000 during the same period.

The reasons for such high increases include, first, shifts in the mode of delivery to use distance learning and e-learning. In FY2000, 98 per cent of the WBI's learning offerings were provided on a face-to-face basis. Utilizing investments made in technology over the past years, the WBI now provides about half its offerings via distance learning through GDLN, through partner institutions utilizing their distance-learning networks, and via the Internet. The second reason is the WBI's working with partner institutions in-country to deliver the learning programmes. Offerings with partners grew from 278 (53 per cent of all deliverables) in FY2001 to 365 (49 per cent of all deliverables) in FY2003. The increase in the absolute number of deliverables with partners coupled with a reduction in the share of deliverables with partners is temporary due to the WBI's shift to country focus, which requires a transition period before all partnership agreements can be renegotiated.

The Joint Vienna Institute (JVI) contributes to this scaling up of activity in three ways: (a) as a partner in delivering learning programmes particularly in the transition and accession countries; (b) as a partner for delivery where one can combine face-to-face and distance-learning techniques using the technology investments made to date; and (c) as a link to capacity-building institutions in the transition and accession countries, such as the training institutes JVI works with. With the potential now in place, it is possible to seek even further scaling up of activities.

The Joint Vienna Institute and the WBI have worked as partners for many years. On behalf of the Bank's International Bank for Reconstruction and Development (IBRD), the WBI was one of the original parties to the agreement that established the JVI. Examples of our cooperation cover a vast array of sectors and topics, and include WBI input into the bi-annual Applied Economic Policy courses, the Balkan Forum in Baden, post-conflict reconstruction in Bosnia and Herzegovina, vision and competitiveness in South-East Europe, water resources in MENA, and sustainable development programmes for Rural Poverty Programme aimed at Africa and Latin America. We remain interested in, and look forward to, delivering future learning programmes with the JVI, and hope to make good use of the upgraded facilities, including the new video conference technology. Looking ahead, we see at least two areas for possible expanded collaboration between the JVI and the WBI. First, there is opportunity to combine the upgraded JVI learning delivery facilities with content from strong Austrian institutions with relevant expertise in key development areas. Such teaming up on substance and dissemination has proved very relevant and sustainable, and capable of producing replicable and cost-efficient learning events in other countries. And given Austria's long involvement in international development, there would seem to be a vast potential to achieve similar results there. Second, we could examine the feasibility of greater involvement of local partners from client countries in the design and delivery of JVI capacity-enhancement activities. Here the use of cost-effective multimedia technology, including the use of GDLN, can be a powerful tool.

5. LOOKING FORWARD: CHALLENGES AND OPPORTUNITIES

How do we improve the impact of capacity enhancement embedded in projects?

Given the large number of projects and teams that embed capacity enhancement in their projects, this will be a challenge. There are a lot of opportunities if one uses instruments already in place such as the Multi-Sectoral

Team (MTL) learning programme, which is aimed at building the capacity of teams, but now focuses more on team-building behaviours. Supporting country teams to understand the types of tools that can be used for capacity enhancement would also go a long way toward making such inputs more strategic.

How do we design processes that allow learning and scaling up?
Because the challenge of capacity enhancement is so critically linked to that of scaling up, the WBI will lead the process in the Bank to have a year-long learning effort to document what it takes to achieve large-scale poverty reduction at the country level. This effort will culminate in a two-day conference in Shanghai in May 2004, where the lessons learned will be presented. Not only will this effort result in a documentation of the key lessons, but also the process of extracting the lessons is aimed at enhancing the capacity of countries to learn for themselves. The entire effort is focused on working with local researchers, policy makers and practitioners, who then share their results with peers in other countries, enhancing their own learning while sharing their lessons learned. Because of the focus on success and failure, the approach is expected to yield rich dialogues that can be reused over time for designing interventions.

How do we sustain long-term support for fundamental change at the country level?
Whether we call it capacity enhancement, capacity development or capacity building, what is being fundamentally addressed is change – fundamental change over a long period of time. It may take 50 years to build capable institutions. And they must be built differently, in different places and at different times.

How do we enhance South-to-South learning?
The lessons learned from the PRSP fora indicate that there is a lot of potential in South-to-South learning. The Shanghai effort described above taps into this possibility. Engaging in South-to-South learning is costly and requires networks to be sustained over time. Fortunately, as a result of investments in GDLN, the Gateway, and GDN, as well as the broader use of other technologies, a larger number of countries are now better able to communicate, exchange information, and learn from each other about what works and what does not. A good deal of what the World Bank now does with these technologies contributes to increased participation at all levels: in planning; in policy and decision-making processes surrounding the preparation of PRSPs; in implementing complex reforms and projects; and in making decisions that affect future generations in terms of the

environment, education, and the welfare of children and youth. More needs to be done, however.

Can we get better impact by refocusing the WBI's products and services?
What the World Bank delivers in the way of capacity-enhancement services through the WBI is an important element for increasingly giving voice and participation opportunities to many more stakeholders than was the case a few years ago. A lot remains to be done for sustainability and more mainstreaming, but significant inroads have been made and there is reason to be confident that with the new business model, the reach, impact and effectiveness of our interventions can be expanded. Success will require the WBI to work even more closely with clients and link up with the Bank's lending operations.

What additional benefits can we get from the harmonization of practices around capacity enhancement?
Initial use of the term 'harmonization' dealt with diverse procedures and requirements from different donors resulting in an inability of borrowers/grantees to fulfil all reporting obligations for projects and programmes. The results of this burden on countries appear to be the same as when borrowers are 'without capacity' to complete development activities in an effective way. The burden of development management is heavier due to the diversity of multilateral and bilateral requisites. Harmonizing procedures would 'enhance capacity' by making it possible for countries to complete these management tasks. The Comprehensive Development Framework (CDF) report on how donors collaborate indicated that capacity enhancement and building was the one area where there was the least coordination. If capacity enhancement is indeed the most crucial area for enabling clients to play their full part in their own development scenarios, partners and donors need to agree on what the essential prerequisites are for capacity enhancement to be delivered in the most effective and efficient way possible.

In what areas can multilateral and bilateral donors collaborate?
Lessons of experience from Vietnam, East Timor and Ethiopia seem to indicate that the most likely areas are those where it is possible to (a) avoid duplication, and (b) share the use of common national resources, according to criteria for which the borrowers' choices are factored in. Such resources can be material (infrastructure), informational (knowledge services, technical assistance) or social (thematic, social and professional networks). National authorities would have to contribute effectively to these criteria (for example, by adopting a demand-side agenda). Cases to date have been 'opportunistic' (no negative connotation intended). There is a need to

systematize the approach so as to determine the most effective entry points for collaboration in different country contexts. We could envisage using the MIC/PRSP/LICUS categories to respond more aggressively to the common but differentiated needs clients have for professional development management and personnel (public, private and civil society). The purpose of such collaboration/harmonization would be to spread the risk on capacity enhancement, especially given the assumption that capacity enhancement is the hardest to do and therefore carries the highest level of risk. Risk would be spread or shared not only between donors, but also between donors and national authorities and organizations. Movement on this dimension can be seen as recognition that capacity enhancement incorporates two mirror-image constraints: the one for clients focusing on their ability to use new/enhanced capacity to achieve results (MDGs) and the concurrent expectation from donors that they will be able to deliver these instruments without adding to the hurdles borrowers have to overcome in order for donors to consider them capable managers who are showing results.

Ultimately the challenge for the World Bank Group will be to marshal the resources to sustain and expand world-class products and services to help our clients meet the challenge of capacity.

APPENDIX 7A.1 CAPACITY ENHANCEMENT – MULTIPLE DEFINITIONS

Operational Policy Review and Dissemination (OPCPD): Approach note for taking stock of the Bank's capacity building. 29 July 2002	Capacity building is a dynamic investment with human, policy and institutional development components that interact over time; it is an investment that requires maintenance. A consensus is emerging on the key aspects of capacity building: • Involves development of individual human beings as well as institutions – rules, policies, knowledge and skills; • Requires ownership and participation from beneficiaries and stakeholders; and • Requires long-term and persistent effort. Institutional development helps improve and enhance a country's rules, enforcement mechanisms and organizations. Policy development strengthens the process in which good policies are generated and translated into concrete results – focusing on how to formulate, implement and monitor

(*continued*)

	policy choices. Human development focuses on sharing and disseminating knowledge and transferring and enhancing skills. While these activities are distinct from one another, when properly designed and implemented, the results they achieve are interconnected and mutually reinforcing
United Nations Development Programme (UNDP) Capacity for Development: New Solutions to Old Problems. 2002	Capacity is the '. . . ability to perform functions, solve problems, and set and achieve objectives'
United Nations Development Programme (UNDP): Capacity development technical advisory paper. 1997	Capacity building is the process by which individuals, organizations, institutions and societies develop abilities (individually and collectively) to perform functions, solve problems and set/achieve objectives
World Bank: 'Perspectives on Technical Assistance'. Operational Core Services (OCS). 1998	'Capacity development is as much about creating the ability to build capacity as it is about creating capacity itself in the form of formal structures and procedures'
Institute on Governance, Policy Brief No. 6 by Mark Schacter, January 2000	The UNDP and World Bank definitions (see above) 'suggest that capacity-building might be so all-encompassing a term as to be "useless" from an analytical and practical point of view. Helping societies "perform functions, solve problems and set and achieve objectives" covers virtually everything that a development agency might wish to do. "Capacity-building" is therefore indistinguishable from a common understanding of "development"'
World Bank, 'PACT Progress Report', 1997	Capacity building refers to the '. . . investment in people, institutions, and practices that will, together, enable countries in the region to achieve their development objective'
Elliot Berg, 'Rethinking Technical Cooperation', 1993	'Capacity building encompasses three main activities: (i) skill upgrading, both general and specific, (ii) procedural improvements, and (iii) organizational strengthening'

(*continued overleaf*)

Carlos Lopes, 'Globalization, Human Development and their implications for Capacity', 1999	Capacity development also refers to developing new kinds of capacities which includes utilization capacity (retention, retraining, conditions of service, empowerment, management skills and strategic planning); process capacity (participatory methods, process consulting, new forms of reporting, negotiation skills, feedback); connectivity capacity (networking, web capacity, appropriate information technology (IT) solutions, knowledge-based systems, organizational systems adaptation); resource mobilization capacity (new partnerships, new packaging, new formulas for funding, new actors)
Elliot Berg, 'Rethinking Technical Cooperation', 1993	Institutional development is 'Changing the incentive structure for individuals and organizations to induce personal and bureaucratic change. Enhancing skills by training and education; strengthening organizational performance; reforming systems or procedures for coordination between organizations; increasing financial capabilities including stronger revenue generation; nurturing social support, encouraging user groups, encouraging greater transparency; cultivating new norms and values. Institutional development implies a fundamental social change and transformation of patterns of behaviour'
Overseas Development Assistance (ODA) Evaluation Department. 'Evaluation summary 559'. By Chris Austin, London, 1994	'Institutional development is achieved through the realistic assessment of socio, political, cultural, budgetary, economic and legal frameworks in order to achieve greater success rates, and by adopting a multi-disciplinary (team) approach toward this end'
International Monetary Fund (IMF), 1994	Institutional capacity is 'shorthand for a country's administrative and management capacity, particularly with respect to implementing policies'
World Bank Technical Assistance Review Task Force. 'Managing Technical Assistance in the 1990s', October 1991	Technical assistance is 'the transfer or adaptation of ideas, knowledge, practices, technologies, or skills to foster economic development. The purposes of Bank technical assistance are classified as follows: (a) Policy development, (b) Institutional development, (c) Capacity building, and (d) Project or programme support'

APPENDIX 7A.2 SUMMARY OF DONOR PERSPECTIVES ON POOLING TECHNICAL ASSISTANCE

Agency	Approaches
Agence Française de Développement (AFD) (France)	Involved in a number of SWAps through parallel financing, but no formal policy; co-financing with other agencies is, however, now the rule
Canadian International Development Agency (CIDA)	Discussion paper for consultations with the Canadian public suggests greater involvement in programme approaches and more untied aid; already moving from heavy emphasis on project funding to increased involvement in SWAps, although most of this is still through parallel financing. Accountability regime encourages this because of emphasis on attribution of results to CIDA rather than to a group of International Development Associations (IDAs). Because of tying restrictions, CIDA is unlikely to become involved in significant budget support in the near future
Danish International Development Agency (DANIDA)	New paradigm, policy, likely to move toward more pooling and collaboration; untying proposed in ongoing policy review, although there is already greater flexibility than in the past. There are also discussions about the level of aid, with the possibility of increasing the ODA budget to 1.5 per cent of GNP
Department for International Development, UK (DFID)	New paradigm; SWAps are now the major way of working in 13 or more countries. DFID wants to develop strong programmes including budget support with countries committed to poverty reduction; budget support is increasingly preferred where feasible; DFID is strong advocate of harmonization
Directorate-General for Development (DGIS). Ministry of Foreign Affairs of the Netherlands	New paradigm, but recognition that major budgetary support is still ten years away; decrease in number of programming countries has created disbursement pressures in the remaining ones. Much interest in pooling and harmonization
European Commission (EC)	New paradigm, but there are major gaps between policy and implementation in general, with limited risk taking; new development policy in 2000 encourages cooperation with other IDAs

(*continued overleaf*)

Agency	Approaches
Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)/ Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ)	Considerable interest in SWAps. The Minister is known to favour programme-oriented approaches, but GTZ does not yet participate in the up-front joint planning of SWAps with other donors
Ireland Aid	Policy being reviewed, but there is informal support for the new paradigm. Irish aid budget will increase to 0.7 per cent of GNP by 2007. Seen by some other IDAs as innovative in its approaches
Finnish International Development Agency (FINNIDA)	New policy for development cooperation in February 2001 clarifies support for poverty reduction and sectoral programming. Involvement in SWAps normally through parallel financing rather than through common activities
Norwegian Agency for Development Cooperation (NORAD)	New paradigm, shifting from projects to programmatic approaches linked to national planning mechanisms such as CDFs and PRSPs. Strong emphasis on building competence and capacity internally – that is, internal institutional development
Swiss Agency for Development Cooperation (SDC)	Wants to expand involvement in SWAps – considers present involvement as experiment for new policy in two or three years. Strongly committed to harmonization
Swedish International Development Cooperation Agency (Sida)	New paradigm, with strong commitment to applying the principles of coordination, ownership, and so on, that underpin SWAps to other funding mechanisms; hence increasing emphasis on finding common ground between programme and budget support, for example the need for institutional strengthening and good governance. Also looking at long-term (ten years) budget support to selected countries

Use of technical assistance and SWAps

Agency	Guidance on SWAps	Status of technical assistance (TA), particularly with reference to SWAps
Agence Française de Développement (AFD) (France)	No	TA plays major role in French aid, although levels have declined dramatically over the last decade
Canadian International Development Agency (CIDA)	Some material in preparation	TA is integrated into projects and is not seen as separate entity, although during the 1990s between 28 and 33 per cent of bilateral assistance has been TA. TA is subject to untying limitations for the overall bilateral programme, although these can be waived in particular cases
Danish International Development Agency (DANIDA)	Yes	New guidelines with clearer statement on TA expected before end-2001. Concern about lack of impact of TA on Capacity Development. Emphasis on more analysis. DANIDA manages much TA including a lot of non-Danish expatriates. Pressure from the private sector to maintain more long-term TA
Department for International Development, UK (DFID)	Yes	DFID provides little long-term but considerable short-term TA and is free to match response to context using different forms of TA. Seen as being able to mobilize TA quickly. Pooling of TA may present problems because it is usually provided in kind through British expertise. Internal questions regarding the advantages of TA pooling over budget support
Directorate-General for Development (DGIS). Ministry of Foreign Affairs of the Netherlands	Yes	Policy framework for TA approved by Dutch parliament in 2000 confirming principles of ownership and free choice among relevant options for capacity development to be given to partner governments. Recruitment of TA as part of agreed programme in principle by partner government or by Netherlands Embassy after consultation with

(*continued overleaf*)

Agency	Guidance on SWAps	Status of technical assistance (TA), particularly with reference to SWAps
		government. The expectation is that this would lead to more considered choices and thus to a decrease in the volume of long-term TA. The unit managing TA in the Ministry has been abolished
European Commission (EC)	Yes	No policy. Tenders for TA (and other activities) are open to both EC and developing-country firms, but as the latter are usually unable to put forward the same quality of personnel, EC spends large sums on European TA. Developing countries analyse bids and make final decisions for large TA contracts, but the system for getting onto the TA list for ad hoc consultancies may not be sufficiently transparent. Difficult to mobilize short-term personnel quickly
Finnish International Development Agency (FINNIDA)	Ad hoc, as needed	No policy, provides considerable expatriate TA. Because TA is no longer attached to individual projects, the number of comptroller positions is being increased in order to ensure accountability
Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)/ Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ)	Being developed	Since TA is seen as valid only when linked to capacity building, gap filling is not possible. The role of GTZ probably limits moves in some countries to dramatically reduce or even abolish TA
Ireland Aid	Yes	Policy not specific, but Ireland Aid has gone from heavy reliance on TA in the early 1980s to virtually none in the late 1990s. The need for focused, demand-led positions is now recognized

(*continued*)

Agency	Guidance on SWAps	Status of technical assistance (TA), particularly with reference to SWAps
Norwegian Agency for Development Cooperation (NORAD)	Yes	Unwritten policy to avoid uncoordinated technical assistance by refusing to link Norwegian funding with the provision of national experts. Where expatriate assistance is required, it is rarely sourced in Norway. Believes that foreign TA is giving programme approaches an IDA-driven flavour. Government-to-government TA has essentially been abolished
Swiss Agency for Development Cooperation (SDC)	No	No policy, provides considerable expatriate TA in general, although the Mozambique office relies heavily on local staff
Swedish International Development Cooperation Agency (Sida)	Yes	No written policy, but has essentially done away with TA supplied on a government-to-government basis; opposed to IDAs recruiting TA for their own projects

Source: Baser and Morgan (2001).

NOTES

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2. Berg and UNDP (1993).
3. These reflected a recognition of the findings from the OED Review of IDA X to XII (covering 1994–2000), that IDA could have had greater development impact over this period if more attention had been paid to capacity building.
4. Sarris and Nair (2003).

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8. The changing institutional needs of the transition economies and the role of the IMF

Saleh M. Nsouli[1]

1. INTRODUCTION

Since its establishment in 1992, the Joint Vienna Institute (JVI), through the training of officials, has been closely involved in the process of building market economies in transition countries across Central and Eastern Europe, the Baltics, Russia, and other countries of the former Soviet Union, as well as the transition countries in Asia. The JVI started operations at a time when transition economies faced acute needs in capacity building, and when many of them got off to a fitful start in the transition owing in part to the lack of appropriate institutions. The mission of the JVI – part of a strong collaborative effort – was to train policy makers who would foster the development of market-oriented institutions and design and implement policies in a market environment.

The objective of this presentation is to take stock of the efforts, in particular those of the IMF and the JVI, to reinforce institution or capacity building in transition economies. In this chapter, I will first underscore the importance of developing sound institutions, pointing to the extensive evidence in the literature that sound institutions contribute to improved economic outcomes. Second, I will review the evolving needs of transition economies in capacity building; the focus will be on some of the major gaps initially facing transition economies and how these have changed over the past decade. Third, using the recent UNDP framework on capacity building, I will explain how the operations of the IMF provide a unique model in capacity building. Finally, I will examine the role that the JVI has been playing in training officials from transition economies in terms of institution building, and how the changing institutional needs of transition economies will affect the training that the JVI offers.

2. THE IMPORTANCE OF BUILDING INSTITUTIONS

When Friedrich August von Hayek was awarded the Nobel Memorial Prize for Economic Science in 1974, the committee cited his 'penetrating analysis of the interdependence of economic, social and institutional phenomena'. Another prominent Austrian economist, J.A. Schumpeter, also saw 'the subject matter of economics' as 'essentially a unique process in historic time' (Schumpeter, 1954). These two leading Austrian economists pointed to the fact that economic systems are evolving over time, and recognized that the understanding of institutional dimensions of economies at particular points in time is essential to good economic analysis. Indeed, enabling institutions – such as legal systems and secure property rights – provide incentives for the development of markets in which private agents can make efficient use of the information available to them. The notion of evolving institutions is central to our understanding of the progress made in transition economies so far and the challenges that still lie ahead.

Another Nobel Laureate, Douglass North, has been more specific in defining institutions as the 'rules of the game of society' (North, 1997). These rules provide the framework of incentives that shape economic, political and social organization. Institutions consist of formal rules (laws, constitutions, rules), informal constraints (conventions, codes of conduct, norms of behaviour), and effective enforcement. The usefulness of institutions, in turn, depends on the capability of their administrators. A broad range of institutions must be in place for market economies to function effectively. In particular, governments must be able to establish and enforce critical rules of the game, bring necessary corrections to and controls over the private sector, enforce contracts and protect property, and mobilize revenues to finance public sector activities. To carry out these tasks, governments require sound institutions run by qualified individuals who are guided by correct incentives. Thus, the goals of those managing the institutions must be aligned with the goals of the institutions, which themselves must be consistent with the public interest. However, such institutions 'do not arise by magic; they need to be created and, once created, continually reformed' (Tanzi and Tsibouris, 2001). This is the task of capacity building.

A rapidly growing body of research provides empirical evidence that the development of institutions is a key ingredient for economic growth. Rodrik (1997) shows that institutions played a crucial role in East Asia's economic performance, and that differences in institutional quality help explain why some countries have done better than others. According to Rodrik, an index of institutional quality that combines measures of the quality of the bureaucracy, the strength of the rule of law, the risk of expropriation, and the risk of repudiation of contracts by government performs very well in explaining growth differentials across countries – differentials which cannot be attributed to classical variables such as capital accumulation, technical progress, and increases in labour.

More recent research compares the relative performance of high-quality institutions with other growth-promoting factors, namely sound macroeconomic policies and trade openness, in explaining economic growth. Rodrik et al. (2002) look at the contributions of institutions, trade, and geography in determining cross-country income levels and find that the quality of institutions matters most. Acemoglu et al. (2002) examine the effects of distortionary macroeconomic policies and the quality of institutions on growth and find that institutions also play the more important role in determining economic growth. The IMF's *World Economic Outlook* (IMF, 2003a) contributes further to the evidence that institutional quality has a significant impact on economic performance. Atoian et al. (2003) find that institutional factors, including good governance, influence importantly both the implementation of adjustment programmes and the macroeconomic outcomes.

On transition economies more specifically, governance and other market-supporting institutions have been linked to economic outcomes by Moers (1999) and Campos (2001). Havrylyshyn and van Rooden (2000) determine that the development of an institutional framework has a significant positive impact on growth, as does implementation of macroeconomic stabilization and broad-based reforms.

Strong institutions are also a prerequisite for building home-grown, nationally owned economic reform programmes in transition economies. The IMF's recent conditionality review (IMF, 2003b) concluded that weak ownership of reforms was at the heart of problems with the implementation of IMF-supported programmes in the 1990s in some transition countries. Strengthening institutional capacity in transition economies should make it possible to avoid these problems in the future and ensure that reform programmes are compatible with domestic political economy realities. But, the relationship between institutional development and ownership is a dynamic one because, as pointed out by Rodrik (1999), imported institutions cannot simply be 'grafted' onto the domestic context. If ownership is lacking, countries adapting their institutions in response to external incentives alone run the risk of falling back to ineffective institutional structures as soon as the external stimulus runs its course. Capacity building, however, can lay the necessary ground work for domestic ownership of the right kind of policies.

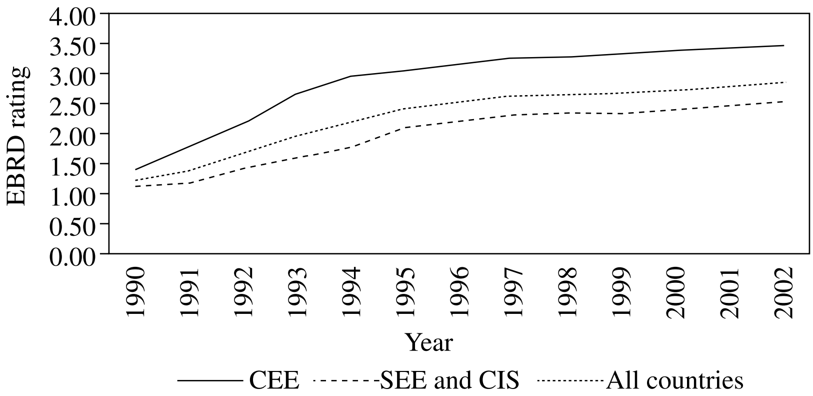
In sum, the development of institutions is critical to sound economic policies and favourable economic outcomes. To the extent that training contributes, as noted below, to building institutions at the level of the individual, it also affects countries' economic performance.

3. THE CHANGING INSTITUTIONAL NEEDS OF TRANSITION COUNTRIES

At the outset, transition countries had to contend with one of the most constraining legacies of central planning, namely the absence of an institutional and legal infrastructure underpinning the operation of market-oriented economies. Transition economies were characterized by poorly defined and insecure property rights, inadequate commercial legislation and competition policy, stunted financial markets, and taxation systems and accounting standards ill adapted to the workings of a market economy. Further, notwithstanding high levels of education in many transition countries, policy makers and administrators were for the most part unfamiliar with modern economic theory and with the design and implementation of policies in a market economy.

Not surprisingly, transition economies at the beginning of the process score very low on indicators of reform and institutional quality as measured by the standards of a well-functioning market economy. The European Bank for Reconstruction and Development (EBRD) has formulated a set of indicators that focus on the reform process, covering the reform of markets and trade (price liberalization, trade and foreign exchange system, competition policy); enterprise reform (small-scale and large-scale privatization, governance, and enterprise restructuring); and financial institutions (banking reform and interest rate liberalization, securities markets and non-bank financial institutions). On a scale of 1 to 4^+, with 1 representing conditions unchanged from those in a centrally planned economy and 4^+ conditions in an advanced economy, the aggregate EBRD transition indicator for all transition economies averaged 1.2 in 1990 (Figure 8.1).

Kaufmann et al. (1999) have developed six clusters of indicators, corresponding to Voice and Accountability, Political Instability and Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Graft. The indicators of Kaufmann et al., which range from -2.5 to 2.5 and begin in 1996, draw a discouraging picture. In 1996, the score for Government Effectiveness, which combines perceptions of the quality of public service provision and of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies, averaged -0.3 for all transition economies (Table 8.1 and Figure 8.2). The average indicator of Regulatory Quality, which measures the incidence of market-unfriendly policies, such



Note: 1. The transition indicator is an average of EBRD indicators covering the reform process, i.e., price liberalization, the trade and foreign exchange system, competition policy, small-scale and large-scale enterprise privatization, governance, enterprise restructuring, banking reform and interest rate liberalization, and securities markets and non-bank financial institutions.

Source: Transition Reports, European Bank for Reconstruction and Development.

Figure 8.1 EBRD transition indicator,[1] *1990–2002 (average by country grouping)*

as price controls or inadequate banking supervision, as well as perceptions of the burden imposed by excessive regulations, stood at −0.4. Similarly, the indicators of Rule of Law and Graft both averaged −0.4. The last two indicators suggest that agents in transition economies had little confidence or respect for the rules of society, including those related to the effectiveness and predictability of the judiciary and the enforceability of contracts, and that corruption represented a serious problem.

Finally, the International Country Risk Guide (ICRG) has developed a risk rating system that includes components reflecting Democratic Accountability, Law and Order, Bureaucratic Quality, and Freedom from Corruption. For Russia and a group of eight countries in Central and Eastern Europe (CEE), the ICRG indicators point to bureaucratic quality as one of the major institutional gaps in the late 1980s and 1990s (Figure 8.3).

These scores, however, mask some important differences in institutional quality at the outset among transition economies. The CEE countries and the Baltics started out with institutions that were stronger than those in South-Eastern Europe (SEE), and even more so, than in the countries of the Commonwealth of Independent States (CIS). Those countries closest to Western Europe had had a more limited experience of central planning

Table 8.1 Governance indicators, 1996 and 2002[1]

	1996	2002	1996	2002
	Government Effectiveness		**Regulatory Quality**	
CEE and Baltics	0.27	0.62	0.45	0.88
CEE	0.32	0.58	0.37	0.79
Baltics	0.16	0.69	0.62	1.06
SEE	−0.43	−0.48	−0.61	−0.22
CIS	−0.73	−0.86	−0.87	−0.85
Transition economies	−0.33	−0.28	−0.37	−0.13
	Rule of Law		**Control of Corruption**	
CEE and Baltics	0.24	0.63	0.21	0.42
CEE	0.30	0.65	0.41	0.46
Baltics	0.12	0.58	−0.20	0.33
SEE	−0.42	−0.54	−0.50	−0.58
CIS	−0.79	−0.91	−0.85	−0.96
Transition economies	−0.36	−0.31	−0.42	−0.42

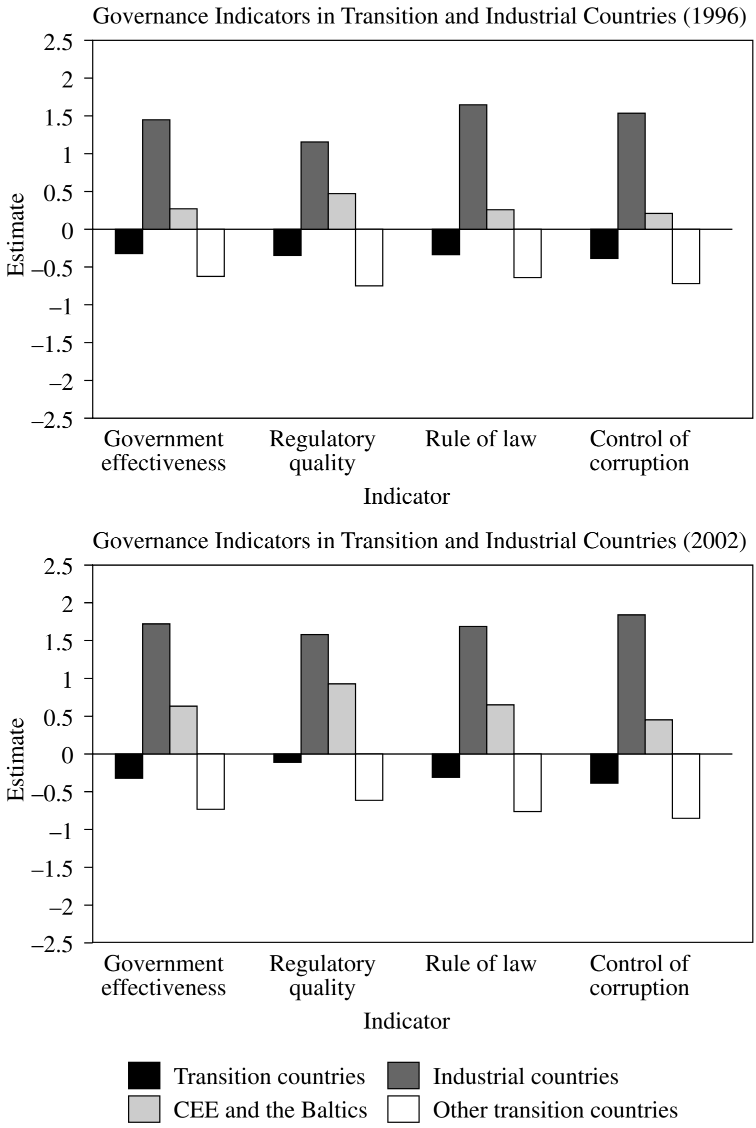
Note: 1. The governance indicators range from –2.5 to 2.5, with higher values indicating better quality institutions.

Source: Kaufmann, Kraay and Mastruzzi (2003).

and better memory of – and contemporary exposure to – market institutions. They had often known a longer period of sovereignty, and possessed legal and institutional traditions that emphasized the rule of law.

Against this background, many transition economies have made important strides in implementing macroeconomic stabilization policies and structural reforms. Progress in carrying out structural reform is illustrated by the consistent upward trend in the aggregate EBRD transition indicator since 1990. In general, reform has been most advanced in the privatization of small-scale enterprises, and to a somewhat lesser degree, in the liberalization of foreign trade and exchange and the elimination of price controls. Structural reforms have been least advanced in the regulation of the banking and financial sector, the development and enforcement of competition policy, the restructuring of large-scale enterprises, and the reform of governance in both the private and public sectors.

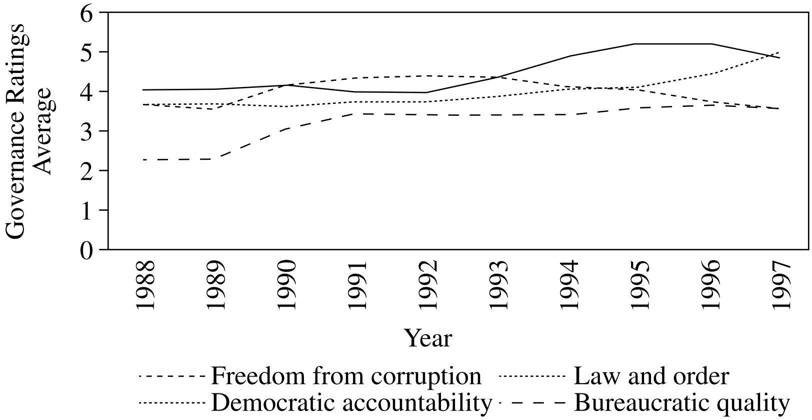
Some progress has also been made in developing an institutional framework supportive of a market-oriented framework. According to Kaufmann and his colleagues, all but one of the indicators of institutional quality (averaged over the transition economies) improved during the period 1996–2002,



Note: 1. These governance indicators range from − 2.5 to 2.5, with higher values indicating better quality institutions.

Source: Kaufmann, Kraay and Mastruzzi (2003).

Figure 8.2 Governance indicators in transition and industrial countries,[1] *1996 and 2002*



Notes:
The data cover eight countries during 1988–91 and nine countries (with the inclusion of Russia in 1992–97.
All the indicators shown range from 0 to 6.

Source: International Country Risk Guide (ICRG), PRS Group.

Figure 8.3 Governance ratings in transition countries, 1988–97

with the indicator of Regulatory Quality showing the largest gain. Within the smaller group of countries tracked by the ICRG indicators, perceptions of Democratic Accountability, Law and Order, and Bureaucratic Quality strengthened overall during 1988–97. The indicator of Freedom from Corruption initially improved, but then declined significantly, a signal of the increasing pervasiveness of graft in a number of transition economies.

There are, however, marked differences in the economic and institutional development of transition countries. On the one hand, CEE countries and the Baltics have substantially reoriented their focus towards Western Europe and put in the strongest economic performance among transition economies. In particular, their ratings of institutional quality have increased at a much faster rate than in other countries in transition. The rapid pace of change in CEE and the Baltics has been due not only to relatively favourable initial conditions, as noted above, but also to strong ownership of market-oriented reforms. Furthermore, the goal of accession to the EU provided the impetus for these countries to align their institutions with those of the EU.

On the other hand, economic and institutional reform in certain countries of SEE, and especially the CIS, has been much slower. Civil and external conflict in some countries, and the entrenched legacy of socialism and central planning in others, have formed serious obstacles to institutional development and weakened the efficiency of policy. In SEE, only one of the four indicators of institutional quality developed by Kaufmann et al. – Regulatory Quality – improved during the period 1996–2002. Across the CIS countries, these indicators, on average, remained roughly unchanged or worsened. In some countries, the efforts to reform institutions stalled, and special interests organized themselves swiftly (Åslund, 1999; Jones et al., 2000). These interests controlled key sectors of the economy and evaded taxes, obtained trade and other state protection from competition, and siphoned off public money. In general, where reforms have been partial and subject to reversal, they have not allowed the new institutions of the market economy to flourish, and have permitted vested interests to gain control over productive assets for private gain and to continue receiving special privileges.

All the transition economies, including those that have advanced most toward meeting the requirements of a well-functioning market economy, continue to face challenges in structural reform and institution building. A sense of the 'institutional gap' that transition countries must still close is given by a comparison of their institutional quality with that of industrial countries (Figure 8.2). Despite the gains that have been made, notably in indicators of regulatory quality, transition countries, to varying degrees, lag well behind industrial countries in terms of the quality of public bureaucracies and legal systems, as well as in control over corruption and vested interests. The specific reform agenda will vary in individual countries, but four areas that appear especially important are redefining the role of the state, strengthening the rule of law and establishing a level playing field for all economic agents, restructuring public enterprises, and building a well-regulated market-based financial sector.

This reform agenda differs substantially from the one at the beginning of the transition period, when the training of policy makers in macroeconomic management in a market-oriented environment was a priority, and will have an important impact on future JVI training programmes.

4. THE IMF MODEL OF CAPACITY BUILDING

Through a unique model of capacity building, the IMF contributes to capacity building and institutional development at several levels through its major activities (Nsouli, 2001). This section details the ways in which IMF operations support capacity building, with an emphasis on transition economies. The analysis is carried out within the framework developed by the UNDP in 1998. The framework identifies three levels of capacity building: the individual level, the organization or entity level, and the broader system or environment level.

The central idea is that a comprehensive strategy for building capacity should ensure that capacity is developed simultaneously at all three levels, as they are closely interlinked. A well-trained individual cannot operate in a vacuum. He needs to function in the context of an organization that provides him with the necessary support and which, in turn, draws on his expertise. But, even then, the effectiveness of the organization depends on the broader system or environment in which it operates. To maximize effectiveness, capacity at the three levels has to be sufficiently developed at any point in time so that no single level acts as a bottleneck (Hakura and Nsouli, 2003).

At the *individual level*, the IMF Institute, along with other departments of the IMF, provided relevant economic training for officials from transition countries. The IMF Institute offered a range of courses that was continuously updated; high-level seminars on policy issues of importance to transition countries; and regional workshops that were often conducted in collaboration with regional training institutes such as the JVI. The focus was to help officials from transition countries better understand the design and implementation of macroeconomic policies in a market environment. To reach a wider audience of participants and enhance the effectiveness of its training, the IMF Institute introduced in 2000 a Distance Learning course on Financial Programming and Policies. Over the last 20 years, the Institute has trained some 30 000 officials in courses at headquarters and overseas, more than 15 000 of whom were trained in only the last five years. The rapid increase in the number of participants reflects the rising demand for technical assistance and training from country authorities, in particular those from transition countries. During the period 1989–2002, the IMF Institute, together with other IMF departments, provided training to about 9300 participants from transition economies. Reflecting the differing levels of needs as well as population size, 61 per cent of these participants came from the CIS, 29 per cent from CEE and SEE, and 10 per cent from the Baltics (Table 8.2).

At the *organization level*, the IMF contributed to strengthening capacity in transition countries through its technical assistance (TA) programme. The IMF responded to the specific needs raised by transition countries in its areas of expertise, such as tax administration and policy, public expenditure policy and management, banking supervision, financial system assessment, assessment of compliance with anti-money laundering and countering the financing of terrorism, standards, and macroeconomic statistics. This assistance was provided by various departments of the IMF – the Monetary and Financial Systems Department (MFD), the Fiscal Affairs Department (FAD), the Legal Department (LEG), and the Statistics Department (STA). It targeted an improvement in the operations of various institutions. Within the fiscal area, this assistance focused on the establishment and operations

Table 8.2 IMF assistance in transition countries, 1989–2002

	CEE and SEE (12)[1]				Baltics (3)[1]				CIS (12)[1]				Total
	1989–91	1992–95	1996–99	2000–02	1989–91	1992–95	1996–99	2000–02	1989–91	1992–95	1996–99	2000–02	1989–2002
Technical assistance (person-years)													
Fiscal area	7.1	20.7	13.1	16.9	0	7.6	2.8	1.3	2.9	57.0	53.9	36.1	219.4
Financial sector	11.6	25.2	20.1	24.9	0.3	9.6	7.6	1.7	0.6	66.3	51.5	25.5	244.9
Statistics	1.2	4.9	4.5	7.5	0	5.7	0	0	0.8	22.1	21.6	9.8	78.1
Training[2]													
Number of participants	86	1053	822	777	0	314	314	303	0	2031	2299	1320	9319
Participant-weeks	706	3363	2654	1917	0	990	881	729	0	5640	5842	3337	26060

Notes:
1. Number of countries in parenthesis. Central and Eastern Europe includes Bosnia and Herzegovina, and the FR of Yugoslavia.
2. Includes training at headquarters, Joint Vienna Institute, and other overseas locations, as well as distance training. Data for 1989–91 include only HQ training.
   Data for overseas training in 1992 are for JVI only. Data exclude training by EXR and include training by FAD, LEG, MFD and STA only where delivered at HQ or JVI.

Source: International Monetary Fund.

of treasuries, and on the reform and implementation of taxation systems. The IMF also provided assistance for the creation of customs and tax administrations and the formulation of public expenditures, including the establishment of social safety nets and pension institutions designed to improve social cohesiveness. Within the financial sector, technical assistance emphasized modern management of central banks, the functioning of a multi-tiered banking system, the establishment of efficient payments systems, and the development of banking supervision and regulation. During the period 1989–2002, technical assistance to transition economies amounted to 542 person-years. Of this total, 40 per cent was devoted to fiscal issues and 45 per cent to financial sector issues; the remaining 15 per cent of technical assistance was centred on statistical issues (Table 8.2).

At the *system level*, the regular Article IV consultations with the transition countries can be viewed as having been and being a major channel for capacity building. In this process, the IMF and the authorities engage in a far-reaching dialogue involving a detailed analysis of the economy, a review of policy options, and the formulation of policy actions. These exchanges involve technical analysts, senior staff in key ministries and the central bank, and higher-level government policy makers. In part because they require a dialogue among these officials, IMF consultations prompt different agencies, as well as units within each agency, to collaborate more closely. These interactions contribute to building the country's capacity to analyse problems and design solutions.

The dialogue surrounding the design of Fund programmes and the monitoring of their implementation in transition countries represented another avenue for capacity building in economic policy management. Even more than Article IV consultations, IMF-supported programmes mobilize important human resources from member countries and other international financial institutions. This common effort greatly helps in strengthening core units of economic management, especially in ministries of finance and central banks. The build-up of expertise and knowledge among these units is cumulative, and, over time, creates increased capacity in many aspects of policy management. With the exception of Slovenia, Serbia and Montenegro, and Turkmenistan, all the transition countries have had Fund-supported programmes.

In addition to supporting capacity building at the system level through the avenues mentioned above, the IMF sets standards that provide a framework for strengthening the functioning of markets and institutions. These include the development and/or dissemination of standards and codes in areas central to its operational focus, namely, fiscal policy, monetary and financial policy, banking supervision, and the compilation of core macroeconomic data. These are embedded in the IMF's Code of Good Practices on Fiscal

Transparency (1998), the Code of Good Practices on Transparency in Monetary and Financial Policies (1999), the Special Data Dissemination Standard or SDDS (1996), and the General Data Dissemination System or GDDS (1997). A total of 11 transition economies now participate in the SDDS and seven in the GDDS.

As part of the efforts to ensure that the benefits of established standards are realized, the IMF, together with the World Bank, has undertaken an initiative to assess members' observance of the standards. At the request of a member country, a Report on the Observance of Standards and Codes (ROSCs), which summarizes the country's observance of the standards, is prepared and published. ROSC modules are prepared by the IMF and Bank in 12 areas that can be grouped into four main categories: data dissemination; transparency standards (focused on data, fiscal, monetary, and financial policies); financial sector standards (banking supervision, securities, insurance, payments systems, anti-money laundering and countering the financing of terrorism); and market integrity standards for the corporate sector (corporate governance, accounting, auditing, and insolvency and creditor rights). By preceding Article IV missions and later on being incorporated into the Article IV reports, ROSCs serve to raise the profile of institutional weaknesses in discussions with the authorities, proposing specific areas for improvement and better focusing technical assistance. As of end-September 2003, 133 ROSC modules had been produced for 18 transition economies.

Another IMF initiative that helped build capacity at the country level is the Financial Sector Assessment Programme (FSAP). The purpose of the FSAP is to improve the functioning of the financial services sector of countries. Under the programme, IMF staff members work with experts from national agencies and standard-setting bodies to identify the financial sector's vulnerabilities, evaluate its developmental and technical assistance needs, and to help prioritize policy responses. The FSAP includes assessments of countries' observance of relevant financial sector standards and codes. The FSAP also forms the basis for the Financial System Stability Assessment (FSSA), in which IMF staff assess risks to macroeconomic stability arising from the financial sector and the sector's capacity to absorb macroeconomic shocks. FSSA reports have been prepared and published for 12 transition economies.

In sum, the IMF supported capacity building in the transition countries at the three levels identified in the UNDP framework. IMF training directly targeted officials at various levels; technical assistance provided expertise in specialized areas; and Article IV consultations, the ROSC and FSAP processes, along with programme negotiations and implementation, assisted countries in designing policies, establishing priorities for action, and in making plans to ensure implementation. Moreover, the standards and codes elaborated by the IMF provided a framework for strengthening institutions and ensuring greater transparency.

5. THE JVI: PAST, PRESENT AND FUTURE

Early on in the transition process, the IMF, together with other international institutions and the Government of Austria, recognized the necessity of boosting the international community's efforts to build institutional capacity in transition countries. While there were many institutions, at least in the West, which could supply basic economics training, particularly to university students, there was a dearth of institutions that could quickly supply practical policy-oriented knowledge to already-employed public sector officials. The JVI was established in 1992 in order to fill this gap. Throughout the past decade, the IMF Institute has been actively involved in the programme of the JVI. The JVI provides an excellent example of how international institutions and governments can collaborate closely to help build institutions in countries in need.

The JVI programme was based on four objectives: (1) to provide comprehensive training over a wide range of operational issues and problems encountered in managing a market economy, notably as regards policy formulation and implementation; (2) to offer specialized training on specific topics within a regional context of commonly shared concerns and experiences; (3) to foster the development of networks of officials across transition countries; and (4) to provide opportunities for nationals of transition countries to gain a first-hand view of a developed market economy.

Since its creation, the JVI has established itself as the pre-eminent institution for training officials from transition countries who work on economic and financial issues. A total of about 15 000 officials have been trained, both from the public and private sectors. During 1998–2001, more than 2000 officials were trained each year at the JVI. Approximately 55 per cent of the participants came from the Baltics, Russia and other countries of the former Soviet Union. Central, Eastern and South-Eastern Europe accounted for another 30 per cent of participants, while Asia accounted for 15 per cent.

The courses offered at the JVI have covered a broad range of topics and have evolved over time with the changing institutional needs of transition economies. Courses on macroeconomics and financial programming, public finance topics, monetary operations and policies, external sector issues, and statistics have aimed at enhancing government effectiveness, that is, the ability of governments to design and implement good policies and to deliver public goods. One of the main course offerings of the JVI over the years – its long comprehensive course in macroeconomics – has undergone significant changes over the years to meet evolving needs. In 1999, it was completely reworked and reborn as the 'Applied Economic Policy Course', a shorter course, with more emphasis on practical applications. Other courses have focused specifically on regulatory quality, including selected issues in monetary and banking law, and banking supervision. Courses aimed at fostering a greater understanding of the rule of law have covered legal issues as well as parliamentary development and government accountability. Finally, courses such as those on government accountability and money laundering have served to increase awareness of the need to control corruption. Structural issues have been the focus of courses bearing such titles as 'Challenges of Structural Reforms: Design and Implementation', 'Competition Policy', and 'Financial Management of Privatized Enterprises'. Addressing the human skills needs in transition economies, several courses have emphasized human resource management, strategic management and leadership, and negotiating with strategic/private sector investors.

As noted in section 3, the changing institutional needs of transition countries will have an important bearing on the future direction of training at the JVI. The countries more advanced in the reform process – many of which are poised to join the EU – are becoming less and less dependent on the JVI for instruction on how to design financial policies in a market environment. However, these countries are encountering new problems as they become increasingly integrated with global capital markets. In response, the IMF Institute, for example, has taken steps to meet the needs of countries encountering problems with international capital flows by offering new, more advanced courses in finance and financial markets. With regard to the countries lagging in the transition process, a greater number of officials need to be trained and a greater focus placed on key structural impediments to reform. As officials from CEE and SEE have received better and more comprehensive training in their own countries and as many have had more access to other training (including from the EU), the demographics of the JVI's clientele are shifting further to the East. Thus, more emphasis will need to be given to courses on the problems of CIS countries. In general, apart from macroeconomic management, training in governance issues, transparency, standards, and financial sector regulation is likely to assume greater importance.

An important lesson from the past decade is that slow reformers lost precious time in the early years of transition. Even though their policies have been steadily improving in recent years, some CIS and SEE countries have not managed to close the gap, and the 'policy distance' between slow reformers and the advanced countries has remained roughly constant.

Thus, the JVI will need to intensify its efforts to attract even more qualified participants from the slow reforming countries.

A principal challenge for the JVI in the future is to extend its reach and make best practices in the fields of economic policymaking known to a broader array of officials. To further strengthen its contribution to capacity building, the JVI is already enhancing its presence in transition countries and its links with the international community. In addition to a full programme of courses and seminars in Vienna, the JVI is intensifying its cooperation with transition countries and international organizations. It has linked up with regional training centres, including the Centre for Excellence in Finance in Slovenia and the Tashkent regional training centre. The JVI is also cooperating with the Vienna Initiative for Central Asia, a pilot training project for regional government officials from Central Asia, and is in discussions with China's National School of Administration to host a training seminar for Chinese government officials in Vienna.

To return to the UNDP framework, JVI training should continue to be seen as but one critical aspect of capacity building – at the individual level. Such training will need to be complemented by continued efforts at the organization and country levels if its effectiveness is to be fully realized.

6. CONCLUSION

This chapter has focused on the changing institutional needs of the transition economies, and on how the IMF has been helping these countries develop their institutions. To this effect, four basic themes were developed.

First, the development of quality institutions is important for sound economic policy making and improved economic outcomes. Training is a key ingredient of institution building at the individual level.

Second, the institutional needs of transition economies have changed considerably over the last decade. There was, from the beginning, a dire need to develop the expertise of officials in the design and implementation of policies in a market economy, as well as to develop the institutional and legal infrastructure underpinning the operation of a market economy. Although progress has been achieved to varying degrees in both areas, there is an 'institutional gap' that transition economies need to close; this gap has a bearing on the prospective training requirements of these countries.

Third, the IMF has contributed to institution building in transition economies at the individual level through its training activities, including through its participation in the JVI; at the organization level through its technical assistance programme; and at the system level through its consultation process, the dialogue surrounding the design of adjustment programmes, and its work with countries on standards and codes. It is the complementarity of all these facets that makes the work of the IMF a unique model of institution building.

Fourth, the JVI has contributed to capacity building at the individual level in transition countries. As the institutional needs of these countries changed, JVI programmes shifted increasingly from an initial emphasis on policy management in a market-oriented economy to more specific structural reform areas. In the period ahead, as the institutional needs of transition economies continue to evolve, JVI training will have to give greater emphasis to governance issues, transparency, standards, and financial regulation, as well as to extend its reach to a broader range of officials.

NOTE

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9. Investing in human capital: experiences from OECD countries and policy lessons

Raymond Torres[1]

In recent years, growing interest has been expressed in human capital as an engine of economic growth and social cohesion. The OECD is no exception in this regard. Indeed, when discussing prerequisites for economic growth, back in 2002, OECD ministers particularly emphasized the importance of investing in human capital. There are good reasons for this: evidence suggests that education and training, two major sources of human capital, are associated with better economic outcomes. The debate is now moving beyond these overall assessments and into a policy debate: what are the implications for policy? If human capital is so good for the economy, why is it that market forces are not strong enough to promote investment in this area? What are the market failures involved?

The purpose of this chapter is, first to document recent evidence on the benefits of human capital, and second to address some of the policy issues outlined above.

1. WHY IS HUMAN CAPITAL SO RELEVANT IN TODAY'S ECONOMY?

Since the bulk of the existing labour force will still be in the labour market in 10 to 15 years' time, it is important to facilitate not only *initial* formal schooling, but to invest also in *continuous* vocational education and training. Due to rapid technological and organizational change, which necessitates a constant upgrading of workers' skills and a constant change of work practices, it has become necessary to rapidly invest in human capital in a lifelong manner. Most OECD countries are rapidly shifting towards an ageing society and this necessitates upgrading skills of older workers to prevent the social security system from collapsing. Workers are increasingly facing uncertainties of losing jobs, long unemployment spells, and difficulties in finding new jobs. Here, skills become the 'best' way to protect your job. In short, human capital is good for both the economy and social cohesion.

2. WHAT ARE THE BENEFITS OF ALLOCATING SCARCE RESOURCES TO HUMAN CAPITAL?

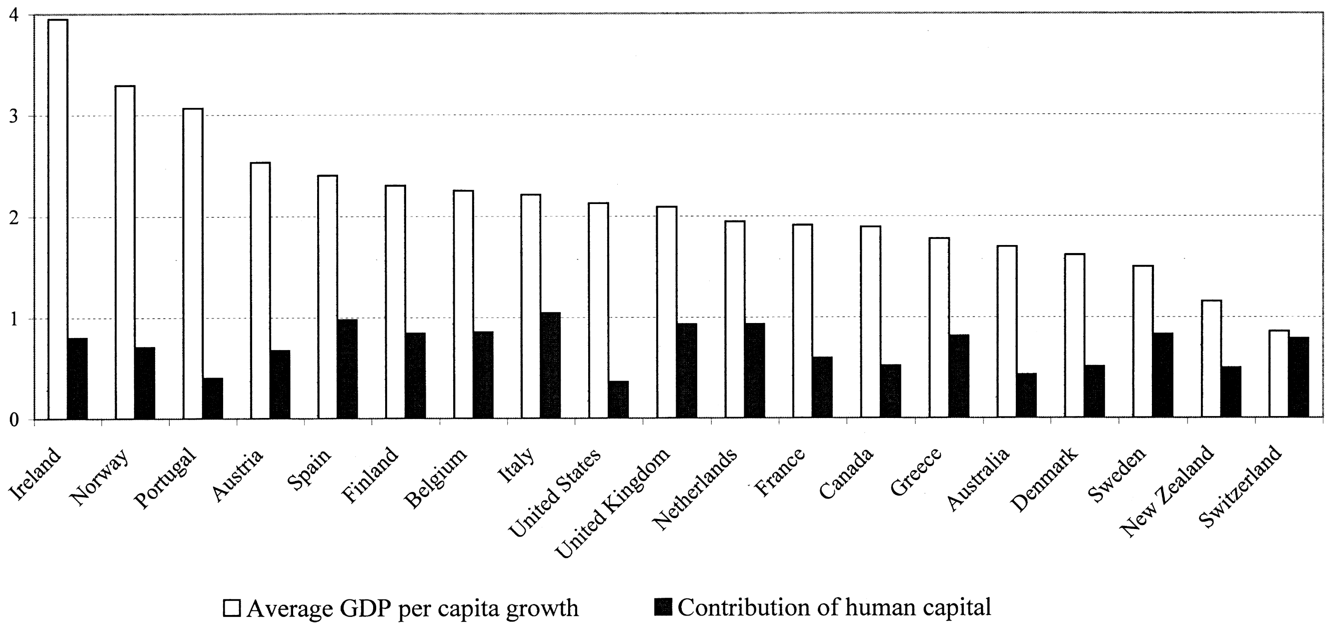
At the OECD, we have estimated that one additional year of average schooling will raise, in the long run, GDP per capita by about 6 percentage points. Indeed, human capital explains about 50 per cent of economic growth (Figure 9.1). Human capital provides important benefits at the micro level as well. Trained workers are found to face a much lower probability of unemployment, namely about half the unemployment probability of people who have not received proper training. When faced with unemployment, trained workers have a substantially higher probability of finding a new job. Furthermore, trained workers enjoy higher real-wage growth than non-trained workers (2.6 per cent higher than non-trained workers).

3. POLICY ISSUES RAISED BY THESE FINDINGS

Although investment in human capital has been shown to be good for growth, it is likely that market forces will lead to an under-provision of human capital due to a range of market failures. But one thing is clear: *policies are needed not just to ensure adequate initial education, but also to create an environment that is conducive to the continuous acquisition of the right skills and competences.*

The general framework for such policies was laid out in the mid-1990s by OECD Ministers, who endorsed a comprehensive lifelong learning strategy. This strategy lays a solid foundation in basic education, *inter alia* by raising completion rates in upper secondary schools (in many countries, over 20 per cent of every youth cohort are under-qualified when they leave the formal education system); places greater attention on school-to-work transition, with a view to spreading and fine-tuning responsibilities among schools, employers and young trainees; and develops the links between higher education and the labour market, for example by making higher education institutions more accessible to adults who wish to update their knowledge and competences (OECD, 2001). For example, in Australia (a relatively high-growth country) about 12 per cent of all enrolees in tertiary education are adults of 35 years and over.

As part of the OECD Growth study, Ministers have put a particular emphasis on the need for continuous vocational training, that is, on policies



Source: OECD (2003a).

Figure 9.1 The significant contribution of human capital to growth, OECD countries, 1970–98 (average annual growth rate, percentage points) to upgrade the skills and competences of adult workers. This emphasis mainly reflects the velocity of technological developments and the decreasing 'half-time' of technical knowledge, which require continuous re-skilling and up-skilling efforts by firms and individuals. This phenomenon may even intensify due to the ageing of the population in OECD countries, which requires increased skill formation of those already in the labour force, as in many cases systems of initial education and training are (or soon will be) no longer capable of producing sufficient numbers of graduates.

This emphasis led to a new OECD project called the Thematic Review for Adult Learning, in which numerous policy initiatives attempted by OECD member countries have been evaluated. Here, a number of policy recommendations have been suggested. They include actively diffusing information on learning opportunities, targeting disadvantaged groups such as older workers and low-skilled workers, and proposing new schemes that were found to be successful in some OECD countries (such as study leaves and innovative financing schemes).

Coming back to the OECD growth study, its concrete recommendations have focused on the following strategies: combating under-investment by providing wider training opportunities for adults, including the provision of tax incentives for human capital investment; improved recognition of competences acquired through formal and informal training; developing innovative instruments, such as Individual Learning Accounts or Training Time Capital; improving access of disadvantaged and lesser-skilled workers to training, in particular that relating to new technology; emphasizing employee involvement and effective labour–management relationships and practices, when re-organizing work and determining subsequent training needs.

From the above Growth study recommendations, let me single out two which have to do with financing arrangements and the role of social partners. First, to improve incentives for both firms and workers, it is crucial to *review financing arrangements*. Some governments intervene to alleviate the financial burden of training participants through various channels, such as direct subsidies, tax incentives and loans with preferential interest rates. What is also important are arrangements for study leave with a certain guarantee of wage continuation. Several countries, such as Denmark and Finland, have had promising results from job rotation practices, where incumbent workers may take training leave in exchange for an unemployed person hired to cover for the permanent member of staff. But one important feature of most existing arrangements is that they are mostly addressed to employers, whose training expenditure, and often labour costs of workers absent for training purposes, are partly covered by the government or by training fund schemes based on levies.

The result is that training opportunities are distributed unevenly. For example, according to the International Adult Literacy Survey, the ratio between workers with less than upper secondary education and those with tertiary education who benefit from continuous education and training is less than 1 to 2 in a large number of OECD countries, and even less than 1 to 3 in, *inter alia*, Belgium, Ireland, Italy, Poland and the United States.

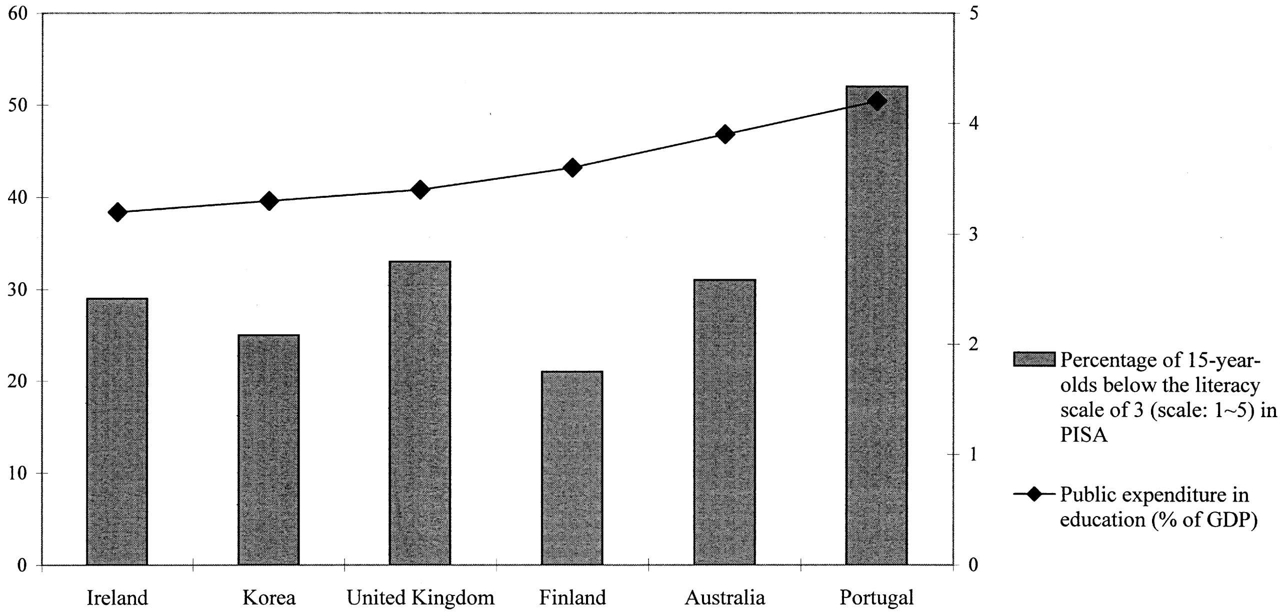
It is therefore worth pursuing innovative ways for sharing the costs of training between the different agents (government, firms and workers). Thus, demand-side financing mechanisms for lifelong learning, such as voucher systems, have generated interest in countries such as Switzerland – even though few rigorous evaluations of voucher schemes are available. Individual Learning Accounts (ILAs), recently applied in a few OECD countries like Sweden and the United Kingdom, represent another innovative funding strategy, meant to encourage learning and training participation. Like training vouchers, these accounts start from the principle that (i) the individual is best placed to choose what skills he or she wants to enhance, and in what way, and (ii) the investment cost is shared between the different agents, as financial support from the government and/or the company are supposed to match the contribution by the individual. ILAs are usually not tied to a company, but follow the individual. While they are still in the development stage and have encountered teething problems in the United Kingdom, they are a welcome innovation destined to raise the overall commitment to training, not the least among the less well trained workers and among small and medium sized firms.

Second, many governments, particularly but not exclusively in Europe, consider that *a more structured involvement of employee representatives and the social partners at various levels of discourse may be of help to overcome deficiencies in the provision of and access to training.* For example, the 1997 EU Luxembourg summit urged the social partners to conclude agreements on continuous training and to jointly develop competences and qualifications in their pursuit of the modernization of work organization, and a top-level agreement was subsequently concluded between the social partners at a European level, which confirms that the development of competences and qualifications is a shared interest and that the two partners should co-operate in anticipating skill needs and in elaborating skill plans. Continuing training also figures, sometimes prominently, in the 'social pacts' or tripartite agreements concluded in a number of European countries with a view to increasing productivity and competitiveness. Furthermore, a number of studies have established relationships between unionism and bargaining measures on the one hand, and training outcomes on the other.

It has been shown that, in the European Union, firms allowing for employee 'voice' and structured forms of participation are more likely to adopt innovative work practices and to provide training to their workers that goes along with work re-organization. More generally, there is thus a good case for social partner co-operation in training decisions. This co-operation could take different forms:

1. Joint governance of training funds in countries characterized by national or sectoral training levies. Experience from countries as diverse as Spain and Belgium has shown that, notwithstanding their potential shortcomings, training levies have the advantage of spreading the burden for funding training among employers and thus mitigating the externalities problem.
2. Collective bargaining, which is occurring to various extents and at varying levels in OECD countries. In countries with levies and training funds, these have usually been given a framework through bipartite agreements at sectoral or even national levels. But bargaining also plays a role in countries with little central steering of continuous training matters, but where trade unions pursue 'qualitative' bargaining strategies not exclusively centred on wages and working hours. Often, agreements will deal with the joint determination of training needs in a company or sector, the set-up of training plans, and the right to training leave. Importantly, agreements on continuing training often do not stand alone, but are linked with other areas of regulation, such as working hours, work organization or human resource management (for example equal opportunity).
3. Participation by works councils or other bodies for employee involvement which, in many countries, have been given strong legal rights to 'co-determine' company training plans and strategies.

Finally, recent experiences in a number of OECD countries have spotlighted a policy failure where building *'quality' human capital* is hard to attain even when it is accompanied by large investment in government expenditures. Here, a recent OECD publication: 'Education at a Glance, 2003', indicates interesting results from the Programme for International Student Assessment (PISA) study. They show that countries such as Australia, Finland, Ireland, Korea and the UK have achieved good results, in terms of literacy and mathematics test scores, by spending a moderate amount of public expenditure on education. On the other hand, countries such as Portugal have spent a large amount of public expenditure on education while student performance is still very low (Figure 9.2). *This is the paradox*. Unfortunately, key drivers of this paradox are not identified as yet, and thus it is difficult to devise policy responses to tackle this problem. However, what is clear is that attaining good results under a moderate



Note: Students proficient at literacy scale 3 are capable of reading tasks of moderate complexity, such as locating multiple pieces of information, drawing links between different parts of the text, and relating it to familiar everyday knowledge. Public expenditure includes those on primary, secondary, and post-secondary, but not tertiary education.

Source: OECD (2003c).

Figure 9.2 Student performance and public expenditure in education in selected OECD countries, 2000 educational financing requires effective schools and teachers with the right combination of trained and talented personnel, adequate facilities and equipments and motivated students. Clearly, more work should be devoted to address this paradox.

4. A NEW ISSUE THAT COULD POTENTIALLY CONTRIBUTE TO SUBSTANTIAL GAINS IN HUMAN CAPITAL INVESTMENT

This is the role of migration of highly qualified people. An alternative for host countries to rapidly developing the required human capital is attracting foreigners who already possess those skills. Let us first check the recent trends in the migration of highly qualified people. Is this an increasingly important phenomenon? A recent OECD work shows that trends in the flows of highly qualified people indicate that on average, international migration of highly skilled workers rose substantially during the 1990s: in Japan, the annual growth rate of foreign high-skilled engineers increased by over 8 per cent in the 1990s; the share of immigrants working in Australia, Canada, the Slovak Republic, the UK and Switzerland under the skill-based category increased by 20 per cent between 1993 and 1998; the fraction of 'foreign population' with tertiary education was fairly large during the late-1990s as compared to the 'national population' with tertiary education.

However, it is not clear for how long this trend will continue. If reverse migration increases and if immigration policies are tightened (the latter happened in the US in the 1990s) this trend may move in the opposite way.

Why is this a good alternative strategy? Because human capital investment, especially when it relates to developing skills in advanced science and technology, takes a large amount of time and resources. When time is pertinent and resources are limited, it may well be the most efficient strategy for countries to import human capital from abroad, at least in the short run, in order to supply the economy with skills that are required in the increasingly knowledge-based economy.

Another reason why this can be a good strategy is that the migration of highly qualified people not only increases the average level of human capital in the host country and alleviates skills shortages, it also facilitates knowledge spillovers through knowledge embodied in highly skilled immigrants.

We have seen a *fairly sizeable increase in the migration of highly skilled workers in the past decade. Why is this the case?* The key factor behind this trend is that migration brings large benefits to both the host and origin countries.

- As mentioned above, host countries appear to benefit from the increasing migration of highly skilled workers since they stimulate innovative capacity and consequently spillover effects.
- Origin countries also benefit from the migration of highly skilled workers through the return of migrants and the development of networks facilitating the circulation of skilled workers between host countries and their country. Other benefits include stimulation of training in origin countries and an increase in remittances.
- While negative features of migration among highly skilled workers such as the brain drain have been an important issue in policy discussions, recent evidence shows that the impact of the brain drain is not as large as previously thought, since an unexpectedly high number of migrants have in fact returned to their home countries.
- Migration-related policies have been adjusted in the OECD countries.
- In the past, traditional immigration countries developed migration policies to provide residence for immigrants and to target employment in the IT sector. Recent policy challenges indicate that it is important to strike a balance between all stakeholders, including the government, employers, and the domestic and foreign workforce.
- Future policy scope to further facilitate the mobility and increase the benefits of high-skilled migration includes the mutual recognition of diplomas and the transfer of social security and pension rights from origin to host countries. Science and technology policies can also have a strong impact on the flows and effective use of highly skilled immigrants. This is because the development of a high-technology and innovative industry is important for attracting highly qualified workers of all origins. Such policies address notably entrepreneurship, mechanisms for allocating capital, training and education, public research and its links with business. More specifically, centres of high-quality research and higher education ('centres of excellence') tend to attract a fairly large number of qualified researchers and students.

In conclusion, this chapter has used the vast stock of policy research done at the OECD to show that:

- Human capital investment is a key input for countries to grow in the new economy as well as to maintain social cohesion.
- Among numerous approaches to increase the level and quality of human capital, utilizing highly skilled immigrants can be a promising area in the future.
- Policies need to address numerous barriers that prevent fast and efficient human capital investment by firms and individuals. This is

closely linked to the recent policy concern among policy makers in OECD countries: 'how to achieve quality human capital with limited spending?'. Here, it is very important to stress the role of policies to tackle market failures related to human capital investment. One must also not forget that mobilizing education and training policies is not sufficient to attain such goals. In reality, much depends on the ability of the labour market to utilize human capital.

NOTE

1. Head of Employment Analysis and Policy Division, OECD Directorate for Employment, Labour and Social Affairs. The views expressed in this chapter do not necessarily reflect the opinion of OECD or its member countries.

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PART IV

The role of FDI and trade integration in the catching-up process

10. The importance of foreign-owned enterprises in the catching-up process

Alena Zemplinerová[1]

1. INTRODUCTION

In 2003, the stock of foreign direct investment (FDI) in the Czech Republic reached about USD 40 billion, which is the highest FDI stock per capita in Central and Eastern Europe. Whereas the world economy and Central and Eastern Europe (CEE) countries including Hungary and Poland experienced a decline in FDI inflows, FDI flows to the Czech Republic in fact accelerated in recent years[2] – not least because of the special efforts the Czech government has made since 1998 to attract strategic foreign investors during the privatization of large banks and utilities as well as through incentives for green-field development. Against this background, an issue of current interest is whether FDI actually enhances welfare, which basically depends on how FDI enterprises perform and how they are distributed among sectors.

Traditional trade theory analyses FDI as capital imports. Yet the modern theory of industrial organization assumes that firms which have the resources to operate internationally possess certain assets (technology, managerial skills, access to credit) that give them technical and organizational advantages over domestic firms. Therefore foreign firms might have other characteristics than domestic firms, and FDI might have additional effects beyond the mere import of capital (Caves 1996). So far empirical studies examining the performance of foreign-owned enterprises (FEs) have been inconclusive. Studies have found FEs to perform better than domestic ones and vice versa (Pfaffermayer and Bellak 2002, p. 13). Furthermore, it is not only the quantity but also the structure of FDI that determines the long-term positive impact on the host economy (Havlik 2003).

The aim of this chapter is to provide evidence on the role FDI has had in trends in the Czech manufacturing industry. The analysis covers the period from 1993 to 2002 and focuses on growth, technology, productivity, wages and shifts in production structures with respect to factor-intensity groups. The hypothesis behind the research is that FEs have had a catalyst effect in the catching-up process and in the transformation of industrial structures towards those of developed countries. Trends in the factor content of industrial branches are relevant for the assessment of future industrial specialization. As there are costs involved in attracting foreign investors with investment incentives and in restructuring privatized enterprises, such an analysis should shed more light on whether such costs are in fact offset by benefits.

2. DATA AND METHODOLOGY

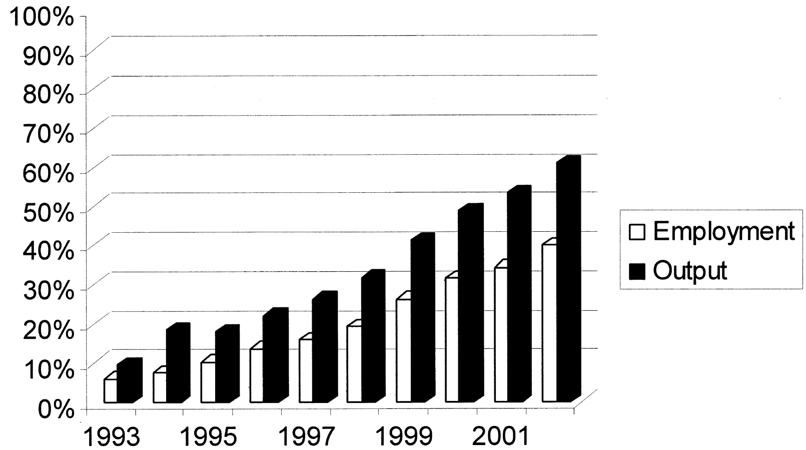
Foreign direct investment is captured through foreign ownership of enterprises. Our analysis draws on corporate financial statements submitted to the Czech Statistical Office (CSO) since 1993, covering the total population of manufacturing enterprises with more than 25 employees.[3] To begin with, we aggregated monthly or quarterly data of individual enterprises to get annual observations, and performed controls for data consistency. Then the enterprises, which can be identified by type of ownership,[4] were broken down into two groups: foreign-owned enterprises (FEs) and domestically owned enterprises (DEs).

We made every effort to ensure data comparability regarding methodology changes made in statistical recording during the review period and at the same time to provide for a broad coverage of data. While the data presented in the chapter result from careful adaptation of CSO data they are not fully comparable with the officially published figures as they reflect own computations.

3. THE FOREIGN SECTOR IN THE CZECH MANUFACTURING INDUSTRY (1993–2002)

The number of enterprises in manufacturing has been steadily increasing since 1993 and grew dramatically in recent years. In 1993, only 190 out of 3000 manufacturing enterprises were foreign-owned; until 2002 this share grew to more than 1300 manufacturing enterprises wholly or partially owned by foreign investors, out of 4700 Czech manufacturing businesses. Figure 10.1 indicates the growth rates of cumulative FE shares in total output and employment during 1993–2002.

In 1993 foreign-owned enterprises accounted for a mere 12 per cent of output while employing only 6 per cent of all manufacturing employees. By 2002 the respective shares had surged to 61 per cent and 42 per cent, which are high levels in comparison with developed countries – in Austria for



Source: CSO data, enterprises with 25 and more employees, own computations.

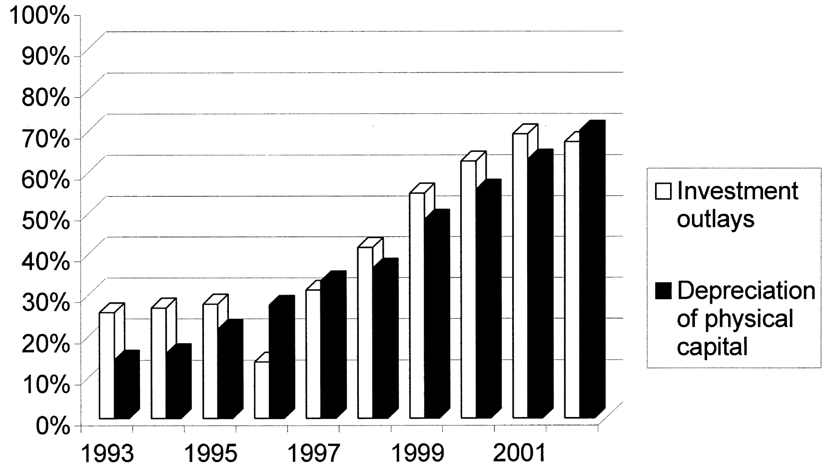
Figure 10.1 Cumulative shares of foreign enterprises in manufacturing output and employment

instance foreign enterprises produce 51 per cent of the manufacturing output, and in Hungary the current level of foreign penetration in manufacturing had already been reached in 1996.

In the Czech Republic FDI inflows were relatively modest during the first years of transition, and were related largely to a few large takeovers made in the course of privatization (Zemplinerová, 1997). The recent period of dynamic growth of foreign involvement in manufacturing can be attributed to foreign takeovers of firms originally privatized by domestic investors, to the build-up of new capacities and to the growth of existing companies funded from reinvested profits and cash-flow. This fact is illustrated by Figure 10.2, which shows the shares of foreign-owned enterprises in both annual investment outlays[5] and annual manufacturing depreciation of physical capital to be over-proportional.

4. INVESTMENT OUTLAYS AND PHYSICAL CAPITAL

In terms of productivity, foreign manufacturing enterprises outperform domestic enterprises by about a third on average, a gap that seems to be relatively stable over time. This is a standard observation made in similar



Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.2 Shares of foreign enterprises in investment outlays and physical capital depreciation (manufacturing sector, 1993–2002)

studies that can be partially explained by structure; but basically it is a firm-specific phenomenon that can be attributed to ownership (Davies and Lyons 1991).

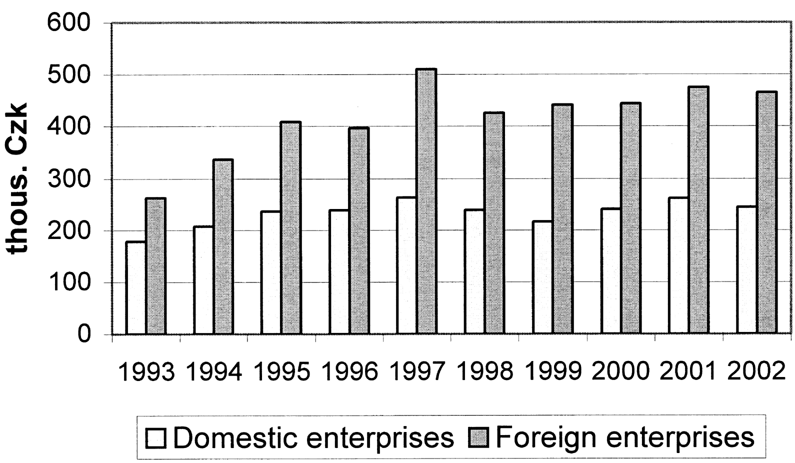
Figure 10.2 explains that higher productivity may reflect technological advantages or a higher physical capital intensity. Foreign enterprises invest more in technology than domestic enterprises and their capital endowment is higher than their labour endowment, as is evident from the over-proportional share of foreign enterprises in physical capital depreciation. The higher investment activity of FEs is also attributable to the fact that they have better access to capital than DEs (EBRD 2003, p. 89). Moreover, past high growth of capital endowment will generate new investment. Through reinvested depreciation amounts and profits and through the dominance of FEs in the Czech economy FDI stocks should thus keep growing even without new foreign green-field investments or privatization deals.

5. PRODUCTIVITY AND WAGES

Furthermore, FEs produce a higher value-added per employee on average than domestic firms but account for a lower share of salaries in value-added on average than domestically owned enterprises. DEs' crowding out effect is depicted in Figure 10.3, according to which the real value-added in DEs is actually declining (figures are in current prices). FEs' lower share of salaries in value-added, as illustrated in Figure 10.4, indicates that FEs are concentrated in capital-intensive rather than in labour-intensive industries. One explanation for this fact may be that natural resources remain a comparative advantage in the Czech Republic.

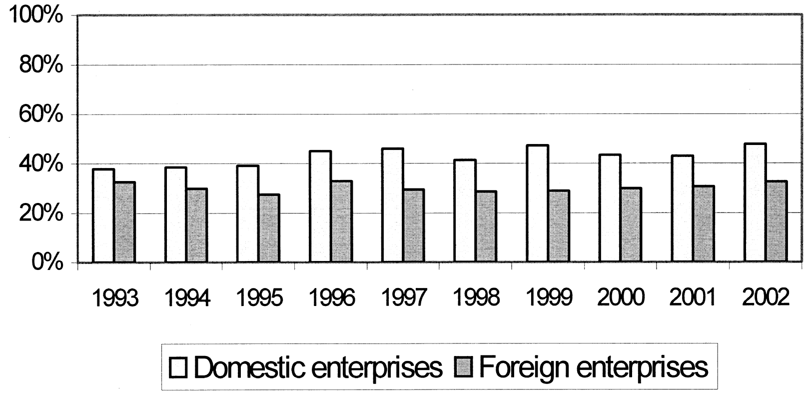
The comparison of gross wages per value-added reveals an intrinsic difference in the functioning of foreign and domestic enterprises. The indicator is closely related to unit labour costs (ULC). The lower ULC are, the more competitive a given production is. Costs beyond gross wages include social security and health insurance payments by employers (proportional to wages, which penalizes domestic producers), physical capital depreciation (proportional to physical capital, which penalizes foreign producers) and gross profits. It is evident that the profit margin in FEs must be significantly higher than in domestic firms. Hence FEs will be more competitive than DEs.

While average wages developed along similar lines in both foreign and domestic enterprises during 1993–2002, productivity grew faster in foreign companies, thus causing the gap between them and domestic enterprises to widen (see Figure 10.5). Employees of foreign enterprises earn higher salaries on average than the staff of domestically owned enterprises. The



Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.3 Comparison of value-added per employee in domestic and in foreign enterprises



Note: Wages include all gross incomes from employment (direct wages, bonuses, gratuities and remuneration for time not worked).

Source: CSO data, enterprises with 25 and more employees, own computations.

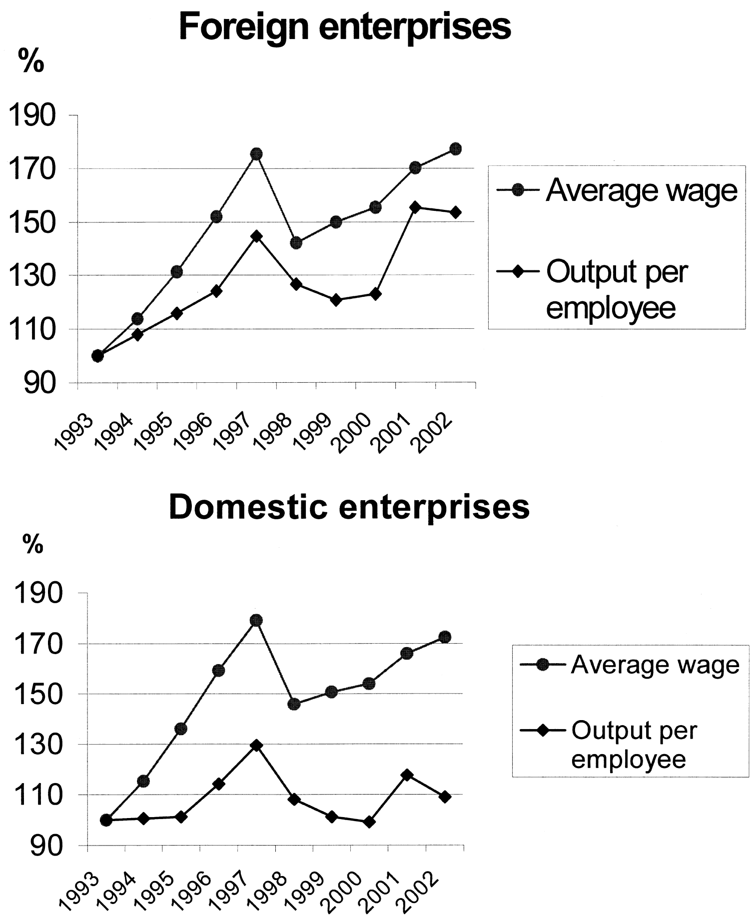
Figure 10.4 Comparison of gross wages per value-added in domestic and foreign enterprises

higher salaries reflect foreign firms' higher labour productivity, and the fact that foreign firms are apparently able to attract higher skilled workers and managers.

As FEs dominate the manufacturing industry, they set the tone for wage settlements in the whole manufacturing sector. The pattern of wage growth is nearly identical in both sectors. There is a wage spillover from foreign to domestic firms, even though FEs were paying higher wages than DEs already in 1993. The lead of wage growth over productivity growth has been common in both sectors. It reflects low ULC values (relative to EU countries) that evolved during the period of economic depression and high commodity price inflation of 1991–92 when wages were largely sticky. The burden of such adjustment is higher for DEs than for FEs.

6. GROWTH AND FOREIGN INVOLVEMENT

The higher average productivity of foreign enterprises can be explained not only by company size (foreign enterprises are larger on average in terms of both employment and output) but also by the type of activities in which they engage – foreign enterprises concentrate on capital-intensive activities

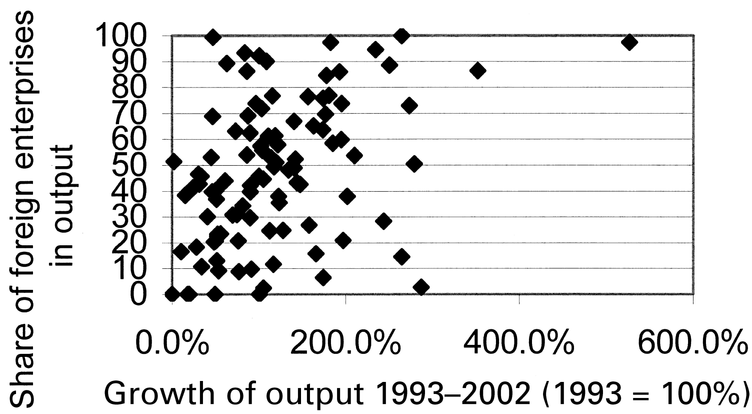


Note: Wages include all gross incomes from employment (direct wages, bonuses, gratuities and remuneration for time not worked).

Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.5 Growth of productivity and wages 1993–2002 (1993 = 100%)

in which economies of scale play an important role. Foreign enterprises have different allocative patterns and thus determine the structural change. For the purpose of this part of analysis, enterprises were aggregated by major activity into 101 industries (3-digit NACE level).[6] Figure 10.6 (x axis) depicts FE shares in the output of 3-digit industries in 2002 and relates the level of foreign involvement to industry growth during the last ten years.

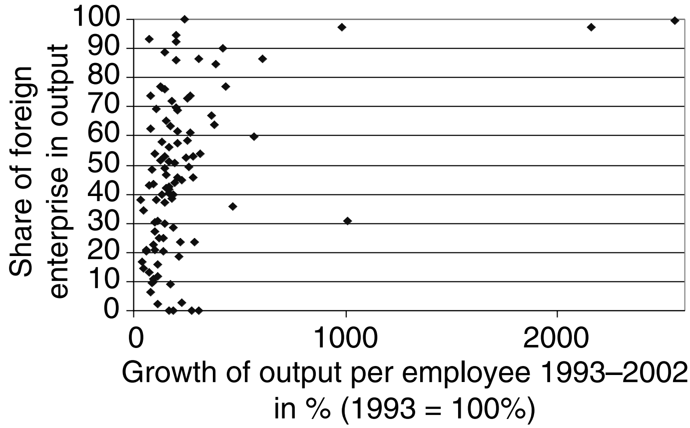


Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.6 Foreign involvement and output growth

It follows from the figure that a fair share of branches are dominated by foreign investors, typically physical capital-intensive industries such as cars and car equipment, electronics or tobacco, and activities that are dependent on natural resources such as manufacture of cement and lime, ceramics, detergents, beverages, sugar, basic iron and steel. At the same time, foreign investors have apparently avoided industries such as textiles, leather, coke oven products, weapons, recycling of metal waste. These are either industries that are yet to be restructured, such as chemicals or machinery, but also industries that are declining, such as the leather, shoe or textile industries. The long-term decline in the leather and textile industries has been accelerated by imports of cheap goods, especially from Asia. In general, industry adjustment to the changing requirements of developed markets is difficult because of internal factors: management deficiencies, low investment activity, financial constraints, privatization-related debt burdens. The establishment of capital stakes in strategic businesses is often prevented by untransparent and broadly dispersed ownership generated by voucher privatization. This, together with the bad financial situation, is the reason why banks were not willing to provide long-term credits and why over-capacities are being cut.

Figure 10.7 juxtaposes the degree of foreign involvement in a given industry with productivity growth in this industry between 1993 and 2002 (in current prices). While there is no evidence for straight-forward correlation for output growth or for productivity growth during the past ten years, there are a number of high growth outliers in terms of both output and



Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.7 Foreign involvement and productivity growth

productivity – computers (NACE 300; output per employee grew 25 times), TV and radio (323; output grew 10 times) and motor vehicles (NACE 341; output per employee grew 21 times). In this respect it is worth mentioning that the electronics industry and the car industry, which are both almost exclusively foreign-owned, were restructured in different ways.

While the car industry was privatized at the very beginning of transition, the electronics industry continued to be neglected even in the initial transition stages. Investment in the car industry was a strategic investment that was rather heavily subsidized and was expected to have a decisive role in backward linkages and transfers of technological know-how from foreign to domestic suppliers and the upgrading of the whole sector. According to recent statistics, car production (NACE 341–343) accounts for 27 per cent of total Czech exports, 16 per cent of manufacturing output and 8 per cent of employment. These developments have been mainly due to the massive inflows of foreign direct investments.

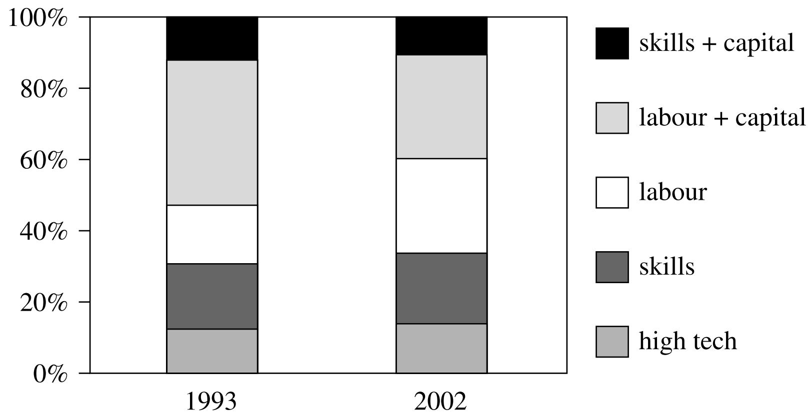
The electronics industry, by contrast, was suppressed during the centrally planned era and neglected during the first years of transition. Despite the lack of support or government subsidies, the industry has started to grow in recent years mainly due to foreign investment that occurred as late as 1996–97 when Asian and Northern American producers of electronics invested in several green-field projects. Nowadays the electronics industry (NACE 300–335) accounts for more than 19 per cent of total manufacturing exports and for more than 13 per cent of total manufacturing output and investments.

In terms of FDI incentives, the Czech Republic has incidentally offered investors – in addition to tax and trade allowances – regional FDI incentive packages since 1998. Local authorities have extended assistance and support to foreign investors by providing the entire infrastructure, for example power lines, gas, water supplies, and telecommunications to the border of the building site. In addition, local government-controlled grants have been available to help firms in the recruiting and re-training of skilled labour.

7. FACTOR INTENSITY ANALYSIS

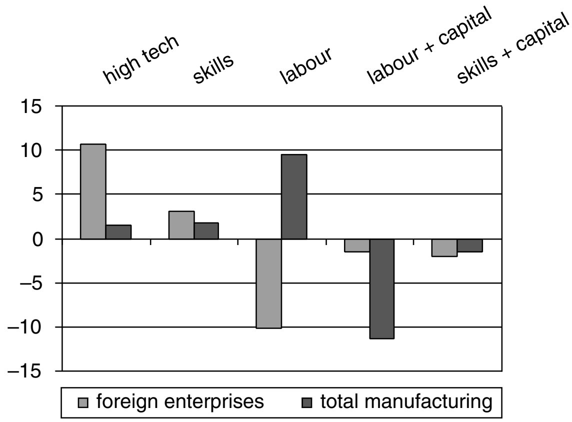
For the purpose of factor intensity analysis firms were classified, based on their major activity, into the five following groups: high-tech industries, industries with high human capital intensity but low physical capital intensity, labour-intensive industries, labour-intensive industries with high physical capital intensity, and industries with high human capital intensity and high physical capital intensity.[7] The shares of these five groups in total manufacturing output and direct exports[8] were computed for 1993 and 2002 (Figure 10.8).

As for total manufacturing (without distinguishing between types of firm ownership), labour-intensive industries strengthened their weight in manufacturing. Furthermore, the structure of manufacturing shifted towards high-tech industries and skills-demanding industries and the two remaining groups – both capital-intensive industries – weakened in terms of both output and exports between 1993 and 2002.



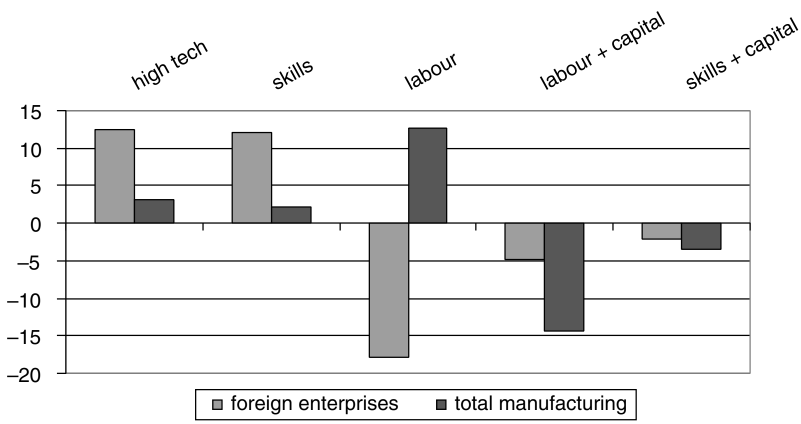
Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.8 Distribution of manufacturing output by factor intensity



Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.9 Change in the structure of output by factor intensity groups 1993–2002



Source: CSO data, enterprises with 25 and more employees, own computations.

Figure 10.10 Change in the structure of export by factor intensity groups 1993–2002

Yet FE and DE structures evolved differently as illustrated by Figures 10.9 and 10.10. From the analysis of the representation of particular factor intensity groups in both output and export volumes it follows that FE shares of high-tech sectors strengthened significantly in the period 1993–2002 whereas the domestic sector shares decreased. Activities with a high content of human capital accounted for increasing shares of output, and even higher shares of exports in the case of both foreign enterprises and domestic enterprises. There was a sharp difference in developments in labour-intensive activities where the position of the foreign sector weakened while that of the domestic sector strengthened. Output and export shares of labour- and capital-intensive activities as well as those of skill- and capital-intensive activities dropped in the case of foreign enterprises.

The last two figures shed new light on the different strategies of foreign and domestic enterprises. FEs evidently escaped from the trap of being involved too long in the labour-intensive industries. Their hey-days ended in 1997, as wages were steadily increasing while the exchange rate of the koruna kept appreciating. The escape from labour-intensive production into high-tech and skill-intensive production in FEs has been evident since 1997 and is accelerating at present. DEs lag when it comes to restructuring strategies, finding themselves trapped in labour-intensive production where the potential for growth and world market penetration is not very encouraging.

8. THE FUTURE OF MANUFACTURING

The weight of foreign companies in Czech manufacturing is high, and foreign involvement in manufacturing is expected to grow in the future. This analysis has shown that foreign enterprises are more competitive than domestic enterprises. The hypothesis that foreign enterprises change the industrial structure towards technology-based activities has been proved. It can also be expected that multinationals will reduce their dependence on heavy assets and build more on skills as they have to be more flexible to be able to anticipate changes and to respond to them adequately.

NOTES

1. Senior Researcher, CERGE-EI, Charles University and Academy of Sciences, Prague. The author is grateful to V. Benacek for valuable remarks. The analysis has been carried out within the 5th Framework Program – project 'Changes in Industrial Competitiveness as a Factor of Integration', supported by the European Commission. The author is however, solely responsible for the research and it does not represent the opinion of the Commission, nor is it responsible for any use that might be made of data appearing therein.
2. UNCTAD, 'World Investment Report 2003: FDI Policies for Development – National and International Perspectives', Geneva, UNCTAD 2003.
3. Time series have to be adapted for both company size and the definition of indicators.
4. The CSO distinguishes the following types of ownership: private, cooperative, state, foreign (100 per cent), international (any 1–99 per cent of foreign ownership), mixed (state and private), others (communal, political organizations and associations or not-identified). For

the purpose of this analysis the two groups of foreign firms (fully and partially owned) were merged into one group.
5. Including both tangible fixed assets and intangible assets.
6. When (groups of) products manufactured fall into several industries, the classification is governed by the product accounting for the lion's share of output.
7. The list of industrial sectors characterized by factor intensities is taken from The European Commission report elaborated by D. Neven (1994). Old NACE classifications were adjusted to the revision 1 of NACE.
8. Export sales: enterprise statistic serves as one source for export data (the second is custom statistics). Exports according to corporate statistics differ from exports according to customs statistics, but are compatible with output data. Corporate export statistics are available for 1993, 1994 and from 1997.

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11. Intra-industry trade between the EU and the acceding countries: the impact of foreign direct investment on trade structures

Jarko Fidrmuc and Martin Djablik[1]

1. INTRODUCTION

Recent economic developments in the acceding countries reflect the fact that, first, macroeconomic and microeconomic disequilibria were rapidly removed during the initial years of economic reform and that, second, economic developments in the (largely) transformed economies remain more dynamic than those in OECD countries.

The stabilization policy proposed in Central and Eastern Europe to reach macroeconomic as well as microeconomic equilibrium necessitated dramatic adjustments in the initial years of economic reform. Following the removal of price controls, high inflation or even hyperinflation was observed, but inflation quickly stabilized at relatively low rates (see Backé et al., 2003). In the more advanced Central and Eastern European countries (CEECs) it took just a few years to remove inefficient production structures and nearly complete privatization (see Djankov and Murrell, 2002). As a result, the CEECs experienced output declines by a significant fraction of GDP and unemployment peaked at internationally high levels (see Svejnar, 2001).

Fundamental changes have also been observed in the CEEC's trade orientation. Based on gravity model predictions, Hamilton and Winters (1992) foresaw a significant growth spurt to the 'potential level' of trade between CEECs and the EU. Fidrmuc and Fidrmuc (2003) document that, with the most recent efforts, this adjustment to the equilibrium level has nearly been completed.

This chapter compares the patterns of EU trade between 1989 and 2001 with OECD countries (including intra-EU trade) on the one hand and with the acceding countries in Central and Eastern Europe on the other hand.

Thus, the set of countries is wider and the period of analysis is longer than in comparable studies.[2] Fidrmuc et al. (1999) compare selected Western and Eastern European countries at the starting (1989) and intermediate (1996) stages of transition. Djankov and Hoekman (1997), Aturupane et al. (1999), Kaitila (1999 and 2001), and Hildebrandt and Wörz (2004) analyse the development of trade structures in the CEECs over a shorter period of time.

At the same time, the commodity groups analysed in this chapter are relatively broad (SITC three-digit commodity groups), and our single data source (UN World Trade Databank) does not provide any information on import and export prices. Therefore, the chapter does not distinguish between horizontal (that is, trade in approximately equally priced products of the same quality) and vertical (trade in products of different quality levels with significantly different prices per physical unit) intra-industry trade. Yet, as Burgstaller and Landesmann (1997), Aturupane et al. (1999), and other authors show, the EU's intra-industry trade with the CEECs is concentrated on vertical intra-industry trade.

The period under consideration was characterized by several dramatic changes apart from the opening-up of Eastern Europe, which is the focus of this analysis. Germany was re-unified in 1990. Slovenia and the Baltic Republics became independent in 1991, while the former Czechoslovak federation was divided into the Czech Republic and Slovakia in 1993. The EU was enlarged with the accession of Austria, Finland and Sweden in 1995. Moreover, the UN introduced a new scheme of trade statistics with detailed commodity groups (SITC Revision 3) at the end of the 1990s. All those developments affected the quality and availability of trade data during the period under review.

Despite these limitations, it is possible to show increases of intra-industry trade in nearly all CEECs. Determinants of the EU's intra-industry trade with OECD countries are analysed and used for predictions in the EU's trade with the CEECs in the long run.

The rest of the chapter is organized as follows. The next section describes the development of EU trade with the CEECs in comparison with intra-EU trade and trade with selected third countries. The third section analyses the determinants of developments in EU intra-industry trade with OECD countries. The fourth section uses OECD estimates to predict potential shares of EU intra-industry trade with CEECs. The fifth section discusses foreign direct investment (FDI) as a special determinant of foreign trade structures in the acceding countries. Finally, conclusions are drawn in the last section.

2. EU INTRA-INDUSTRY TRADE WITH SELECTED COUNTRIES

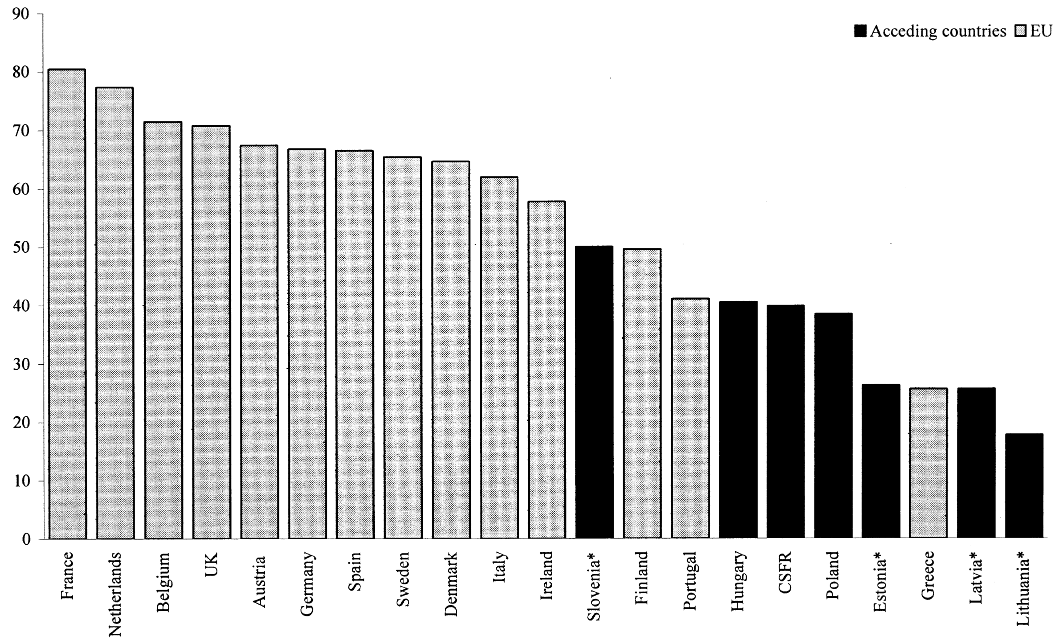
The growth of Central and Eastern European exports to the EU went along with a significant restructuring of trade. The redirection of goods that had traditionally been exported to the CEECs and the former Soviet Union to newly opened Western markets did not play an important role. Djankov and Hoekman (1997) find that the export growth reflected a surge in products that had not been exported to Eastern European countries before or a substantial upgrading of redirected exports. In contrast to initial expectations of a specialization of the CEECs on labour- and resource-intensive products (see Collins and Rodrik, 1991, and Neven, 1995), the growth of intra-industry trade has been one of the most important features in the development of East–West trade.

We apply the Grubel–Lloyd index of intra-industry trade (Grubel and Lloyd, 1971), which represents the share of the absolute value of intra-industry trade in trade turnover, that is

$$GLI_t = 1 - \frac{\sum_i |X_{it} - M_{it}|}{\sum_i (X_{it} + M_{it})}, \tag{11.1}$$

where X and M denote EU exports and imports using three-digit SITC commodity groups i (as published by the UN), respectively. An index value of 0 shows that there is exclusive inter-industry trade, that is a complete specialization on different products for each country, while an index value of 1 indicates exclusive intra-industry trade.

At the beginning of economic transition, the acceding countries' levels of intra-industry trade in manufacturing products[3] with the EU-15 (based on SITC three-digit commodity groups, see Figure 11.1) were in a range of 20 per cent (18 per cent for Lithuania in 1992) to about 50 per cent (40.6 per cent for Hungary in 1989 and 50.1 per cent for Slovenia in 1992). In other words, in 1989 intra-industry trade with the EU-15 was roughly as important in the acceding countries as in the more peripheral EU countries such as Greece (25.6 per cent) and Portugal (41.1 per cent). At the same time, these shares were far below the intra-industry, intra-EU trade figures reported by the more centrally located EU countries, which were between about 60 per cent (Italy: 62.0 per cent and Spain: 66.5 per cent) and about 80 per cent (Netherlands: 77.4 per cent and France: 80.5 per cent).



Note: *Data are available only for 1992.

Source: UN, own calculations.

Figure 11.1 Intra-industry trade in the manufacturing sector with the EU-15 in 1989, per cent

During the 1990s, nearly all CEECs experienced a significant growth of intra-industry trade (see Figure 11.2). This propelled some acceding countries' shares of intra-industry trade with EU manufacturers (Czech Republic: 70.7 per cent, Slovenia: 59.7 per cent, and Hungary: 58.2 per cent) to levels comparable with or even slightly above that of intra-industry, intra-EU trade in Spain (71.0 per cent) and Italy (63.2 per cent) in 2001. The shares of Estonia (42.1 per cent), Slovakia (47.7 per cent) and Poland (52.3 per cent) were somewhat lower in 2001 than in 1989, but still comparable with the share of Finland (44.2 per cent). Finally, the shares of Latvia (23.4 per cent) and Lithuania (25.5 per cent) were similar to those of Greece (20.8 per cent) and Ireland (30.4 per cent).

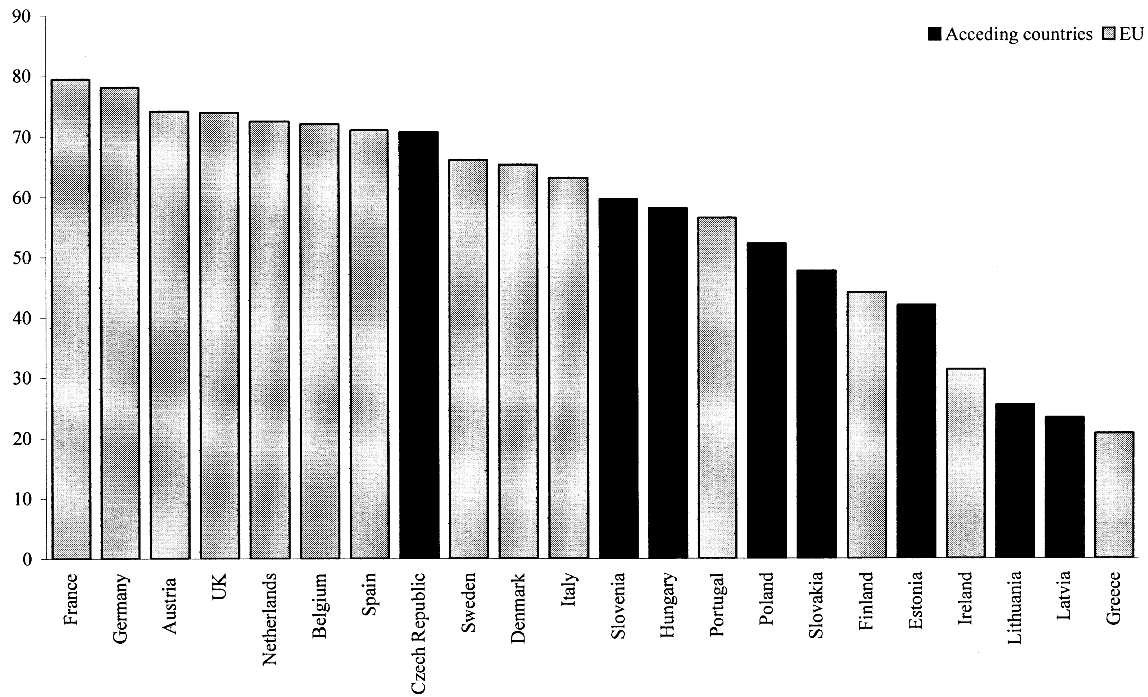
However, several CEECs have experienced slight declines of intra-industry trade following the initial growth spurts. Slovakia is a case in point, where the highest share of intra-industry trade with the EU was observed in 1996 (50.7 per cent), followed by a drop of about six percentage points thereafter. A similar pattern of development, if less pronounced, has been observed for Latvia. This may indicate a stabilization of the EU's intra-industry trade with these countries at long-run levels. We can see similar fluctuations, however, also in the intra-industry trade of EU countries. Some incumbent EU members, notably Ireland, also showed declines of intra-industry trade between 1990 and 2001 (see Figures 11.1 and 11.2).

3. DETERMINANTS OF INTRA-INDUSTRY TRADE IN THE EU'S TRADE WITH OECD COUNTRIES

According to the new trade theory, the intra-industry trade shares of catching-up countries should increase amid the convergence process to the income level of developed countries. Furthermore, large countries are expected to have a more diversified trade structure than small countries, which specialize in few products. Barriers to trade may also influence the structure of trade. Originally, Loertscher and Wolter (1980) noted that intra-industry trade between countries is intense if GDP per capita is high and the difference in GDP ratios is relatively small, and if the average size of aggregate output is high and similar. It is generally argued that GDP per capita is a proxy for factor composition. In particular, Helpman (1987) estimates

$$\begin{aligned} GLI_{ij} = {} & \alpha_0 + \alpha_1 \log|y_i - y_j| + \alpha_2 \min[\log(Y_i), \log(Y_j)] \\ & + \alpha_3 \max[\log(Y_i), \log(Y_j)] \end{aligned} \tag{11.2}$$

on separate cross-sections of 91 country pairs for 1970 to 1981, where GLI_{ij} is the Grubel–Lloyd index (for four-digit SITC groups) in trade between



Source: UN, own calculations.

Figure 11.2 Intra-industry trade in the manufacturing sector with the EU-15 in 2001 (preliminary data), per cent countries i and j, and where Y and y are aggregate income and income per capita of the countries under review.[4] Based on models of trade in differentiated products, Helpman argues that the share of intra-industry trade is negatively correlated with income differences ($\alpha_1 < 0$) and positively correlated with country size ($\alpha_2 > 0$ and $\alpha_3 < 0$). Helpman finds the data to support these predictions, a result that has since been confirmed by Hummels and Levinsohn (1995) and by Durkin and Krygier (2000). This section starts with the estimation of a form of Helpman's equation (11.2) for the EU's intra-industry trade with OECD countries[5] (see Table 11.1),

$$\log\left(\frac{GLI_i}{1 - GLI_i}\right) = \alpha_0 + \alpha_1 \log|y_i - y_{EU}| + \alpha_2 \log(Y_i) + \alpha_3 \log(Y_{EU}) + \beta X. \tag{11.3}$$

In comparison with (11.2), equation (11.3) reflects that the Grubel–Lloyd index (for manufacturing products) is defined between 0 and 1. Therefore, Hummels and Levinsohn (1995) suggest using the logistic transformation, log $(GLI_i / (1 - GLI_i))$, which removes this restriction. Furthermore, equation (11.3) does not distinguish between the maximum and minimum of total incomes of trading partners because the aggregate output of the EU-15 represents the highest GDP in the data sample in nearly all periods.[6] This does not change the interpretation of α_2, which is again expected to be positive. The aggregate output of the EU-15, Y_{EU}, is used to scale the individual Y_is.

Finally, equation (11.3) includes several other explanatory variables, which are denoted by X. In particular, the distance between trading partners serves as a proxy for transport and transaction costs, which have important effects on trade volume, as documented by gravity models. Falvey (1981) shows that trade barriers (tariffs) reduce trade in vertically differentiated products, although the effect is expected to be weaker for horizontally differentiated products.

The distance between two countries is typically measured as the distance between their capitals. For the EU as a whole, however, this measure of distance (that is, the distance between Brussels and the national capitals) is not appropriate.[7] Deardorff (1995) argues that the overall geographic position of countries is more important than the distance to other countries. Following this argument, Wei (1996) defines a remoteness measure as a weighted-average distance to other countries. Following this approach, the following remoteness indicator is used,

$$R_i = \sum_{j=1}^{14} w_j D_j, \tag{11.4}$$

Table 11.1 Determinants of intra-industry trade in the EU's trade with the OECD countries, 1989–98

Specification	(11.3.a)	(11.3.b)	(11.3.c)	(11.3.d)	(11.3.e)	(11.3.f)	(11.3.g)
Constant	−1.982	−13.449	3.785	−8.188	3.117	−9.375	3.419
	(−0.458)	(−0.411)	(1.870)	(−0.540)	(1.744)	(−0.702)	(12.950)
$\log\|y_i - y_{eu}\|$	−0.110	−0.112	−0.057	−0.057	0.023	0.026	
	(−2.280)	(−2.247)	(−2.472)	(−2.421)	(1.032)	(1.098)	
$\log(Y_i)$	0.246	0.247	0.307	0.307	0.258	0.258	0.259
	(6.318)	(6.200)	(16.770)	(16.496)	(14.904)	(14.686)	(15.097)
$\log(Y_{eu})$	0.097	1.335	0.043	1.337	0.021	1.370	
	(0.209)	(0.377)	(0.198)	(0.815)	(0.110)	(0.948)	
EU			−0.129	−0.129	5.371	5.409	5.022
			(−2.040)	(−2.000)	(7.489)	(7.394)	(7.941)
$\log(R_i)$			−0.732	−0.732			
			(−22.784)	(−22.359)			
EU $\log(R_i)$					−1.348	−1.351	−1.309
					(−15.875)	(−15.630)	(−17.112)
$(1 - \text{EU}) \log(R_i)$					−0.611	−0.610	−0.619
					(−18.835)	(−18.444)	(−19.709)
Annual dummies	no	yes	no	yes	no	yes	no
No. of observations	210	210	210	210	210	210	210
Adjusted R^2	0.183	0.151	0.824	0.818	0.863	0.859	0.863

Note: t-statistics are in parentheses.

Source: Own calculations.

where D_j denotes countries' distance (as measured by the distance between capital cities) to 14 member states of the EU (Belgium and Luxembourg are taken as a single region) and the weight w_j is the share of a member j in EU's aggregate output.

EU membership might have important effects on trade structure as well, although the signs and magnitudes of these effects are ambiguous. On the one hand, Falvey's (1981) model of vertically differentiated products implies a positive effect of trade liberalization on vertical intra-industry trade. On the other hand, Krugman (1993) argues that countries may make more intensive use of their comparative advantages in a free trade area and specialize more. Furthermore, there is a political economy argument that industries with balanced trade (that is, with a high share of intra-industry trade) implying balanced interests of exporters and importers are less likely to be subject to trade restrictions than other industries. In addition to the direct effect of participation in a free trade area, the effects of other variables (for example transport costs as proxied by remoteness) may be different in the intra-union and the extra-union trade.

Finally, possible short-term effects are covered by annual dummies for years 1991 to 1998 (not reported), which are included in several specifications; these effects remain insignificant, however. This result is also confirmed by a joint Wald test. Table 11.1 reports seven formulations of (11.3) including various sets of explanatory variables.

In the first two specifications (11.3.a) and (11.3.b), the coefficients of the basic explanatory variables (differences in GDP per capita and country size) are very similar to those reported by Helpman (1987) and by Hummels and Levinsohn (1995). However, these specifications provide a relatively poor fit for EU intra-industry trade, with an adjusted R^2 below 0.2, which is nevertheless comparable with the previous results. The inclusion of the additional explanatory variables remarkably improves the quality of explanation. In particular, more than 80 per cent of the variance of the EU's intra-industry trade is explained if the remoteness indicator is included.

The effects of trade liberalization within the EU are, as discussed above, ambiguous. It seems that the negative effects dominate if a measure of remoteness is included, see (11.3.c) and (11.3.d). However, the importance of the geographical location, but not necessarily the size of transport and transaction costs, is about twice as high in intra-EU trade than in the trade with the non-EU countries if different coefficients for these country groups are allowed,[8] see specifications (11.3.e) to (11.3.g). A Wald test also rejects the null hypothesis that the coefficients of the remoteness indicator are the same for the EU and the non-EU countries. In these specifications, EU membership is revealed to have positive effects on intra-industry trade.

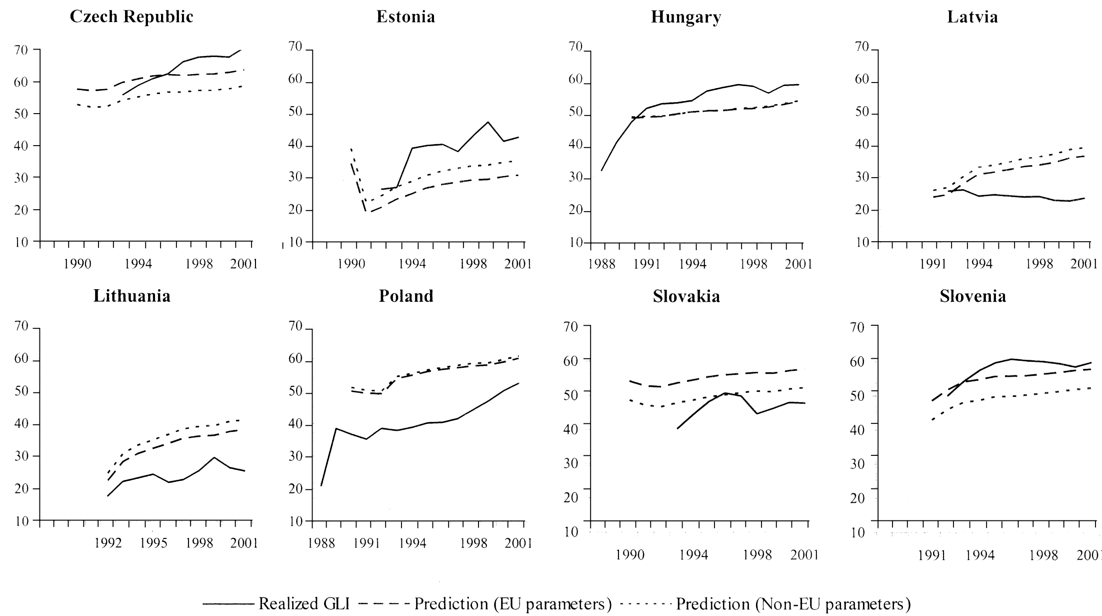
However, the size of the coefficient for income per capita differentials drops by about a half after the inclusion of the remoteness indicator in (11.3.c) and (11.3.d). Furthermore, the differences in income per capita turn out to be insignificant in specifications (11.3.e) and (11.3.f), even when this variable has the opposite (positive) sign. By contrast, the output of the trading partners of the EU, Y_i, is robust in all specifications of (11.3). The aggregate EU output, Y_{EU}, has no significant effects on the EU's intra-industry trade. Thus, it seems that the size of a country and the distance to its markets are the most important determinants of intra-industry trade. Therefore, the last specification (11.3.g) provides a parsimonious estimation of the determinants of the EU's intra-industry trade, which excludes all insignificant variables.

4. DOES THE LEVEL OF INTRA-INDUSTRY TRADE OF CEECS CONVERGE TO EU LEVELS?

At the beginning of economic transition, the development of the EU's intra-industry trade with the CEECs seems to have been influenced largely by convergence to standard levels (from the perspective of models estimated above) of intra-industry trade. In contrast with the EU's trade with the OECD countries, the shares of intra-industry trade increased despite sharp reductions of output in transition countries. This development differs from the pattern observed in the OECD countries, which predicts a positive relation between intra-industry trade and aggregate income. Nevertheless, it may be explained by a convergence to 'potential' shares of intra-industry trade given countries' structural determinants, which were discussed above. However, the dominance of the adjustment dynamics results in a poor statistical performance of (11.3) when applied to the CEECs. Therefore, an estimation of (11.3) for the EU's intra-industry trade with the CEECs cannot be used for the computation of its equilibrium or potential shares.

Nevertheless, the results of previous estimations for the OECD countries (see Table 11.1) may be used to compute out-of-sample forecasts for the EU's trade with the CEECs. This reflects the assumption that the CEECs are on a convergence path to standard OECD economies. Although this approach may be doubted because of fundamental differences between both regions, this assumption was successfully used by other authors for predictions of various macroeconomic indicators for the CEECs (for example Hamilton and Winters, 1992, and Fischer et al., 1998).

Figure 11.3 shows the development of intra-industry trade and the out-of-sample predictions computed on the basis of (11.3.g). The estimations as computed for the EU's intra-industry trade with the OECD countries



Notes: The solid line denotes the development of the Grubel–Lloyd indices. The dashed line (EU parameters) denotes a prediction using $\log[(GLI_i/(1 - GLI_i)] = (3.419 + 5.022) + 0.259 \log(Y_i) - 1.309 \log(R_i)$. The dotted line (Non-EU parameters) denotes a prediction using $\log[GLI_i/(1 - GLI_i)] = 3.419 + 0.259 \log(Y_i) - 0.619 \log(R_i)$. See Table 11.1 and the text for detailed explanations.

Source: UN, own calculations.

Figure 11.3 Predictions of intra-industry trade for acceding countries, 1988–2001 allow a comparison of predictions including and excluding the EU effects. In particular, (11.3.g) shows that there is a positive fixed bonus for the EU members, which is estimated by the coefficient for the EU dummy, and a negative effect for the peripheral countries (see Table 11.1). When we apply parameters estimated in (11.3.g) to the acceding countries, the positive effects of geographical location on intra-industry trade dominate in the Czech Republic, Slovakia and Slovenia. Both positive and negative effects are balanced in Hungary and Poland, while the negative effects of the peripheral location prevail in the other CEECs.[9]

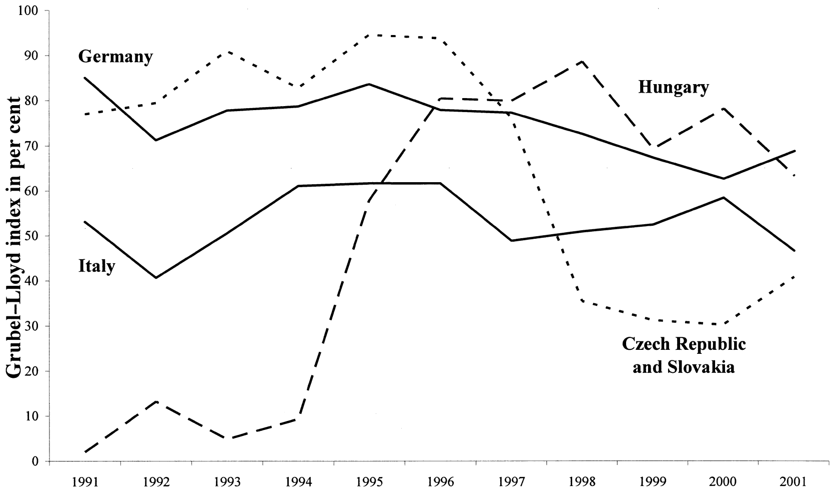
The scenarios including and excluding the EU effects are computed because the structural parameters in some CEECs might have converged already towards their EU equivalents in a response to the Europe Agreements and the stepwise adoption of the *acquis communautaire*. Indeed, Figure 11.3 reveals the expected pattern of adjustment from relatively low shares at the beginning of transition to standard levels.

Finally, specification (11.3.g) may be used to make predictions for the development of intra-industry trade in the long run. Including the EU effects and under a relatively optimistic assumption of an average annual GDP growth rate (in nominal terms converted to euro) at 7 per cent until 2010,[10] the EU-15's intra-industry trade with the Czech Republic could account for nearly 70 per cent of the bilateral trade volume. This indicator could be slightly lower (about 60 per cent) in Hungary, Poland, Slovakia and Slovenia. The long-run predictions of EU intra-industry trade with the Baltic States are between 35 per cent and 40 per cent.

5. INTRA-INDUSTRY TRADE AND FOREIGN DIRECT INVESTMENT

A comparison of the predictions with actually observed levels of intra-industry trade reveals that the latter are higher for the Czech Republic, Estonia, Hungary and Slovenia, whereas Poland and Slovakia are relatively close to the predictions. Thus, only two acceding countries (Latvia and Lithuania) display significantly lower intra-industry trade than levels corresponding to their trade determinants. Overall, this implies that the acceding countries have largely completed the adjustment to the trade structure observed in the EU's trade during the 1990s. Furthermore, these results indicate that there might be some other trade factors driving the levels of intra-industry trade even beyond EU levels.

Numerous authors (see Zemplinerová, 2004) document that the accession countries have experienced huge capital inflows. FDI has significantly influenced the macroeconomic performance of the target countries as it provided



Source: UN, own calculations.

Figure 11.4 Case study on intra-industry trade: SITC781 – passenger cars

funding for imports of capital goods and new technologies (see Fidrmuc, 2003). This has speeded up the restructuring process in the CEEC's industries.

What are the expected effects of capital imports on trade structures in the accession countries? If capital was the scarce production factor at the beginning of transition, then FDI is likely to increase the production of capital-intensive products, which largely contribute to intra-industry trade. Thus, intra-industry trade increases as a result of an increased capital-to-labour ratio. However, if a country is already catching up, then further investment in the capital-intensive production will increase the specialization in this sector. As a result, shares of intra-industry trade may decline during the later stages of the catching-up process.

We can document this hump-shaped development with the example of the automobile sector, which is characterized by comparably high shares of intra-industry trade within the EU (see Figure 11.4). For example, Italy and Germany show shares of intra-industry trade between 50 and 80 per cent in the automobile sector. Furthermore, this sector has received a continuous and significant inflow of foreign capital since the beginning of economic reforms in Central and Eastern Europe.

The starting position of the CEECs in the automobile sector was very mixed. Hungary, for example, started out with no domestic car production, but attracted important FDI projects at the beginning of the 1990s (Audi and Suzuki). As a result, intra-industry trade shares increased to about 70 per cent. By contrast, the Czech Republic and Slovakia had a comparably significant passenger car industry already at the beginning of the economic reforms, in addition to which it attracted foreign investors (Volkswagen and Toyota in the Czech Republic, and Volkswagen and more recently Peugeot in Slovakia). While initial investment in upgrading the available production capacities increased the already high shares of intra-industry trade between 1990 and 1995, further mainly green-field investment, especially in Slovakia, reinforced the specialization in automobile production, reflected in a sudden decline of intra-industry trade in this commodity group. Actually, the decline of aggregate intra-industry trade in Slovakia in 1996 can be largely attributed to the development in this particular sector.

6. CONCLUSIONS

The 2001 data indicate that the acceding countries are already participating successfully in the European division of labour. In fact, the European Union has become the most important trading partner for all acceding countries. The regional re-orientation of Central and Eastern European trade towards the EU has been associated with successful restructuring. The increase of intra-industry trade has been one of the most important features of the recent developments in East–West trade in Europe.

At the same time, there seem to be important differences among acceding countries. In particular, Hungary, Slovenia and the Czech Republic have already reached shares of intra-industry trade comparable to those of Italy, Spain and Sweden. Poland and Slovakia show slightly lower shares of intra-industry trade. Nevertheless, these figures are comparable with those of Finland, Portugal and Ireland. By contrast, the shares of intra-industry trade in the EU's trade with Latvia and Lithuania have still remained at the level of EU intra-industry trade with Greece. However, the differences between these country groups and possible implications should not be overvalued, as similar differences can be found among the countries of the European Union.

Furthermore, the low levels or even declines of intra-industry trade may reflect specialization beyond the levels prevailing in the EU. Despite the potential vulnerability to demand shocks for the products concerned, this trade pattern can support a sustainable growth path if the industries are expecting to display a good growth performance in the future. Foreign investors are likely to indicate that the industries (for example the automobile sector in Slovakia) are expected to develop positively also in the coming years.

The chapter discusses the determinants of the EU's intra-industry trade with the OECD countries. In particular, income-per-capita differentials, which serve as a proxy for countries' endowments, turn out to be insignificant if additional explanatory variables related to trade liberalization and geographical location are included. By contrast, country size remains robust in various specifications. The aggregate output of the EU has no significant effects on the EU's intra-industry trade. Thus, the size of a country and the distance to its markets are the most important determinants of intra-industry trade.

In contrast to the OECD countries, the development of the EU's intra-industry trade has been largely influenced by short-term factors. Therefore, the results of the estimations for the OECD countries are used to compute out-of-sample forecasts for the EU's trade with the CEECs. This approach describes well the pattern of adjustment from low shares of intra-industry trade at the beginning of transition to equilibrium or potential shares as observed in Estonia, Hungary, Slovakia and Slovenia. Somewhat surprisingly, the acceding countries are found to have even higher shares of intra-industry trade than comparable EU countries (reflecting the standard determinants of trade structure). This may be explained by the countries' progress in implementing structural reforms and FDI patterns.

NOTES

1. We benefited from comments by Doris Ritzberger-Grünwald, Martin Wagner, Balázs Égert, Lászlo Halpern, Stephan Barisitz, Maria Antoinette Silgoner, and other participants of the East–West Conference, 2–4 November, 2003, Vienna. Language advice by Irene Mühldorf and Susanne Steinacher is acknowledged. The views expressed in this chapter are those of the author and do not necessarily represent the position of the Oesterreichische Nationalbank.
2. Fidrmuc (2001) and Fidrmuc (2004) analyse earlier versions of the data presented here.
3. The EU's intra-industry trade is concentrated on manufacturing products. Correspondingly, the shares of intra-industry trade in total trade (including manufacturing and non-industrial products) of the European Union are slightly lower than those of manufacturing trade alone. In general, the shares of intra-industry trade in total trade were up to 3 percentage points below the shares of trade in manufacturing (see Fidrmuc, 2001).
4. Throughout the chapter, GDP and GDP per capita figures have been converted to ECU/euro.
5. Our data sample includes the EU's trade with the USA, Canada, Switzerland, Norway, Japan, Australia, New Zealand, as well as the individual member states of the EU (Belgium and Luxembourg are counted as one region) between 1989 and 1998.
6. As converted to euros, only the US GDP was slightly higher than the EU's aggregate output in 1989 and 1998.
7. This simple measure of distance, for example, would imply zero transport and transaction costs for the Belgian trade with the EU.
8. This seemingly surprising result is consistent with Krugman's (1991) model of geography and trade.

9. However, this considers only intra-industry trade of the current member states of the EU with the CEECs. In general, the CEECs are not as peripherally located from the point of view of an enlarged Europe as is implied from the remoteness indicator defined by (11.4). Furthermore, a successful catching-up in the CEECs will also shift the economic centre of Europe eastwards.
10. This figure assumes a real annual growth by about 5 per cent and real annual appreciation by about 2 per cent on average.

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12. Trade integration in South-East Europe and the trade potential of Croatia

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1. INTRODUCTION

In this chapter we investigate the degree of trade integration within the South-East European (SEE) region and the trade potential of Croatia. Specifically, we look at Croatia, Bosnia and Herzegovina, Yugoslavia, Macedonia and Albania, which are all very small economies and which all used to be 'trade isolated', being neither candidates for EU accession nor CEFTA members in the 1990s.

The trade regime of these countries has in recent years been subject to a debate among policy makers and academics from both within the region and the EU, with the discussion focusing on trade liberalization as a means of enhancing the catching-up process. Yet the discussion has not been very insightful about 'hard facts' on the present level of integration within the region and its relationship with the EU, and it has not led to a consensus on how liberalization should proceed.

For the purpose of our analysis, we first present some stylized facts on Croatian and SEE trade. Second, we analyse the level of trade integration within the region, using such simple tools as the trade openness ratio and trade concentration indices. We try to explain why trade developments in Croatia did not display the canonical transitional behaviour. Then we run a single-country gravity model to get more insights into the trade potential of Croatia. Two scenarios are calibrated in order to determine Croatia's trade potential with respect to SEE, EU and CEFTA countries. They illustrate the trade dynamics that may unfold once the observed trade biases gradually decrease. We also mention selected trade issues arising from the specific institutional features of these countries. Finally, we discuss the issue of the 'right' trade regime design for Croatia and SEE.

2. TRADE AND TRANSITION: THE FORCES AT WORK

At the onset of transition, three distinct forces were shaping the trade pattern of a typical transition country (a small and open economy, often with newly (re)gained independence): first, the collapse of the Council for Mutual Economic Assistance (CMEA); second, the dissolution of supranational states like the USSR, the Czech Republic and Yugoslavia, which contributed to a new economic geography; and third, an increase in the trade openness ratio (TOR) as a consequence of the policies of stabilization, liberalization and privatization.

Although the former Yugoslavia was not a member of the CMEA, the collapse of the latter amid the fall of the iron curtain led to a diversion of excess trade with that block. Havrylyshyn and Pritchett (1991) suggest, based on an estimated gravity equation, that Yugoslavian trade with the Central and Eastern European countries (CEECs) exceeded the 'natural' volume by 13 percentage points of the trade total during the period 1980–82. At the same time, trade with Northern Europe fell short of 'natural' trade levels by 18 percentage points. This is a fairly small trade bias compared with the degree of trade reorientation needed in other CEECs according to their estimates. For example, Czechoslovakia was estimated to need to reorient more than 70 per cent of its total trade. Based again on a gravity approach, Winters and Wang (1994) draw a somewhat different conclusion for 1985. Although intra-CMEA trade, according to their estimates, broadly matched the potential, trade with market economies was by and large below potential. Hungary appeared to be the most open of the CEECs with actual trade with market economies reaching 30 per cent of the potential. While Wang and Winters did not estimate the potential trade for Yugoslavia, one can assume, judging from other studies, that Yugoslavia (Croatia) suffered from a smaller trade bias than other CEECs.

Looking at 1989, the last pre-transition year, Baldwin (1994) also found intra-CEEC trade to be way too high. The extent of trade diversion varied from 160 per cent of excess trade with the East for Romania to 40 per cent for Poland. Potential CEE exports to the EU-12 were 4.8 times higher than actual exports, while potential EU-12 exports to CEECs were 2.1 times higher than actual exports. Although Croatia was at that time still a part of Yugoslavia, which prevented a comparison of potential with actual values, Baldwin also estimated a pattern of potential exports for Croatia. According to these estimates, the EC-12 should in the long run attract as much as approximately 60 per cent of Croatian exports. With exports to EFTA-6 included, this share increases to 76 per cent.

Baldwin also presented a projection of the trade pattern in the scenario of partial income catch-up. Although the effects of the partial income catch-up would cause trade among the CEECs to remain important, trade with Western Europe would become dominant, with the trade share ranging between 50 and 70 per cent for different countries.

Even though different studies arrive at different quantitative conclusions with respect to intra-CEEC trade, they coincide on the large potential that exists for an increase in trade with Western European countries compared with the level prevailing before the collapse of the CMEA. The main reason behind the different estimates, apart from differences in the estimation methods, samples and periods for which the simulation exercises were run, lies in the great uncertainty about the exact values of the relevant variables. This is especially true for the CEECs' GDP figures and the value of trade flows between them, estimates of which varied a great deal.

Although the trade reorientation caused by the CMEA's collapse led to a slump in demand, this was not entirely bad since it contributed to a convergence towards the 'natural' pattern of trade. Indeed, most of the CEECs recovered fairly quickly as their exports to the EU were growing at double-digit rates.

The dissolution of the supra-national states left the inheritance of large home-country biases in the trade structure among the successor states. Even if the impact of the war that followed Croatia's separation from Yugoslavia is neglected, the emergence of borders dividing previously united economic areas necessarily depresses the level of trade among the newly independent countries. Moreover, while the division of a country decreases the home-country bias existing in trade, this effect usually takes a long time to fully materialize. There are different explanations how and why this happens. While Djankov and Freund (2000) consider the home-country bias to be mostly a result of tariffs and endogenous historical developments that are specific to each country (for example the development of the transport network and other infrastructure, production and consumption chains, and business networks), other researchers quote a number of other reasons. Rose (2000) points to the role that a common currency has in promoting trade among countries (some of the most obvious reasons being the disappearance of exchange costs and of exchange rate uncertainty). Others point to the increase in the costs of acquiring information when business is done across borders (see, for example, Obstfeld and Rogoff, 2000).

A classical case of separation is the break-up of the Austro-Hungarian Empire in 1919. According to estimates of De Ménil and Maurel (1994), five years after the break-up trade had decreased to 60 per cent of the pre-war level, which was still four times more than the gravity model implied.

Contemporary estimates of home-country bias in trade for high-income economies vary across countries as well as across different studies. McCallum (1995), using 1988 data, estimated the bias for the Canadian provinces. He showed that the Canadian provinces, controlled for size and income, used to trade 22 times more among themselves than with the US federal states. Later studies present somewhat lower estimates. Helliwell (1998) found that during the period 1993–96 the Canadian provinces traded 12 times more among themselves than with US federal states. According to Wei (1996), who estimated home-trade biases for a number of countries, the average bias for an OECD country during the period 1982–94, controlled for a number of possibly important factors (adjacency, remoteness, language), was about 2.3, which is much smaller than the previous estimates. Even so, this still means that national borders play an important role in directing trade flows. The estimated home-country bias showed a great deal of variation through the sample – the USA exhibited the smallest bias at only 1.4, while Portugal exhibited the highest, with internal trade exceeding external trade by a factor of 5.7.

One cannot look at the home-country bias without also taking into account the level of openness, which represents the other side of the coin. Since larger countries have a natural tendency to trade less abroad, in comparison with smaller countries, it is possible to overcome shortcomings of the simple trade openness ratio (TOR) by looking at the home-country bias in trade.

The secession, quite naturally, increases the openness level of the country by turning previously domestic trade into foreign trade. However, due to a decrease in the home-country bias, a country's post-secession foreign trade may quite possibly be smaller than its total (domestic and foreign) trade before.

Before the transition process started, except for trade flows that existed among them, transition countries were relatively closed economies. This was a consequence of the restrictions imposed by central planning, and of the planners' aspirations to insulate the country from influences of the world economy. One of the manifestations of that phenomenon was a rather high home-country bias.

The successor states of the former Yugoslavia were, by international standards, not an exception to this rule, although some of the studies mentioned show that the quantity of trade distortions in Croatia was below that of other transition countries. The share of Yugoslavia's merchandise exports and imports in GDP in 1987, five years before the break-up, was less than 40 per cent (World Bank, 1989). Croatia accounted for a quarter of the Yugoslavian GDP (Sirotković, 1996). The data from the 1987 input–output tables reveal that Croatian trade with the former Yugoslav republics was more than twice as great as overall foreign trade. Although detailed estimates of the home-country bias in trade are not available for former Yugoslavia, the above-mentioned ratios imply that trade among the former Yugoslav republics exceeded trade with other countries by a high multiple even after controlling for factors such as income and distance. Abundant foreign trade regulations together with extensive capital account controls were the main impediments to larger foreign trade.

Fidrmuc and Fidrmuc (2000) present a partial piece of evidence on the size of the home-country bias in the former Yugoslavia. According to their study, the level of trade between Slovenia and Croatia in 1990, prior to the break-up, exceeded the 'normal' level 24 times. This figure is rather high in comparison with the above-mentioned estimates of home-country biases prevailing in high-income countries, but low in comparison with other transition countries. For example, according to the same study, trade flows among the three groups of newly independent (successor) countries – the Czech Republic and Slovakia; the three Baltic States; and the Belarus–Russia–Ukraine area – exceeded 'normal trade' by 41–43 times. Even a number of years after the separation (in 1998), the levels of trade still surpassed the effect of preferential trade agreements (PTAs) which replaced the unitary state system. The level of trade between Croatia and Slovenia was double the 'normal' level, between the Czech and the Slovak Republics it exceeded it by seven times, 13 times among the Baltic States and 30 times among Belarus, Russia and Ukraine.

Havrylyshyn and Al-Atrash (1998) showed that countries that have made the most progress in structural reforms have also gone farthest in diversifying their exports to new destinations – at least regarding the EU. This finding points to the fact that there is a correlation between domestic policies and the convergence of actual and potential trade structures. The second regularity observed by Havrylyshyn and Al-Atrash is the relationship between the progress of reform and the level of openness. This is in concordance with the predictions based on gravity equations and assumed impediments to trade prevailing before reforms took place.

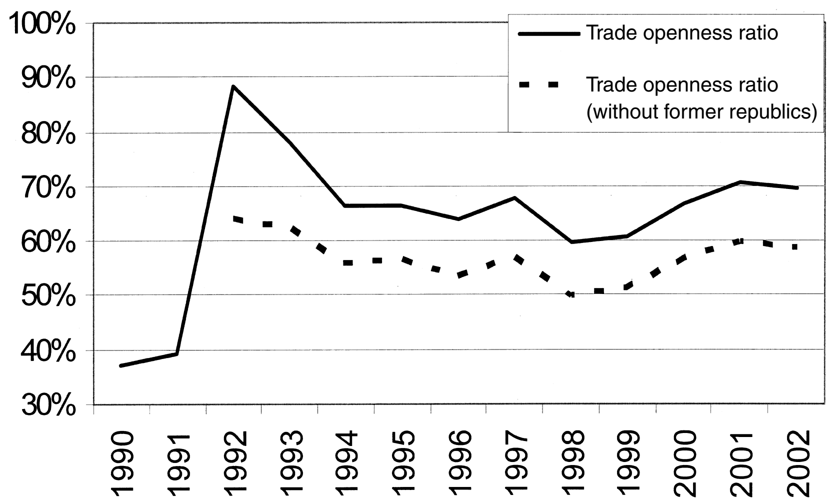
In addition to the three issues mentioned above, which affect trade in a more or less unambiguous manner, GDP growth also plays an important role in driving the quantities of international trade and the levels of openness. Countries that grow faster end up trading more both in volumes and as a share of GDP. Other, less successful countries have lower trade shares and volumes on average.

3. CROATIA: A SOMEWHAT ATYPICAL TRANSITION STORY

At the time of the declaration of independence, with TOR being as high as 88 per cent, Croatia was a very open economy. Considering the above-mentioned determinants of trade that were expected to increase Croatia's trade integration with the EU and other developed economies, as well as to further decrease a modest (for instance in comparison with 1987) share of trade with former Yugoslav republics, one would have anticipated the level of openness to increase further. Yet quite the opposite happened. In 1993, exactly a year after Croatia became independent, TOR sharply decreased to 78 per cent. The fall continued in 1994, when TOR declined further to 66 per cent; thereafter, the ratio broadly remained at that level, with the exception of 1998 and 1999 during which imports were reduced due to the economic slowdown and recession (see Figure 12.1).

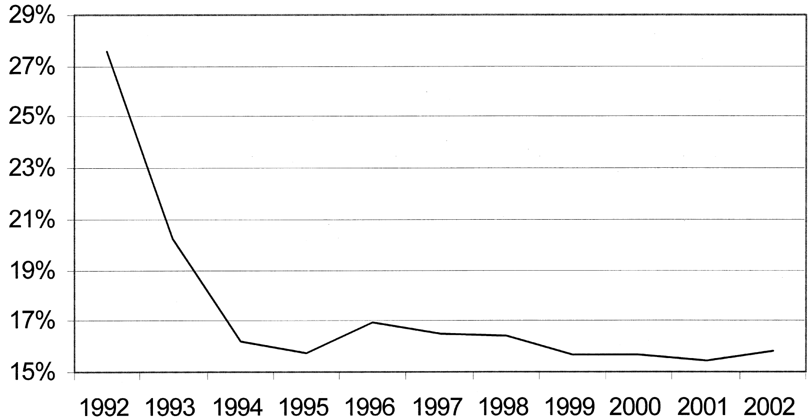
It has to be noted that the fall in TOR can only partly be attributed to a sharp decrease in trade with other successor states of the former Yugoslavia (Figure 12.2). If the latter are excluded, a similar trend of decline can be observed, although less pronounced.

How can this unusual decline in TOR be explained, especially having in mind that Croatia, according to the most commonly used indicators (for instance EBRD), belongs to the group of advanced transition economies, that



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues.

Figure 12.1 Trade openness ratio (TOR) – Croatia

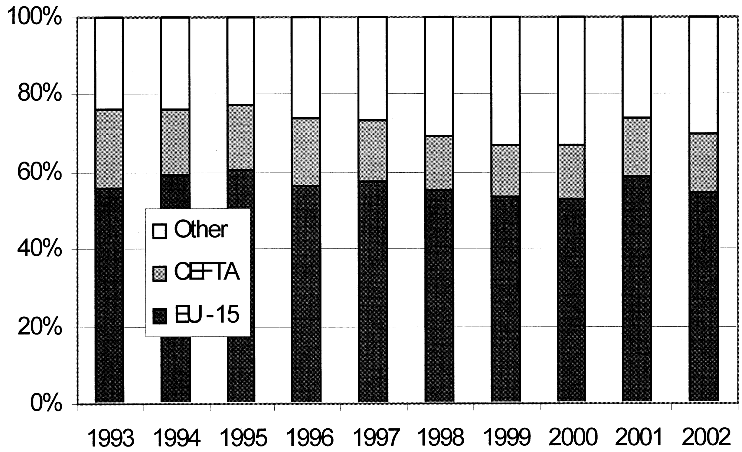


Source: Central Bureau of Statistics, Monthly Statistical Report, various issues.

Figure 12.2 The former republics' share in Croatian foreign trade

is those countries that are, according to the findings in Havrylyshyn and Al-Atrash (1998), supposed to progress most quickly in opening-up and diversifying their trade? Not only did TOR not increase, contrary to expectations the regional structure of Croatian trade did not change either. Following the declaration of independence, the share of trade with the EU-15 was 57 per cent, or about two percentage points more than ten years later. At the same time, the trade share of the countries constituting CEFTA dropped from 23 per cent to 15 per cent. Most of this fall was compensated for by an increase in trade with other former Yugoslav republics – Bosnia and Herzegovina and Macedonia – after the end of the war in 1995 (see Figure 12.3).

So, what are the likely reasons behind the observed fall in openness and the stagnant trade structure? In 1993, and in 1994, the main reason for the rapid decline in TOR was a break-up of trade links with former Yugoslav republics, as can be seen from Figure 12.1, which demonstrates that the decline in TOR was much slower when we exclude the former Yugoslav republics. However, even with the former Yugoslav republics excluded, TOR recorded a falling trend. The main explanation, along the reasons mentioned in Vujčić and Presečan (1999), was Croatia's exclusion from trade associations in the region. Croatia did not have an association agreement with the EU, was not a member of CEFTA, and did not even have bilateral trade agreements with its main trading partners except for bilateral free trade agreements with Slovenia (in force since January 1998) and Macedonia (since October 1997). Bosnia and Herzegovina was the first country to sign a PTA agreement, but also the first to cancel it (in 1998;[2] the



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues.

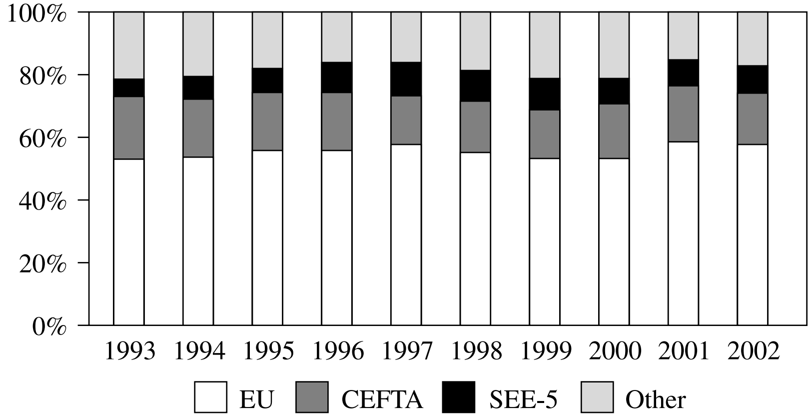
Figure 12.3 Geographical pattern of Croatian trade

agreement was subsequently renewed on an asymmetrical basis in January 2001). Until mid-2001 Croatia was not even a WTO member. These were all huge impediments to trade development and to an increase in TOR.

4. HOW DOES CROATIA FIT INTO THE REGION?

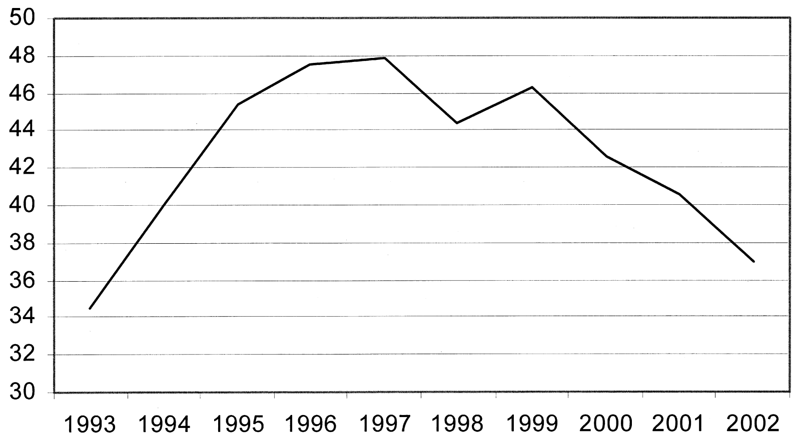
Having looked at the dynamics of Croatian trade during the 1990s, we address the question of the present degree of Croatia's integration with the five South-East European countries (SEE-5) and likely future developments. The intra-regional trade share of the SEE-5 countries stood at 5.6 per cent in 1993. This share increased once the war was over in 1995, reaching 10.3 per cent in 1997, and fell slightly afterwards (see Figure 12.4). The increase was mostly at the expense of trade with CEFTA countries, whose share decreased, as well as with other countries, while the share of trade with the EU countries remained practically unchanged. Croatia, accounting for over half of the region's trade total and well above a third of intra-regional trade, was the principal force driving integration among the countries in the region.

Taking into account the fact that, for example, the share of trading among the Benelux countries – a highly integrated and, as measured by economic size, much larger region – was 13 per cent (Flörkemeier, 2002), a share of 10 per cent for a much smaller and less integrated SEE-5 group seems to be quite high. Adjusting the intra-regional trade share by a



Source: IMF Direction of Trade Statistics, 2002.

Figure 12.4 The regional trade pattern of SEE-5 countries



Source: IMF Direction of Trade Statistics, 2002 and author's calculations.

Figure 12.5 Trade concentration indicators for the SEE-5 countries

measure of the region's importance in the world trade gives a trade concentration ratio (or trade intensity ratio, see Figure 12.5).

Interestingly, during the war in former Yugoslavia trade concentration in the region increased sharply, reaching the value of 48 at the end of the postwar period. This tells us that at the end of the conflict in former Yugoslavia,

Table 12.1 Trade concentration ratios for different regions

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SEE-5	34.5	40.0	45.4	47.5	47.8	44.4	46.3	42.5	40.6	37.0
APEC		1.6								
ASEAN-6		3.6								
EU-15		1.6								
EU-12		2.1								
Mercosur		12.8								
Andean Community		12.6								
NAFTA		2.2								

Source: Frankel (1997) and author's calculations.

countries from the region used to trade among themselves 48 times more than with a typical country anywhere in the world. Trade concentration has been on a decreasing trend since 1997, but still remains very high. In Table 12.1 we compare trade concentration among the SEE-5 countries with some of the well-established regional trading blocks.

It can be noticed that trade concentration ratios reveal a much higher level of integration amongst the SEE countries in comparison to the existing trading blocs. Although the data on intra-regional trade show that EU countries trade a lot among themselves, because of their size and importance in the world economy the level of actual trade concentration is much smaller in comparison with other trading blocs. Also, one has to be careful when comparing the absolute levels of the trade concentration index for countries at different levels of development because more developed economies tend to export a wide variety of products and to better diversify their exports geographically (Flörkemeier, 2002). More surprising is the very high trade concentration among the SEE countries even in comparison with smaller blocs such as the Mercosur or the Andean Community. Judging from trade concentration indices, the SEE-5 group seems to be very highly integrated.[3]

The trade concentration index controls for the level to which a country is integrated in the world economy, which means that different country sizes and different levels of openness do not affect the result. This index, however, does not take care of the income and transportation cost effects. Moreover, it can compare across different levels of integration, but it cannot tell anything about the levels of trade creation and diversion resulting from the formation of trading blocs or about the optimality of the trading structure. The more sophisticated gravity approach can take care of some of these issues.

The gravity approach was launched as a more or less 'atheoretical' approach to the analysis of trade flows. However, the idea of using economic potentials and trading costs in an analysis of bilateral trade flows proved to have deeper theoretical roots than was thought at first. Frankel (1997) surveys literature that tried to root the gravity approach into different theoretical rationales, the Hekscher–Ohlin model as well as the theory of imperfect substitutes. The establishment of theoretical foundations of the gravity approach also contributed towards some extensions of the model, an important one being the inclusion of 'similarity' or 'dissimilarity' variables to test for the relevance of different trade theories. Although compatible with the range of trade theories, the gravity approach remains unable to predict the trade structure – a composition of the goods a country is supposed to import and export. In order to get an answer to that question, one has to look into the underlying theory of trade.

The gravity model is usually estimated over a pool of countries for a number of years using a panel approach. However, because we are solely interested in the pattern of Croatian trade, we rely on a single-country equation. The gravity equation that we estimate, in its simplest form, is the following semi-log specification:

$$TR_i = \beta_0 + \beta_1 GDP_i + \beta_2 DIST_i + \sum \gamma_k D_{ik}$$

where TR_i stands for the natural logarithm of Croatian trade with country *i*, GDP_i for the natural logarithm of the gross domestic product of the country *i*, measured at exchange rate parity (World Bank 2000, 2003) and $DIST_i$ for the distance between Zagreb and the capital of country *i*. D_{ik} represents dummies for selected preferential trade agreements (PTAs). A number of different dummies, accounting for adjacency and common history, were also tested, but they are highly correlated among themselves and with the trade preferential variable for 1999.

A single-country specification, apart from serving our aim well, also avoids some troubling specification problems that arise in pooled estimations. In the later case, differences in the relative remoteness of trading partners produce systemic biases that depend on the location of a specific country (Brenton and Di Mauro, 1998). Furthermore, the issue of heterogeneity of the countries may also be alleviated with a single-country specification.

Estimates of the gravity equations for Croatia are presented in Table 12.2. Estimates refer to 1999, a year before massive negotiations started for preferential trade agreements, and 2002, the latest year for which we could get a full coverage of trade and GDP data. In 1999 Croatia had only 3 PTAs while between 1999 and 2002 a total of 25 preferential trade agreements came into

Table 12.2 Gravity equations for Croatia – aggregate trade flows

	1	2	3	4	5	6
Year	(1999)	(1999)	(2002)	(1999)	(1999)	(2002)
const	10.49	10.03	10.22	7.25	7.27	8.60
	(7.2)	(4.7)	(5.8)	(5.6)	(4.6)	(5.2)
GDP1999	1.03	1.13		0.97	0.97	0.99
	(7.2)	(8.3)		(16.2)	(15.4)	(14.5)
GDP2002			0.99			
			(10.7)			
dist_car	−1.58	−1.61	−1.36			
	(−4.5)	(−4.6)	(−6.7)			
dist_air				−1.08	−1.08	−1.24
				(−8.4)	(−6.0)	(−6.9)
FTA1999	2.58	2.58	2.05	3.22	3.21	2.70
	(−3.5)	(−3.5)	(3.4)	(5.6)	(4.7)	(2.5)
FTA2002		−0.63	−0.69		−0.02	−0.23
		(−1.3)	(−1.9)		(−0.1)	(−0.5)
N	42	42	42	155	155	144
R2−adj	0.72	0.72	0.88	0.68	0.68	0.74

Note: t-values in parenthesis.

Source: Author's calculations.

force, increasing the total number of PTAs to 28. Dummy variable FTA1999 was used to denote countries for which a preferential trade agreement existed before 1999 (all three of these countries were also members of the former Yugoslavia, while two of them share a common border with Croatia so that the FTA1999 dummy captures these effects too). The FTA2002 dummy variable denotes countries with more recent preferential trade agreements only (this dummy was, however, also included in the 1999 regression to check whether the preferential trade agreements had any impact). Two different sets of observations were used: European countries (N = 42), for which road distances were used, and all Croatian trading partners (N = 155 for 1999 and N = 144 for 2002), for which air distances were used. This gives a total of six regressions. A number of other variables were also included, like measures of similarity or dissimilarity with trading partners. Yet neither were significant at the level of 10 per cent. This means that neither the Linder nor the Hekscher–Ohlin effect could be traced in those gravity specifications.

GDP and distance variables are significant in all six specifications. Moreover, the coefficient with the GDP variable is close to 1 in all of them. The parameter on the distance variable, also significant and with the expected sign, shows a bit more variability, depending on the period under observation and the selection of a dummy variable. The overall level of the explained variation is quite satisfactory, with the adjusted coefficient of determination ranging from 72 per cent to 88 per cent, which is standard in the empirical gravity-model literature. The overall level of fit was somewhat better for the smaller sample, probably reflecting the fact that the land distance variable is a better proxy for costs of conducting trade than the air distance. In most regressions heteroskedasticity was found using the White's heteroskedasticity test, so White heteroskedasticity-consistent standard errors were used where necessary.

The most noticeable conclusion arising from the gravity model is that actual Croatian trade conducted within the SEE region is above potential according to all estimates, regardless of the specification and even after the usual PTA effects have been taken into account. Effect of belonging to the 1999 PTA group is estimated to increase trade between 11 (equation 1: $\exp(2.58) = 12.2$) and 23 times (equation 4: $\exp(3.22) = 24.0$) above the 'normal' level, depending on the definition of the 'normal' level. These figures by far surpass the normal effects of trade integration. The effects of adjacency, common language and being a former Yugoslav republic are intertwined with the PTA effects and it is impossible to make a plausible distinction between them. The estimated size of the common language/history/PTA effects is huge, which makes us believe that a major part of these effects can be explained by the home-country bias leftovers. These findings also confirm the conclusions that can be derived from the simpler trade concentration indices.

A high level of trade concentration with countries of the former Yugoslavia (which also comprises Slovenia, one of the three countries that had PTAs with Croatia in 1999) may be ascribed to two main factors. First, to the trade links established prior to the break-up leading to liberal trade policies and PTAs after the break-up. Second, Croatia as well as other SEE-5 were excluded from closer integration with the EU and CEFTA countries. Prior to 2000 Croatia was not even a WTO member. Exclusion of the SEE-5 countries from trade integration with the rest of the world resulted in an increased home-country bias in spite of the conflict in the region. Once trade liberalization with the rest of the world started, the trade bias started to decline as well. Regression results demonstrate that the home-country bias in Croatian trade declined between 1999 and 2002. The trade volume with 'FTA1999 countries', according to different specifications, dropped from 12 to 7 times above the 'normal' (specification 1) or from 24 to 14 times above the 'normal' (specification 2). This is also consistent with the dynamics of trade concentration indices, which have declined since 1998. However, the size of the home-country bias still remains significant.

Estimated trade potentials with the EU and CEFTA (most of the FTA2002 countries), represent the other side of the coin. According to equation 3, Croatian trade with 25 countries denoted with the FTA2002 dummies, of which EU, EFTA and CEFTA countries are the majority, is significantly below the 'normal' level, while according to equation 6 it does not significantly differ from the 'normal' level. These results are not easy to interpret since the bulk of trade flows are dummied out. Therefore, the 'normal' trade flow is confined to only a minor part of the overall trade volume. Also, the level of trade with the EU is assessed as 'normal' with respect to the non-European countries and not in comparison with the SEE countries. This may, at least in part, be due to a misrepresentation of the trading costs with the dist_air distance variable. Nevertheless, the results seem indicative of an unfulfilled PTA potential with EU and CEFTA countries.

Due to the notion that PTAs follow rather than precede actual trade flows, in the gravity literature it is customary to test for the presence of above-normal trade flows even before a PTA takes effect. The FTA2002 dummy was included in regressions 2 and 5, performed on the 1999 dataset, but apparently even 2002 was still too early for any major impact of recent PTAs on the Croatian trade structure, let alone 1999. Since these PTAs are very recent, we expect that they will result in a continued trend of trade reorientation and decline of trade concentration among Croatia and the SEE-5 countries.

5. A LOOK INTO THE FUTURE

What is the likely pattern of Croatian trade flows in the future? In order to provide an answer to that question, we have to make certain assumptions on the forces that will shape tomorrow's trade pattern and their intensity. The gravity approach confirmed an initial conjecture that Croatia was leaning against the forces of trade diversification most of the time after the declaration of independence. This was mainly due to its exclusion from trade arrangements with the EU, CEFTA and the WTO. We believe that it is rational to expect a more rapid trade diversification in the future due to the recent adoption of closer trade arrangements with the EU and accession to CEFTA and the WTO. The trade intensity indices and the gravity model imply that trade diversification has already started, but the results are still weak. Further trade diversification could be expected because of the further decrease in the home-country bias observed in the post break-up countries and increasing effects of PTAs with the EU and CEFTA countries. Furthermore, the expected continuation of the reforms in Croatia as well as a speeding up of reforms in other countries of the region should also contribute to the same result (Havrylyshyn and Al-Atrash, 1998). All that should lead towards the continued decrease in the share of intra-regional trade. At the same time, if the countries in the region are to catch up with the EU, the relative difference in the growth rates of these countries *vis-à-vis* other countries should drive up the intra-regional trade share. The actual outcome will depend on the interplay of these effects and their intensity.

We use gravity models estimated for 2002 (equations 3 and 6) in order to project the pattern of Croatian trade in 2010. These projections are based on the following assumptions. First, we assume the SEE countries to grow at a rate of 5 per cent. The assumed growth rate of the CEFTA region, as well as that of Croatia (since Croatia has a higher GDP per capita than the SEE countries, comparable to countries belonging to the CEFTA region) is 4 per cent, while we expect the EU to grow at a rate of 2.5 per cent. The projected growth rates implicitly presume a partial income catch-up resulting in rising trade opportunities within the region. Further on, we assume that Croatia's PTAs with EU, EFTA and CEFTA countries, as well as PTAs with the SEE countries, will stay in place. Finally, we have to deal with the quantitative effects of the PTAs. As we have already mentioned, in our gravity model the PTA effects are intertwined with the cultural effects. Projecting further the expected decrease of home-country bias, we assume the common culture to increase trade with FTA1999 countries by six times in equation 3 (down from an estimated seven times in 2002) and 12 times in equation 6 (down from an estimated 14 times). The exception is Slovenia, where diversification has gone farthest, and we assume the cultural effects to double trade (quadruple in equation 6), which is based on results from Fidrmuc and Fidrmuc (2000). Therefore, assumptions of a home-country bias leftover are strongly present in our projections, which should be kept in mind when interpreting the results. Croatia's PTAs with EU, CEFTA and SEE countries are assumed to bring trade in line with the 'normal' flow in equation 3, while in equation 6 this is assumed to increase trade by 30 per cent, which is roughly similar to the estimates from other studies (Frankel, 1997).

According to the projections in Table 12.3, the largest trade potential for Croatia clearly lies with the EU and CEFTA countries. Due to always arbitrary assumptions on the evolution of the PTA and home-country bias effects, these projections should not be interpreted as an attempt to predict future trade flows. They should rather be interpreted as an attempt to illustrate the size of the existing bias in the Croatian trade with SEE countries and the likely behaviour of the trade flows when these biases will gradually be reduced.[4]

Table 12.3 Projected trade growth rates (projected trade potential over current actual trade flows, in per cent)

	Projection 1	Projection 2
EU	89	70
CEFTA	103	56
SEE	−40	−36

Source: Author's calculations.

6. CONCLUSION

In this chapter we have looked at the trade concentration among the five SEE countries which were excluded from trade integration with the rest of the world during the 1990s, and at the trade potential of Croatia. Trade concentration ratios reveal a much higher level of integration among the SEE-5 countries in comparison with all existing trading blocs. Moreover, during the war in former Yugoslavia trade concentration in the region sharply increased in spite of the fact that most of the countries were engaged in the conflict.

The most noticeable conclusion arising from the gravity model is that actual Croatian trade conducted within the SEE region is much above potential according to all estimates, regardless of the specification and even after the usual PTA effects have been taken into account. The high level of trade concentration with countries of the former Yugoslavia (including Slovenia) could be ascribed to two main reasons. First, to the trade links established prior to the break-up leading to liberal trade policies and PTAs after the break-up. Second, Croatia as well as other SEE-5 countries were excluded from closer integration with the EU and CEFTA countries. Prior to 2000 Croatia was not even a WTO member. The exclusion of the SEE-5 countries from trade integration with the rest of the world resulted in an increased home-trade bias in spite of the conflict in the region. Once the trade liberalization with the rest of the world started, the trade bias started to decline as well.

An obvious conclusion from projections of trade in the future is that the largest trade potential for Croatia lies with EU and CEFTA countries. In terms of trade system design it would, therefore, not be desirable to exclude any of those countries from the pan-European trading arrangements, as they pursue further trade liberalization among themselves. Proper sequencing of trade liberalization will eliminate current trade biases and contribute most towards realizing potential trade growth.

NOTES

1. Boris Vujčić, Deputy Governor, Croatian National Bank, Croatia. Vedran Šošić, Economist, Research Department, Croatian National Bank, Croatia. Views expressed in this chapter are those of the authors, and do not necessarily reflect views of the Croatian National Bank. We would like to thank, without implication, participants of the WIIW workshop 'Regionalism in Southeast Europe', and in particular, László Halpern for helpful comments on the first draft of this chapter. We also thank Maja Bukovšak for her assistance with data handling and collection.
2. Because of the IMF's insistence on higher tariff revenues for Bosnia and Herzegovina.
3. It should, however, be noted that Albania is not highly integrated with the other four countries. Therefore, the conclusion mostly applies to the four successor countries of Yugoslavia.
4. Dimitrov and Stanchev (2001) point out a few important obstacles to further regional trade integration based on survey results. Contract enforcement and payment collection rank high amongst the difficulties faced by firms engaged in regional trade. Legal procedures in SEE countries are bad and it usually takes an unacceptably long time before cases are resolved. One third of all transactions are made in cash, which may be connected with illegal funds and certainly makes facilitating the transaction more expensive. Moreover, barter is involved in 12 per cent of total transactions, which causes difficulties to exporters and may be connected with tax evasion. Further on, even when transactions are made through the financial system, banks located outside the region are frequently used. This complicates matters even further and makes trade more expensive. Given all the difficulties faced by the companies, business in SEE countries appears to provide only a temporary relief for selling uncompetitive products. Therefore, a successful exporting strategy cannot be based on these markets as it may trap exporters into unsustainable market niches.

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PART V

The road to monetary union

13. The accession economies' rocky road to the euro

Barry Eichengreen[1]

Now that the decision has been reached to admit to the European Union eight of what were once called the transition economies, attention has naturally turned to whether these countries should also adopt the euro. But whereas there is a consensus that joining the EU, while posing certain difficulties, will be a source of net benefits, there is no such consensus about the consequences of monetary union. In part this reflects the unusual difficulty that monetary economists have in translating theory into policy. We specialists, in other words, cannot even agree amongst ourselves.

In this chapter I suggest that this uncertainty is unwarranted. Adopting the euro is clearly superior to the other monetary options available to the new EU members. These countries are right to be committed to joining the euro area as soon as possible. And the incumbent members of the euro area should be happy to have them. To be sure, enlarging the monetary union will pose difficulties for both the incumbents and the new members. But these are minor compared to the difficulties that will arise under other scenarios. From this point of view, it is regrettable that the incumbents appear to be placing unnecessary obstacles in the path of the aspirants.

1. OPTIONS

On 1 May 2004 the ten new member states of the European Union will join EMU with a derogation (that is, they will not be obliged to adopt the euro at the outset). They will also become part of the European System of Central Banks, although they will participate only in its General Council.

What monetary alternatives will be open to them subsequently? They can run a currency board, like Estonia, or euroize unilaterally if the EU does not penalize them for doing so. For countries inclined in this direction, joining the euro area is clearly the first-best alternative. Monetary policy is identical either way, and if they participate in the European Central Bank (ECB) they will have a voice in its formulation.

Another option is to float, but the new EU member states will not be able to float freely. In contrast to the UK and Sweden, much of their debt is denominated in foreign currency.[2] Hence, when the exchange rate moves, they are hammered by balance-sheet effects. This means that their floating exchange rates must be heavily managed. To be sure, aside from monetary union, floating is still the best option going. But there are limits on how freely the exchange rate can float. There are also limits on the utility of monetary policy as a stabilization device.

Closer to where I live, Brazil exemplifies these dilemmas. Some 40 per cent of the country's debt is dollar denominated or linked. Hence, when the exchange rate weakens, the central bank is forced to hike interest rates to limit the extent of the depreciation. Not infrequently, the source of that depreciation is a decline in domestic demand. A weaker currency is the market's way of crowding in export demand and keeping production from falling as sharply as domestic sales. And the Brazilian *real* was permitted to fall in the recent slowdown, by as much as 30 per cent. But it was not permitted to go beyond that for fear of damaging balance-sheet effects. And the interest rate increases needed to limit those balance-sheet effects are precisely the wrong policy from the point of view of stabilizing domestic demand. This has meant, for much of the recent period, that monetary policy has been pro-cyclical. The problem is not that Brazilian policy makers are inept, but they face an unavoidable dilemma. Luis Felipe Cespedes and co-authors describe this nicely in a recent NBER working paper entitled 'IS–LM–BP in the Pampas'.[3] In their model, there may be no way to shift the IS, LM and BP curves so that they intersect at a happy equilibrium. Central Europe may be very far from the Pampas, but its dilemma is the same.

This leaves the option of limiting the currency's movement to a narrow fluctuation band. If you are a believer in bands, then there may be relatively little that I can do to convert you. But as a long-standing sceptic, I am convinced that prescribing bands for the new EU members for an extended period is the worst form of macroeconomic malpractice. Bands are fragile and difficult to manage. Their fragility is clear from Europe's own experience in 1992. A fine illustration of the difficulties of managing them was inadvertently provided by Hungary in 2003.[4] And the costs when they collapse can be enormous.[5]

Theorists can construct models of well-behaved exchange rate bands. Readers will be familiar with Paul Krugman and Lars Svensson's models of target zones that reconcile limited exchange rate flexibility with significant monetary autonomy.[6] But exchange rates will be stabilized only if the commitment to the band is credible. If there are suspicions that the authorities may change their minds, then the band can become a destabilizing force.[7] And if depreciation within the band raises debt-servicing costs, then the resulting monetary autonomy will be of little value.

Consigning the new EU members to a narrow-band ERM II as a half-way house on the road to the euro area sets them up for precisely the kind of crisis that Europe suffered in 1992. Hopes that they will successfully navigate the transition to monetary union and its lower interest rates have already stimulated convergence play flows. Indeed, Central and Eastern Europe is the only emerging region forecast to receive significant net debt flows in 2003.[8] But both domestic political disruptions and statements emanating from Brussels and Frankfurt could abruptly end this happy state of affairs. Those flows would then turn around, bringing the whole house of cards crashing down.

By process of elimination I therefore conclude that joining the euro area is the best option going. The new EU members already enjoy little monetary autonomy. They display little exchange rate flexibility anyway. Joining the euro area will render their monetary policies more predictable and their finances less fragile. It will give them at least some say over a monetary policy that they would otherwise have to import from the euro area as a fait accompli.[9]

Why then are the incumbents reluctant to have them join? So long as they are catching up with the West, the new economies will experience relatively fast Balassa–Samuelson inflation, creating fears that the ECB will feel compelled to maintain a tight monetary stance inappropriate for slower growing countries. But on a GDP-weighted basis (which is the basis on which central banks conduct monetary policy), the new members will be too small to dominate the stance of ECB policy for a long time – until, that is, they are considerably richer and the Balassa–Samuelson effect has largely disappeared.

Another explanation for the incumbents' reluctance is the fear that these countries could have financial problems that will compel the ECB to intervene, compromising its anti-inflationary resolve. While there is no question that the new EU members have fiscal work to do – I will return to this shortly – the danger they pose to the financial stability of the euro area and the threat they pose to the anti-inflationary credibility of the ECB are in fact considerably less than in the case of the incumbent members. Their debts are low. Their banking systems are not at risk since these are largely foreign owned. Without getting into the debate over the Stability Pact, suffice it to say that the logic of the argument connecting fiscal policy to central bank credibility is disputable.[10]

A final reason why the incumbents may be reluctant to admit ten new members is that doing so will render the Governing Council of the ECB unwieldy, forcing the institution to move finally to a rotation system under which even the large countries will periodically have no vote. I share their dislike for rotation, although the basis for my dislike is different: I fear that it will reintroduce nationality into the deliberations of the Governing Council without doing much to streamline decision making. Better would be to delegate monetary policy decisions to the Executive Board. But this is viewed as unacceptably radical. The upshot is that significant enlargement of the ECB would force the incumbents to rotate off the Governing Council from time to time. If this is what is fuelling their reluctance to accept new members, it is short-sighted.

2. THE TRANSITION

It is against this background that Pedro Solbes' statement in May 2002 that the new EU members will be expected to adhere to the narrow bands of ERM II for two years as a precondition for qualifying for monetary union is particularly disturbing.[11] The new members have enough financial problems; they do not need this additional burden. As we learned in 1992, a strict interpretation of the convergence criteria that makes holding currencies within the ERM's narrow ± 2¼ per cent bands for two years without involuntary realignment is a recipe for disaster. The new EU members will want to follow policies consistent with early admission to the monetary union, but they will also have to attend to their domestic economic needs, and in particular to implications for the government's re-election prospects. If doubts develop and capital begins to flow out, they will have to raise interest rates, perhaps very sharply, in order to attract it back.

Higher interest rates are not helpful, of course, for the employment situation.[12] Thus, the authorities are in the unenviable position of having to choose between raising interest rates to hold open the promise of admission to the monetary union later, or not raising them to avoid aggravating the unemployment problem now. Politicians finding it difficult to delay gratification, there is the danger that a loss of confidence, even if unwarranted, could tip the balance. Forced to pay an even higher price now for the promise of monetary union later, the loss of confidence may lead them to abandon a peg that they would have otherwise happily maintained. This is an instance of multiple equilibria. It is a classic example of a self-fulfilling balance of payments crisis.[13]

This risk is greater with narrow bands than broad bands, as the EU learned after moving from the former to the latter in 1993. If a successful attack leads the government to abandon hope for early admission to the monetary union, causing it to shift to a more accommodating policy, the attack will precipitate a sharp drop in the exchange rate, conferring significant gains on currency speculators. If the attack is unsuccessful, on the other hand, the exchange rate will barely move, confined as it is to narrow bands. Currency speculators will therefore lose nothing. Under wide bands, in contrast, there is a two-way bet; speculators are confronted with the possibility of losses as well as gains. As early birds develop doubts about future prospects, the currency can weaken considerably within the band before the central bank is forced to take action. But when other investors decide whether or not to pile on, they must recognize that if the currency eventually recovers to its initial position within the band (a reasonable expectation on the assumption that nothing else changes) they will suffer serious capital losses. This helps to limit herding and the force of the purely speculative pressures with which the central bank must cope.

The problem is likely to be even greater with ERM II than with the old ERM, insofar as the ECB will feel only limited obligation to intervene on behalf of the accession economies or to provide them with short-term financing. The original ERM was all for one and one for all. A crisis that jeopardized one country's participation might jeopardize the entire system, as Europe learned in 1993. While there were limits on how far the strong-currency countries would go to support their weak-currency counterparts, there was still a clear perception of shared interest in the system.

Now, in contrast, the euro will not have ERM bands; if a country exits ERM II or if the system collapses, this will not much affect the value of the euro or exchange-rate stability within (most of) the single market. This makes it more likely that the provisions allowing the ECB to withhold intervention until a currency has reached the edge of its fluctuation band and to halt such intervention if it fears that price stability is threatened will be invoked. And currency speculators know it.[14]

There is also the possibility that the narrow bands of ERM II will be incompatible with the other convergence criteria. The Maastricht criteria, as interpreted by the Commission, require both stable exchange rates and low inflation. Fast-growing economies catching up with the leaders necessarily have appreciating real exchange rates. By definition, then, either the exchange rate criterion or the inflation criterion will have to give.

Assume that the differential rate of productivity growth between the traded and non-traded goods sectors in the new and old EU member states is running at 3 per cent a year. This is not unrealistic: between 1973 and 1991, this differential was 2.8 per cent per annum higher in Italy than in Germany, and 2.3 per cent higher in Spain than in Italy.[15] Without going into details, suffice it to say that comparable figures for the accession economies in the 1990s were significantly higher.[16]

If the share of non-traded goods in consumption is a half, then consumer price inflation in the new economies will run 1½ per cent per year above the euro area average, assuming that the law of one price holds for traded goods and labour is perfectly mobile between sectors.[17] It will run even further above the rate of inflation in the three best-performing euro area economies, which remains one of the other convergence criteria. If we think that yearly inflation in the three best-performing euro area economies will be a percentage point below the euro-area average (which was the actual situation in June 2003 and is not out of line with historical norms), then the new countries need only half a percentage point of Balassa–Samuelson inflation a year before they encounter this problem. It is not implausible, in other words, that this constraint will bind.

To make my point simple, consider the case where inflation in the three best-performing EU economies is a percentage point below the euro area average of 2 per cent, and the differential rate of increase of traded versus non-traded goods prices is 3 per cent higher in the new member states, making their overall inflation rates 3½ per cent. The inflation differential between the new member states and the three best performers is then 2½ per cent per annum. The exchange rate then has to be pushed up by a full percentage point in the year prior to the evaluation in order to avoid violating the inflation limit of 1½ per cent above the three best-performing incumbents. But doing so comes within a hair of breaching the limit on the range of permissible exchange rate fluctuations, assuming that the exchange rate began the year at its central parity. If the exchange rate was stronger than this, which will almost certainly be the case if expectations of a favourable outcome are running high and capital is flowing in, then either the exchange rate or the inflation criterion will be violated.

One can imagine various ways around this particular problem. Perhaps there will be a fortuitous anti-inflationary shift in the terms of trade in favour of the accession economies.[18] Maybe the EU will recognize that the provision focusing on inflation not in the euro area as a whole but in its three lowest-inflation countries is archaic now that monetary union actually exists.[19] Maybe it will adopt a flexible interpretation of the precondition requiring ERM II members to maintain narrow 2¼ bands without involuntary realignments, classifying all revaluations as voluntary. In effect, this would amount to narrow bands on the downside and wide bands on the upside. Perhaps it will opt for 15 per cent bands on both the up and down sides.

But by making qualification sensitive to events and interpretation, this process will also make the financial situation fragile and the new member states crisis prone. The Commission has not shown an ability in recent months to articulate a clear and consistent party line. If the expectation is that it will adopt a permissive interpretation, capital will flow in, strengthening the exchange rate and fuelling inflation (and therefore creating a conflict between the two convergence criteria if a strict interpretation of the rules is enforced). To prevent the exchange rate from more than modestly exceeding the top of its band, the authorities will have to cut interest rates (fiscal policy being hard to manipulate in the short run), adding to the inflationary pressure. If there is then a suggestion that the Commission will require a strict interpretation, capital flows will turn around. The potentially self-fulfilling speculative dynamics that I described earlier will then come into play.

For all these reasons, I fear that the narrow bands of ERM II would be a recipe for disaster. Wide bands would be better, but no bands would be best. Just because Greece was able to skate through this uncomfortable situation is no reason why the accession economies should now be required to do the same. In the days before Stage III approached, it was possible to make a case for bands, namely that EU member states needed to be prevented from engaging in exchange rate manipulation that might be corrosive of cohesion and even threaten the single market. But now the monetary union exists, and the new member states want to be in it. If they are allowed a reasonable transition path, most of them will enter quickly, rendering any intervening exchange rate fluctuations transitory and therefore of only ephemeral impact on the single market. This suggests focusing on the inflation and budgetary criteria to determine whether they are capable of running sound and stable policies. If they fail to do so, they will not be allowed to enter the monetary union. But then they will not be able to operate narrow bands either. There is no case for ERM II either way.

3. FISCAL POLICY

From this point of view, the major challenge for the new members will be fiscal adjustment. To be more precise, this is the major challenge for the Czech Republic, Hungary, Poland and Slovakia (the CEE-4). There is a striking divergence between the budget deficits of the CEE-4, which have exploded, and those of the smaller accession economies, which remain firmly under control. While estimates for 2003 deficits are all over the map, suffice it to say that investment banks are forecasting deficits on the order of 5 to 7 per cent of GDP for the Czech Republic, Hungary, Poland and Slovakia. This is in contrast to the situation in the four small accession economies, whose deficits are either very close to 3 per cent (in the cases of Latvia and Lithuania) or well below that threshold (in Estonia and Slovenia).

Thus, in order to understand the prospects for fiscal consolidation and therefore early euro adoption by the CEE-4, it may be illuminating to ask why the fiscal positions of the large and small countries diverged in the first place.[20] One factor is surely the different value that large and small countries place on monetary union itself. The small ones benefit more from the convenience of the common currency; this is a standard argument from the theory of optimum currency areas. For them, the threat that a failure of fiscal discipline will mean delay in entering the monetary union is an effective deterrent. The large countries are less impressed by this threat. Poland, with 40 million residents, may feel the same ambivalence as, say, the United Kingdom. Consequently, the pressure to rein in deficit spending is less.

But, as I have argued, any benefits that the large countries may currently perceive from staying out of the euro are likely to prove illusory. They are not going to have an easy ride either in or out of ERM II. Unlike the UK, many of their foreign liabilities are euro-denominated, limiting their monetary autonomy. This suggests that they too will come to appreciate the advantages of adopting the euro, but they may learn this the hard way, after a period of macroeconomic and financial turbulence and a delay in fiscal consolidation.

A second difference between the CEE-4 and the Baltics is their style of regulation and the structure of their welfare states. The big Central European countries are becoming ‘westernized’, complete with structured labour markets, regulated product markets, and generous welfare states, at a rapid rate. Welfare-state-related transfers account for a large share of the increase in their public expenditure and are notoriously difficult to cut. The Baltics remain more market-oriented and have smaller welfare states. Welfare-state-related transfers are notoriously difficult to cut; they can therefore encourage the growth of public spending and deficits.

Third, political business cycles may operate less powerfully in small countries.[21] Pump priming through deficit spending is less effective because the leakages through imports are greater. In addition, manipulation of the economy in the run-up to elections may be more transparent and thus less effective.

Fourth, the small countries have more efficient budgetary institutions that are less prone to free riding and faster to adjust to shocks. Here I rely on the work on Holger Gleich, who has constructed indices of the efficiency of budget institutions for all ten accession economies (see Gleich, 2003). Gleich assigns higher rankings to countries whose institutions are conducive to coordination and cooperation in decision making and that should thus promote fiscal discipline.[22] Ranked 1 to 10 (where 10 is best), the four small countries have an average score of 8, while the four large ones have an average score of only 5. Estonia, Latvia and Slovenia have the three best scores in terms of the efficiency of budgetary institutions, while Hungary and Poland have two of the worst.

Finally, fiscal control simply may be harder in larger, more decentralized economies. Where there are more regional governments and spending ministries, there is a more pronounced common-pool problem – a greater temptation for each to spend more now and ask for a transfer from the central government later. Where there is more ethnic and economic heterogeneity, there may similarly be a greater tendency for each group to demand more spending on its particular need, to the neglect of the aggregate consequences.[23] Institutional reform making the budgeting process more centralized can address this problem, but there are obvious pressures against centralization in large, diverse economies. And delegating agenda-setting power to a strong finance minister tends only to be effective when there is a strong one-party government, which is not the norm in this part of the world.

None of this means that fiscal consolidation is impossible in the larger accession economies, only that it faces hurdles not also present in the smaller countries.[24] It also raises questions about the feasibility of some countries' consolidation strategies. Hungary, for example, proposes to embark on an ambitious three-year deficit reduction plan culminating in an evaluation of its readiness for monetary union in 2006 (with an eye toward entry in 2008). Unfortunately, this will collide with the next round of general elections, which creates worries that the authorities' fiscal goals may end up being sacrificed on the altar of electoral politics.[25] The structure of the country's fiscal institutions does not suggest that this problem will be easily addressed.

The pressure to abandon consolidation will depend, of course, on whether initial efforts at belt-tightening aggravate macroeconomic problems or help to solve them. This brings us, inevitably, to the issue of expansionary fiscal consolidation. Do the large accession economies meet the preconditions for this exceptional case where deficit reduction stimulates growth and reduces unemployment?

I must admit to not being optimistic. Fiscal consolidation does least to aggravate unemployment when the exchange rate is flexible, so that the decline in domestic absorption can crowd in exports via a weaker currency. But this mechanism will not be operative in countries that immediately enter ERM II. It will only benefit the others to a limited extent, given that the euroization of their liabilities will prevent them from allowing their currencies to depreciate too far.

In addition, to the extent that the fiscal imbalance stems from a public sector that is too large or growing too quickly, fiscal consolidation will only be sustainable if it addresses this core problem, which means limiting the growth of spending rather than raising taxes. That this is the medium-term strategy (meaning starting in 2005 or 2006) in all the large accession economies is reassuring.[26]

But in truth most of these countries display little appetite for cutting spending now. Hungary is relying mainly on tax increases to address its immediate fiscal problem, reflecting the fact that the vast majority of expenditure takes the form of programmes that are politically difficult to cut. Thus, the government's 2004 budget proposal foresees no reduction in the expenditure/GDP ratio, which will remain at 48 per cent of GDP.[27] Reductions in the public expenditure ratio will only kick in later. In Poland there will be no decline in the government expenditure/GDP ratio between 2003 and 2004, according to the 2003 Pre-accession Programme; to the contrary, it will rise further, to 48 per cent of GDP. Expenditure reductions are scheduled to kick in only later, starting in 2005.

Again, why is not hard to see: social transfers account for a substantial share of general government expenditure, and this component of the budget is notoriously difficult to cut. The same Pre-accession Planning Programmes that project eventual declines in the share of general government expenditure foresee no decline in social transfers as a share of GDP (aside from a limited decline in Poland).[28] Some of my colleagues have argued that we should not worry about large deficits in these countries, because there is still ample scope for productive public investment. They argue similarly that one should not be alarmed by the absence of more rapid public expenditure reduction, since the new EU members need to match their receipts from the Cohesion Funds. When one sees the large share of national income absorbed by public spending and how much of this takes the form of transfer payments, I continue to believe that what is needed is expenditure reduction, not more deficits.

Finally, medium-term fiscal scenarios are based on overly optimistic growth forecasts.[29] Governments are projecting declines in the deficit by making exceedingly rosy assumptions about revenues. They see public spending as a share of GNP declining not as a result of slower growth in the numerator but of faster growth in the denominator. Households, firms and financial markets are likely to see this rosy scenario for what it is. Their awareness that the authorities have taken only half measures means that consumer and investor confidence will be less than otherwise. And this in turn means that consolidation is less likely to be expansionary.

I am not questioning that fiscal consolidation is needed in the large accession economies. I am not questioning that it will happen. But I am challenging the assumption that it will be painless. Hence, there are likely to be reversals along the way. The process may take several additional years to complete.[30]

All this may mean a few additional years before the large accession economies are accepted into the euro area. They will find it easiest to complete their preparations if they are not at the same time required to participate in ERM II, especially one with narrow bands. But neither will life be pleasant outside ERM II. It too will almost certainly be a rough ride. This will further drive home the advantages of belonging to Europe's monetary union. Requiring the new EU members to participate in ERM II would of course have the same effect, but perversely make it more difficult for them to complete their preparations. If the incumbent members have the common sense to abandon their ERM II requirement, I see no reason why the large accession economies cannot join a euro area that already includes Estonia, Latvia, Lithuania and Slovenia by the end of the decade.

NOTES

1. University of California, Berkeley. I thank Eduard Hochreiter and Charles Wyplosz for helpful comments.
2. Why is not hard to see. Their domestic financial markets are less well developed, limiting the market among residents for domestic-currency-denominated debt. They are only now developing the strong policies and institutions needed to create a market in local-currency debt among non-residents. And their small size, compared to the UK or even Sweden, makes it unattractive for most foreign investors to sink the costs of managing exposures in their currencies. These are the classic preconditions for the problem of 'original sin' (the inability to borrow abroad in one's own currency) analysed by Eichengreen et al. (2003). The Czech Republic and Poland are something of an exception, for reasons detailed there.
3. Cespedes et al. (2002).
4. The country devalued the forint by 2.3 per cent on 4 June 2003, partly with an eye, one presumes, toward obtaining a more favourable ERM II parity. The authorities having failed to prepare the markets, investors were taken aback; the currency immediately fell by another 6 per cent, forcing the central bank to raise interest rates sharply in order to defend it – none of which enhanced credibility or the fiscal position.
5. This is the conclusion of the first systematic study of the subject, Eichengreen et al. (1998). An extension and update of their analysis can be found in Duttagupta and Otker-Robe (2003).
6. See Krugman (1991) and Svensson (1994).
7. This is shown analytically in an unjustly neglected article by Bertola and Caballero (1992).
8. The most recent Institute of International Finance estimates at the time of writing forecast net debt flows into the region of USD 17 billion in 2003, compared to USD 3.5 billion for the Asia-Pacific region, USD 2.7 billion for Latin America, and USD 0.7 billion for Africa and the Middle East (Institute of International Finance, 2003).
9. To be sure, they would be even better off if their labour markets were more flexible (they may still be more flexible than those of Western Europe, but in recent quarters wages have shown a distressing tendency to be flexible only in the upward direction). Similarly, they would find monetary union more comfortable if labour mobility between Eastern and Western Europe was higher (if it was not restricted by the incumbent EU members for a transitional period of six or seven years). The point, though, is that more flexible labour markets are equally important whether or not the new EU members join the monetary union, so long as they enjoy relatively little monetary autonomy in the event that they stay out.
10. We in the United States have no trouble reconciling irresponsible fiscal policy with sound central banking, although that is hardly a recommendation!

11. Subsequent statements by Pedro Solbes have been constructively ambiguous about this question, which is not helpful for creating confidence about the prospects of the accession economies.
12. Unless the economy in question is growing rapidly and the worry is overheating rather than recession, as was the case in Greece during that country's run-up to the euro (see Hochreiter and Tavlas, 2003).
13. The particular model I describe is due to Ozkan and Sutherland (1994). Even sceptics of multiple equilibria like the late Rudi Dornbusch recognize this incarnation of the problem. To quote Dornbusch (1998), 'But if interest rates cannot be raised to defend exchange rates, then the slightest piece of bad news means capital outflows, those capital outflows quickly become punitive. If there isn't a lot of reserves in the central bank, then everybody knows that this is going to end with a currency crisis, and that currency crisis is sure because the government isn't making it expensive for the speculators to bet against their currency, they can't afford to, so it's only a question of time. Anything that is only a question of time is certain to happen, and anytime that rumour spreads, of course, all the sharks will come: the big ones, and all the little ones along.'
14. This difficulty is of course reinforced by the absence of capital controls like those that were so important to the operation of the original ERM over its first decade, which will be gone as soon as the new members join the EU.
15. Canzoneri et al. (2002), Table 1.
16. Thus, estimates in Rother (2000) imply a traded-goods productivity differential in Slovakia of 5 per cent in the period 1993–98. Those in Sinn and Reutter (2001) imply differentials ranging from 5 to more than 10 per cent in the Czech Republic, Slovenia, Estonia, Poland and Hungary, with most national values clustered in the neighbourhood of 5–6. To obtain the contribution to CPI inflation, one must first subtract euro area values – say, 1 per cent – and divide the remainder by two (assuming that non-traded goods account for half of consumption – see below). Comparable numbers for the current decade may be lower insofar as the catch-up process in Central and Eastern Europe is now well underway; on the other hand, they may be higher if EU membership accelerates convergence, as intended.
17. I am tempted to assert that this is precisely the mean estimate of Balassa–Samuelson inflation, estimates of which are evenly distributed between 1 and 2 per cent.
18. Lee and Tang (2003) show that such fluctuations can be quite important, although they are equally likely to move against the accession economies as to move in their favour.
19. As argued by Kenen and Meade (2003).
20. Here it may also be tempting to argue by analogy with Western Europe, where there also seems to be a divergence in fiscal stance between the large and small countries, with France and Germany currently in breach of the Stability Pact's limits, to the aggravation of the smaller EU members, most of which have significantly stronger budgets. But the situation in the West is different. There, France and Germany essentially think that they are too large and politically important to ultimately become the subject of EU sanctions and fines (we shall see). In the East, countries like Hungary and Poland recognize that they are not too important to be sanctioned, and that if their budgets remain outside the Maastricht limits they will not be admitted to the monetary union. Thus, the political underpinnings of deficits in the large countries of the two parts of Europe are very different.
21. There is considerable evidence of political business cycles in the accession economies: see Clark and Hallerberg (2000) and Hallerberg and de Souza (2002).
22. The relevant coordination mechanisms include the delegation of budgetary power to a strong finance minister or prime minister, and mechanisms for facilitating communication among competing interest groups leading to binding decisions.
23. This is the central finding of Alesina et al. (1999).
24. Tightening fiscal policy is also the right response to the capital-inflows problem that these countries are likely to experience following accession. See Begg et al. (2003).
25. Note that the country's budget deficit targets were revised up significantly following the last round of general elections at the beginning of the decade.

26. See European Commission (2003), Table 1.25.
27. Spending by local governments included. Instead, the authorities anticipate reducing the deficit ratio by 1 per cent of GDP by limiting personal income tax and VAT rate cuts.
28. European Commission (2003), Table 1.26. Discussions subsequent to the Pre-accession Planning Programmes on issues like pension reform point in more optimistic directions, at least for some countries. Pension reform that more closely links benefits to contributions and raises the retirement age or limits the indexation of benefits, where doing so is needed to put the scheme on a sustainable footing, is important for sending a signal that pension systems will not remain a major drain on the general government budget. Poland proposes changes in pension indexation that promise to save 0.3 per cent of GDP per annum in 2004–07. The Czech government has proposed a modest change in pension indexation that will save 0.1 per cent of GDP in 2004–06.
29. Most prominently in Poland and Slovakia.
30. Given all this, what would be sensible preconditions for admission to the euro area? Inflation rates within 1½ per cent of the euro area average (not the three lowest-inflation members of the euro area). Debts below 60 per cent of GDP. The same deficit criterion that applies to the incumbent members. In saying this I am assuming that the Stability Pact is going to be sensibly reformed in the direction of greater flexibility. Beyond that, the new EU members should receive no special concessions. Granting them exemptions for public investment will only encourage manipulation of public-sector accounts. And where deficits are truly excessive, public investment is not the explanation.

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14. EU enlargement and monetary integration – the next steps: ERM II and beyond

Peter Mooslechner

Monetary integration has been one of the main dimensions of European economic integration since World War II. Initial ideas and attempts to establish closer monetary cooperation were emerging in the 1960s, if not before. As early as in 1971 the Werner plan – based on political decisions agreed on in The Hague in 1969 – presented a detailed proposal for a monetary union, including the final step of a common currency for Europe.

The basic vision of working towards a monetary union in Europe was the idea to create a zone of monetary stability and, most of all, exchange rate stability. In particular following the break-down of the Bretton Woods system in the early 1970s the question of how to cope with the challenges of international monetary and financial instability led to a number of important European initiatives, although they turned out to be mainly short-lived in the end: the 'snake' and the creation of a European Monetary System (EMS) in 1979 are two examples in this respect.

In the end, the repeated attempts to establish a monetary framework in Europe as a prerequisite for further economic and political integration developed into a system of several European countries following an exchange rate peg strategy *vis-à-vis* the Deutsche mark. Given its rather high degree of openness and given the importance of Germany as its by far most important trading partner, Austria – even though not a member of the European Communities at the time – was among the first European countries to adopt such a strategy of stabilizing the exchange rate almost immediately after the end of the Bretton Woods system.

Yet for Europe in general the time was evidently not yet ripe for a common commitment to exchange rate stability. While EMS worked successfully initially, major exchange rate crises emerging in the 1980s not only triggered some painful adjustments but also revealed that only a fully fledged monetary union would deliver the expected benefits of monetary stabilization. Rather soon, however, the Treaty of Maastricht – based on the Delors plan of 1989 as well as on the decisions taken at the Madrid Summit in 1990 and signed in 1992 – fixed the framework for creating a European monetary union.

From a political point of view, German re-unification and the opening up of Eastern Europe were essential elements in this process. Right from the beginning it was also clear to everybody that as a next step the transition economies would be integrated into the EU and thereby also into the unfolding process of European monetary integration. With their accession to the EU from 1 May 2004 on, this monetary integration process becomes one of the key avenues into the euro area for the new member states. The accession countries (ACs) have accepted that they will eventually adopt the common currency. The process to achieve this goal consists of several important steps, from EU membership to ERM II participation and finally the fulfilment of the convergence criteria.

To make this way into the euro a successful one, the new member states need to make substantial adjustments to their economic policies: the challenges range from macroeconomic imbalances like fiscal and current account deficits to questions like overall competitiveness and monetary stability. On this way it seems to be very likely that some flexibility or adjustment of exchange rates might still be needed. At the same time, unjustified volatility of exchange rates should be avoided as much as possible, and the existing European economic policy framework should and can be used as a tool in this respect.

The exact point in time when the new member states will start to participate in ERM II is not pre-determined and can be chosen by each country. The decision to participate can be made directly upon accession to the EU or at any later point. ERM II participation is based on well-defined rules and the decision to join the mechanism asks for an overall agreement concerning the appropriate central parity and the width of the fluctuation band, a decision to be taken by the Ministers of Finance based on advice provided by the European Commission and the Eurosystem. However, the challenges and requirements of making ERM II participation useful and successful raises a number of important economic questions to be tackled in advance.

1. THREE STEPS TO MONETARY UNION

The EU's official roadmap provides for three stages of monetary integration after EU accession. In a first stage, upon entering the EU, the new member states also become members of the Economic and Monetary Union (EMU) as 'Member States with a derogation'. Their formal legal status will be different from that of the UK and Denmark, since these two countries insisted on an ‘opt-out clause’ when the Maastricht Treaty was agreed upon. While the new member states will not take part in EMU to the full extent when they join the EU, they are already required to observe a number of obligations embodied in the stability architecture of EMU: their central banks will be represented in the General Council of the ESCB and will take part in monetary policy coordination within the EU. The new member states will participate in the coordination of economic policies and in multilateral fiscal surveillance. They are obliged to accept the adoption of the euro as a goal to which their policies have to be oriented and they have to bring into line their economic and monetary policies with the overall goals of EMU. In particular, they are obliged to treat their exchange rate policies as a matter of common interest, as the functioning of the single market must not be weakened by real exchange rate misalignments or excessive nominal exchange rate fluctuations. They may continue their existing exchange rate regimes or may follow any other exchange rate regime as long as this requirement is respected.

The second stage in the new member states’ monetary integration is participation in the exchange rate mechanism ERM II, which is voluntary and therefore does not have to start promptly after joining the EU. The new member states can nonetheless be expected to join the mechanism in the medium term. The main policy challenge is thus to design an appropriate speed for this process. It is the formal right of a new EU member state to apply for ERM II membership any time after accession, subject to an agreement on the level of the central parity and on the width of the fluctuation band. At the same time, participation in ERM II is a necessary, albeit not sufficient condition to fulfil the convergence criterion on the exchange rate, as this second stage constitutes the ‘observation period’ for the convergence criterion on the exchange rate stipulated by the Treaty provisions so that they may adopt the euro.

The third and final stage of monetary integration will be participation in the euro area, that is, full participation in EMU, following the adoption of the euro upon fulfilment of all convergence criteria.

2. FUNCTIONS AND DESIGN OF ERM II PARTICIPATION

The elements and challenges for new member countries to participate in ERM II are well known:

1. The final objective of eventual participation in the euro area;
2. The potential need for some adjustability of exchange rates after EU accession;

3. The need to avoid excessive exchange rate flexibility/volatility after accession;
4. The double challenge of the right degree of flexibility and stability of the exchange rate as well as to adopt an appropriate monetary policy strategy and a general policy mix consistent with ERM II participation.

To cope with these challenges as successfully as possible, ERM II basically is designed to provide a useful convergence framework for EU member countries on their way into the euro area. First, it aims at fostering convergence by supporting some degree of exchange rate stability. From this perspective, the central rate provides guidance to participants in exchange markets and is expected to anchor expectations – of course, also depending on the quality of the overall policy mix a country will be able to deliver. Second, ERM II is expected to provide for sufficient flexibility to accommodate varying degrees and strategies of economic convergence. In particular, it is designed to avoid real exchange rate misalignments and the wide bands leave significant margins for catching up-related equilibrium appreciation on the one hand and room for flexible nominal exchange rate responses to external shocks on the other hand.

Substantial financial support is also part of the construction, as it entails not only common automatic and unlimited foreign exchange interventions at the margins, but also voluntary intra-marginal interventions. In general, ERM II has not been designed as a pure legal requirement or as a mere waiting room for the adoption of the euro. More suitable interpretations may be that of a training room on the way to establish overall stability orientation and/or that of a search engine for the most appropriate level of the exchange rate and the right policies. It follows from this that it may turn out to be advisable to use ERM II in this respect for a longer period than just the minimum requested depending on the individual situation and the individual economic policy needs of the respective country concerned.

Without doubt, it should not be forgotten that given the character of ERM II as an intermediate exchange rate system, it might potentially carry some risk of speculative attacks. In this context, it has to be stressed that the standard design of ERM II is expected to be much less vulnerable to speculative attacks than a fixed peg or a narrow band regime. The basic precondition for any exchange rate system to function properly is the choice of an appropriate and credible policy mix that makes the intended stabilization of the exchange rate in the context of the overall economic situation possible and sustainable.

Obviously, the sensible period a country spends in ERM II very much depends on the concrete policy mix it applies as well as on the ability of the institutional framework to deliver policy credibility. Somewhat different from that, the appropriate timing of entry will be determined very much by existing specific features of the individual countries, *inter alia* by the type of exchange rate regime in place and the monetary policy strategy followed. Therefore, the question of the entry date has to be assessed on a case-by-case basis. Depending very much on the specific starting point it may take longer for some countries to make the necessary adjustments to adapt their exchange rate and monetary policy system and strategies according to the needs for entering ERM II. The ECB has clearly communicated to the public[1] that some exchange rate regimes will be treated as compatible with ERM II participation – like some kind of currency board arrangements or a euro peg – whereas others will not, for example pegs to other currencies than the euro or free floating.

3. SOME THEORETICAL CONSIDERATIONS IN A BROADER ECONOMIC CONTEXT: WHAT ARE THE CRITERIA FOR THE DEFINITION OF AN APPROPRIATE CENTRAL PARITY?

One of the most obvious and most important questions concerning ERM II entry is the search for an appropriate central parity. This question is not only important in terms of timing because some ACs are expected to apply for ERM II membership quite early, it is also very difficult because basically any answer has to be based on an encompassing understanding of what the relevant issues are in the entire context of modern exchange rate theory and its historical foundations.

> The historical experience of the EMS has shown that there is nothing like an equilibrium exchange rate. (Opinion voiced in an economic policy discussion on ERM II issues in late 2003.)

Starting with some thoughts on exchange rate theory first, it has to be kept in mind that exchange rate theory as we know it is rather young. Growing interest in exchange rate issues suited to financial market and economic policy challenges of the modern world mainly started after the breakdown of the Bretton Woods system. Given a lack of market integration, substantial capital controls as well as significant non-market elements in exchange rate regimes, the world before the late 1970s was almost incomparable with what we observe as the essential elements and problems today. Of course, well known theoretical advances have been made to deal with different types of exchange rate regimes in theoretical models but they were almost exclusively oriented towards extreme cases of pure fixed or fully flexible exchange rates. Differences in the development of (international) financial markets and (international) financial market integration form another important aspect of why exchange rate theory about 30 years ago has to be qualified as a purely theoretical exercise compared with today's economic policy challenges.

Without doubt, exchange rate theory has evolved impressively since that time, which can be illustrated by comparing surveys of exchange rate economics over time, for example. Modern style textbooks like Sarno and Taylor (2002) focus mainly on three central issues: (i) foreign exchange market microstructure and efficiency, (ii) new open-economy macroeconomics and (iii) currency crises and speculative attacks, while a widely used and famous historical survey – like the one by Dornbusch (1980) – sets a quite different focus. Comparisons like this give a clear indication how perspectives on exchange rate issues and exchange rate determination have changed over time, in particular also related to the fact that the set of factors held important in exchange rate analysis has changed more or less completely over time.

A conclusion from re-reading modern exchange rate theory literature in a historical context, or vice versa, may lead to the following stylized facts: exchange rate theory today seems to be well established as an intrinsic part of the overall macroeconomic and macro policy framework, thereby integrating a very broad range of determinants, ranging from elements of market structure and market participants' behaviour to the current account and the overall policy mix of the country (countries) concerned. 'Old' exchange rate determination theory relied on a much narrower view and on a rather small set of very specific explanations. Most importantly, market structure and efficiency considerations as well as vulnerability and instability issues have entered the scene and gained in importance considerably, to a large extent simply because of practical experience of how foreign exchange markets have developed and behaved since the 1970s.

While estimating equilibrium exchange rates is a very specific task, the factors that have gained in importance over time clearly also provide some important lessons for the whole exercise. To mention only some of these elements, there is (i) a pretty large number of relevant factors obviously not to be neglected, (ii) the weight and explanatory power of these factors change considerably over time and (iii) foreign exchange market and financial market issues play an increasing role in not only driving exchange rates away from their 'fundamental value', at least in the short term, but have to be observed as well when dealing with questions of long-term stability and possible 'justified' ranges of equilibrium values.

When Isard (1995) states that 'economists today still have very limited information about the relationship between equilibrium exchange rates and macroeconomic fundamentals' this is also due to the fact that the framework conditions for any equilibrium to strive for may have changed significantly. The requirements concerning the concept of an equilibrium exchange rate under these preconditions can be illustrated in the following way: find a single and preferably stable level of the exchange rate that secures (i) internal and external equilibrium of a country, (ii) equilibrium for tradables and non-tradables in foreign transactions, (iii) equilibrium for financial flows (short-term, long-term, FDI and equity) as well as (iv) portfolio equilibrium for outstanding stocks of real and financial assets and liabilities at the same time. Therefore, it comes as no surprise that in Obstfeld and Rogoff (2000) two out of 'Six Major Puzzles' directly concern the exchange rate ('PPP puzzle' and 'exchange rate disconnect puzzle') and the remaining four are closely related to exchange rate issues. Based on Obstfeld and Taylor (1998), Obstfeld et al. (2003) once again tackle the traditional 'trilemma' issue on the consistency of fixed exchange rates, free capital mobility and monetary policy, concluding that 'The overall lesson is that the trilemma makes sense as a guiding policy framework' – a lesson clearly underlining the challenges for any exchange rate policy regime.

4. THE DIFFICULT EMPIRICAL SEARCH FOR THE RIGHT EQUILIBRIUM EXCHANGE RATE

As soon as the ACs have joined the EU and thereby entered the first stage of European monetary integration, the focus of the public debate and media coverage will, no doubt, shift to the questions of how quickly and with which parity new member states should join ERM II as a prerequisite for subsequent adoption of the euro. As the agreement on the central parity is the core formal condition for this move, these questions are by definition closely related to the concept of the equilibrium real exchange rate. Sooner than later, it will therefore become unavoidable to assess in detail and empirically what exchange rate might be best suited for a country's entry to ERM II.

In accordance with the Maastricht Treaty, participation in ERM II plus a stable exchange rate for at least two years before the examination of convergence and low inflation are crucial preconditions for eventually becoming part of the euro area. A considerably undervalued exchange rate parity could, however, make it very difficult to attain low inflation. At the same time, fixing the exchange rate at an overvalued level against the euro may very likely over time require policy adjustments mechanisms that harm growth and thus real convergence. The ideal exchange rate should therefore trigger neither inflation caused by undervaluation, nor a marked loss of competitiveness caused by overvaluation. This is all the more important since financial markets may be eager to test the chosen parity if the policy mix of a certain country is seen not to be fully in line with market expectations. In other words, there is the risk of inducing unacceptably large exchange rate fluctuations, which in the end may make it difficult to comply with the criterion of exchange rate stability. It is mainly for this reason that the spotlight has brightened on the issue of equilibrium exchange rates.

Assessing equilibrium real exchange rates empirically is no easy task. In the case of transition economies, special attention should be devoted to the appreciation of the real exchange rate that most of these countries witnessed in the aftermath of their economic transformation to market economies. The Balassa–Samuelson (B–S) effect, based on market service inflation driven by productivity increases in the exposed sector, is the traditional approach of explanation for this. Recent research, however, attributed a strikingly low relevance to the B–S effect: a sustainable appreciation of the real exchange rate can also result from changes in regulated prices, and most importantly, from the appreciation of the tradable prices-based real exchange rate.

Attempts to compare estimates of the equilibrium real exchange rates of acceding countries support the idea that the equilibrium appreciation of the real exchange rate in the transition economies is based not only on higher service prices, but also on higher prices of domestically produced tradable goods. Labour productivity is found to be the most stable determinant of the overall inflation-based real exchange rate but as well of the real exchange rate measured in terms of tradable prices.

In general, estimates of the equilibrium real exchange rates and the underlying real misalignments are fairly sensitive to the chosen econometric method, period and model specification and to differences in the included variables.[2] Therefore, further research is required to systematically evaluate the sources of different results. In particular, medium-size and large panels are needed, as is a structural model-based assessment. In addition, there are still significant problems related to data quality. Although statistical standards were constantly improved to reach international standards, this implies frequent revisions and often a worse quality of earlier observations of the same time series. Furthermore, one has to keep in mind that the German re-unification, the creation of the single market in 1992, the EMS crisis of 1992/93, the accession of EFTA countries to the EU, the monetary union and the cash changeover, as well as globalization and the so-called new economy have represented comparable structural breaks in the time series applied as well. Hence, data problems of this kind are by no means peculiar only to the acceding countries.

All in all, assessing equilibrium real exchange rates for acceding countries appears to be no easy task. There is a great deal of model uncertainty related to the theoretical background and to the fundamentals chosen, and an array of methodological and statistical problems also renders the mission very complicated. But why should this task be easy if similar difficulties are encountered when estimating the equilibrium exchange rate of the euro or the US dollar?

However, it appears that a systematic assessment of the equilibrium exchange rate is necessary or even inevitable for countries thinking about entering ERM II. In the context of this exploration it appears that assessing equilibrium exchange rates is a worthwhile exercise that may provide useful information to policy makers. Of course, the results should be dealt with very carefully and they should be complemented by all other relevant information. Because of the well-known differences and caveats of each methodological approach they should be applied simultaneously and it also seems useful to conduct a systematic sensitivity analysis of econometric estimates employing different econometric techniques. What one can expect from all this in the end is some knowledge of relevant equilibrium ranges and some information about the stability and sensitivity of available estimates. Given the high degree of unavoidable uncertainty incorporated in any policy decision on the issue, the practical value of this additional information should not be underestimated.

5. SOME LESSONS TO LEARN FROM THE AUSTRIAN EXPERIENCE?

In general, one has to be very cautious in drawing conclusions from the experience of one country with a view to giving advice to another country. As was already mentioned above, Austria's experience in joining the EU and monetary union may nevertheless provide some useful lessons to be observed for accession countries.

Long before joining the EU and monetary union was an issue, Austria's economic history was characterized by a very strict peg of the Austrian schilling to the Deutsche mark. This policy developed after the break-down of the Bretton Woods system, based on a widespread feeling that freely floating exchange rates would have negative effects on long-term expectations and, therefore, negative consequences on investment and employment. Over time, this DEM peg came close to a monetary union of the Austrian economy with Germany, where in the end ERM entry did not make much of a difference.[3]

It was clear right from the introduction of this exchange rate peg that a number of crucial preconditions for making it a success were fulfilled: Germany's role of being by far the most important trading partner; a 'social compromise' to accept this kind of 'monetary integration' and its consequences; the acceptance of German macro policies as well as the 'absorbing flexibility' to adjust to this economic policy framework whenever needed. On a more theoretical level the so-called 'Scandinavian Model of Inflation' (Mooslechner, 2002) substantially contributed to the concept. It was accepted by all important social groups that there will be an ongoing adjustment burden for the real sector and that its structural flexibility will be tested intensively.

What were the important framework conditions for this specific kind of policy orientation? The implicit objectives held important were mainly threefold: (i) low inflation, (ii) exchange rate stability and (iii) competitiveness, taken as the major factor for employment under the conditions of a small open economy. The specific role of incomes policy developed mainly from the recognition that it would be almost impossible to address all these economic policy goals at the same time by macroeconomic strategies alone. Therefore, a simple productivity-oriented wage policy element was added to the framework in a coordinated and centralized manner, taking into account macroeconomic needs whenever necessary (Hofer and Pichelmann, 1999).

Despite a high degree of 'institutional stability' this specific mix of policies created a labour market characterized by a high degree of macroeconomic real wage flexibility. Until today, collective wage agreements made explicit reference to past and projected productivity growth and inflation as well as to the state of the labour market and the business cycle. But what really counted in the end was a high degree of credibility that macroeconomic policy would be adjusted whenever needed. In fact, it was perceived 'controllability' that was seen as the main factor to make this policy approach successful.

Even though the Austrian schilling had been pegged to the Deutsche mark for about 20 years and even though Austria had created a specific kind of incomes policy to keep inflation under control and to strengthen competitiveness, its accession to the EU in 1995 had a considerable impact on the economy (Breuss, 1992 and 1996). The country experienced price pressures at both wholesale and retail levels, the trade balance deteriorated and a marked increase in perceived competition was felt in several sectors, for example in the retail sector and in agriculture. Thus, even after a very long period of adjusting the Austrian economy to the European market in general and to the German economy in particular, joining the EU obviously has created further pressures for structural and policy adjustment.

If one wished to draw – very tentative – conclusions from the Austrian experience, they would tend to indicate that even after a very long and successful adjustment process – and even if there were no concerns whether the economy had adjusted to the 'right' central parity for its exchange rate – integration could come as some kind of shock. This suggests that the adjustment needs and the related challenges for policy making which result from integration should be duly taken into account when discussing the timing of integration steps and the overall preparedness for these steps.

For accession countries, this historical experience appears to underline the importance of several important elements, in particular, creating a robust policy framework which delivers macroeconomic adjustment as well as a microeconomic setting providing for the structural flexibility needed to cope with external shocks and/or structural changes.

6. SOME PRELIMINARY CONCLUSIONS AND FURTHER PERSPECTIVES

Having addressed a number of the obvious issues concerning the process of monetary integration of the new member states and some factors that might be of theoretical and practical importance to prepare especially for ERM II entry, one is still left with substantial further questions but only a limited range of clear-cut answers. Thus, the discussion will and should go on and there is plenty of room and need for further research. What are the main issues under discussion? Notwithstanding the assumed merits of ERM II as a useful convergence framework, several acceding countries have expressed a rather critical view on participating, and have argued for an immediate adoption of the euro as the ultimate step of integration as the preferable solution. At the same time, a broad variety of exchange rate regimes and monetary policy strategies are operated in the acceding countries, making the degree and kind of necessary adjustment vary heavily from country to country. Also from a domestic policy point of view, within ERM II and even before, central banks' interest rate policies will face the simultaneous task of achieving price stability and fulfilling the requirements of the exchange rate mechanism. Given this pre-defined exchange rate constraint, the role of interest rates as a policy tool for domestic reasons will become more limited and the weight of the exchange rate as an (intermediate) objective of policy will increase at any rate. Some, many, if not all acceding countries are confronted with one or the other type of imbalances that need to be corrected in the medium term. If this should or could be done before entering ERM II, or if ERM II membership would be a major advantage in achieving this goal, is apparently being discussed from quite different perspectives. Last but not least, the most important questions to be considered are the likelihood and nature of possible asymmetric shocks. In the very short run, EU accession may be qualified as the main challenge in this respect, in the medium and long term, types and sources of possible asymmetric shocks have to be identified and the tools helping to absorb these potential shocks must be developed. This is altogether by no means an easy task for economists, policy makers and European institutions who have to deal with this selection of hot issues ahead.

NOTES

1. See European Central Bank (2003) for an official Policy Position of the ECB Governing Council on these issues.
2. For a detailed survey of these aspects see the contributions published in Oesterreichische Nationalbank (2003).
3. Austria joined the ERM in January 1995, a few days after acceding to the EU. The strict DEM peg continued without any change, and the ±15 per cent standard fluctuation band was solely used against other participating currencies, in tandem with the DEM movements against these currencies.

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15. The ERM II milestone on the road to the euro – the views of the acceding countries' central banks (panel discussion)

Compiled by **Zoltan Walko**

List of participants:

Oldřich Dědek, Vice Governor, Česká národní banka
Märten Ross, Deputy Governor, Eesti Pank
George Thoma, Senior Manager, Head of the Economic Research and Statistics Division, Central Bank of Cyprus
Arvils Sautins, Member of the Board of Governors, Latvijas Banka
Ramune Vilija Zabuliene, Deputy Chairperson of the Board, Lietuvos Bankas
György Szapáry, Deputy Governor, Magyar Nemzeti Bank
Michael C. Bonello, Governor and Chairman of the Board of Directors, Central Bank of Malta
Adam Czyżewski, Director of the Macroeconomic and Structural Analysis Department, Narodowy Bank Polski
Mitja Gaspari, Governor, Banka Slovenije
Elena Kohútiková, Deputy Governor, Národná Banka Slovenska
Barry Eichengreen, University of California, Berkeley

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1. PROS AND CONS AND THE OPTIMAL DURATION OF ERM II MEMBERSHIP

The first question to the panel was intended to explore acceding countries' stance on the advantages and disadvantages of ERM II participation, identify their plans for timing ERM II entry, and invite proposals concerning how the exchange rate mechanism may better fulfil its designated functions. The question was directed towards the representatives of the Czech, Estonian, Polish and Hungarian central banks.

The different approaches towards ERM II and the different assessments of when compliance with all relevant Maastricht criteria is likely were clearly evident from the different target dates for ERM II entry that the panellists specified. The two poles were represented by Hungary and Estonia on the one hand, and the Czech Republic and Poland on the other. The former two intend to join ERM II as soon as possible after accession to the EU, whilst the latter two countries prefer to limit participation to the necessary minimum of two years and thus intend to delay entry to ERM II until a later date when it can be realistically expected that all Maastricht criteria can be fulfilled within two years from the start of ERM II participation.

In this respect, the deputy governor of the Estonian central bank, Märten Ross, stressed that his country had been successfully following a currency board arrangement (CBA) for many years, which had contributed to increasing stability and the credibility of economic policies. Given the current exchange rate regime, participation in ERM II was not seen as a major policy change, particularly as the Estonian central bank intended to commit itself unilaterally to maintaining zero fluctuation bands around the multilaterally agreed ERM II central rate instead of the standard ±15 per cent bands. Nevertheless, M. Ross added that ERM II participation might introduce expectations of some flexibility to the foreign exchange regime – an impression which the Estonian central bank wanted to avoid.

Similarly, the deputy governor of the Hungarian National Bank, György Szapáry, pointed out that Hungary's exchange rate regime had mirrored ERM II since late 2001. The current regime was based on a unilaterally fixed central rate against the euro and a fluctuation band of ±15 per cent around it. Looking ahead, the only need for action was to introduce a multilaterally agreed central rate, but in this respect he did not see any need for drastic changes.

On a more sceptical note, the vice governor of the Czech National Bank, Oldřich Dědek, highlighted that entry to ERM II would require an adjustment to the current monetary regime, as the Czech Republic was operating an inflation targeting regime with a relatively flexible managed floating exchange rate regime. Direct inflation targeting had been beneficial over the past few years in helping to anchor inflation expectations and to stabilize the macroeconomic environment. This approach also made monetary policy making more transparent and more effective in the long run. O. Dědek expressed his belief that the inflation targeting framework was the appropriate regime for the Czech economy at the current stage and that entry to ERM II might burden it unnecessarily through occasional conflicts between the exchange rate and the inflation target. He also argued that inflation targeting seems to be an appropriate arrangement for a successful fulfilment of the Maastricht inflation criterion. In the same vein, Adam Czyżewski, the director of the Macroeconomic and Structural Analyses Department of the National Bank of Poland, pointed out that there was no single exchange rate regime that could fit every country. He explained that Poland had gone through several exchange rate regimes over the past decade and that its experience with the current monetary regime of direct inflation targeting combined with a freely floating exchange rate had been very positive.

Opinions were also mixed with respect to the standard fluctuation bands of ERM II. O. Dědek pointed out that maintaining reasonable macroeconomic stability would call for keeping exchange rate fluctuations well within the ±15 per cent bands of ERM II. At the same time, with regard to the function of ERM II as a measure of exchange rate stability for the qualification for euro adoption, he proposed that one should not insist strictly on the narrow bands of ±2.25 per cent around the central rate as this would trigger frequent and massive interventions with no obvious benefits for the economy. G. Szapáry qualified the ±2.25 per cent bands as principally reasonable. Nevertheless, he also called for a flexible assessment of deviations from this narrow band. This should in particular take into account the duration of the deviation, its amplitude and the instruments (interest rates, intervention, fiscal measures) which were applied to bring back the exchange rate into the desired band. He also supported the idea that a trend appreciation should be judged differently from a depreciation, whilst foreign exchange interventions to prevent excessive appreciation should be tolerated, as was the case with other current EMU members. Putting the finger on this room for interpretation of the Maastricht exchange rate criterion, A. Czyżewski recommended that the ambiguity of the 'severe tensions' term be limited by making it clear-cut that staying on the weak side of the parity, but not breaching the −15 per cent band, would not have to run counter to the stability requirement. In the case of Estonia, finally, exchange rate fluctuations did not play an important role as it intended to carry on with the CBA within the ERM II framework.

The Czech, Hungarian and the Polish panel participants all highlighted that a clear understanding would be required as to the scope and conditions of marginal and intra-marginal foreign exchange interventions by the ECB and the participating non-euro area central banks. They put a question mark on whether such a clear understanding currently existed and called for a clarification as this would help the assessment of the stabilization potential of the mechanism. Adam Czyżewski from the National Bank of Poland was even more specific and called for an increase in the general (that is requiring no prior permission) volume limits for unilateral intra-marginal interventions and a widening of the access to the Very Short-Term Financing facility to discourage speculation.

The potential disciplinary impact of ERM II participation was also an issue in the debate. G. Szapáry expressed his hope that external surveillance, coming into force upon accession to the EU, would function as a discipline multiplier to strengthen the stability-oriented policies of governments and enhance their credibility. O. Dědek sounded less optimistic, describing such hopes as wishful thinking. He believed that if governments were unable to recognize the adverse impacts of loose fiscal policy then the distant perspective of euro adoption would not push them onto the right track. The fulfilment of externally imposed requirements could become politically damaging if these are used as a justification for the implementation of painful fiscal reform. This might provoke an aversion against the euro long before its actual adoption. O. Dědek expressed his fear that loose fiscal policies might be rather counterproductive to the stabilization potential of ERM II. The commitment to maintaining the exchange rate within the ERM II fluctuation band might be questioned by the markets and trigger speculative attacks. Märten Ross from the Estonian central bank explained that the Estonian economy had in the past few years adjusted to shocks with the help of fiscal and structural policies and that these policy areas had thus well supported the functioning of the CBA. He warned that ERM II membership should not introduce the impression that exchange rate adjustments could serve as an option in the future, but fiscal and structural policies had to remain sound.

2. TO WHAT EXTENT DOES THE CURRENT EXCHANGE RATE REGIME MATTER FOR ERM II PARTICIPATION?

The second question to the panel explored to what extent currently operated exchange rate regimes may have to be modified, potentially independently from any ERM II entry considerations, and whether the type of regime currently applied was thought to be a decisive factor behind the timing of ERM II entry. Panellists were also asked if they feared any particular risks arising from the need to adjust the regime for participation in ERM II. The question was directed to the representatives of the Lithuanian, Slovene, Maltese and Cypriot national banks. The deputy chairperson of the Lithuanian National Bank, Ramune Vilija Zabuliene, pointed out that Lithuania had been successfully operating a currency board arrangement for years. This had served the country well, as it helped to anchor macroeconomic stability and deterred short-term capital inflows. At the same time, competitiveness had remained strong, as a good export performance with substantial gains in market shares shows. Fiscal consolidation continued as well, reflected by a general government deficit of 1.2 per cent of GDP in 2002. R.V. Zabuliene expressed her view that Lithuania should introduce the euro early. In her words, given the CBA, Lithuania was virtually already in the euro area and was paying the price of membership while being unable to enjoy its benefits fully, as for example businesses still had to pay conversion costs and the premium for country risk was also higher than it would be otherwise. Ramune Vilija Zabuliene did not see the need for policy changes prior to or during ERM II participation as it would not be sensible to undergo a double regime shift within a couple of years, jeopardizing its hard-won credibility, because the potential benefits of such a change appeared to be very vague. As to potential risks of ERM II participation, R.V. Zabuliene referred to what she called 'political bargaining' in the run-up to entry to ERM II, which might increase nervousness in the financial markets as no one could guarantee that the future exchange rate regime would be completely unchanged from the current set-up. Therefore, she feared a 'public relations disaster' most.

Similarly, George Thoma, senior manager of the Central Bank of Cyprus, expressed his view that no adjustments to the Cypriot exchange rate policy framework were envisaged prior to participation in ERM II. The Cyprus pound had already been pegged to the euro for years, in the framework of a currency regime that shadowed ERM II with a unilaterally fixed central parity against the euro and a ±15 per cent fluctuation band around it. In actual fact, exchange rate fluctuations had been much smaller, mostly lying within a ±2.25 per cent fluctuation band. This exchange rate stability should be seen against the background of gradual capital account liberalization, which had processed smoothly, creating no undesired fluctuations of capital flows or the exchange rate.

The governor of the Slovene national bank, Mitja Gaspari, did not see any need to change the current exchange rate regime (tightly managed float) either. He explained that since inflation was falling, the central bank would be in the position to gradually cut interest rates in the foreseeable future. As Slovenia was currently depreciating the tolar according to the uncovered interest rate parity so as to eliminate the interest rate differential between Slovenia and the euro area, the decline in interest rates would allow a gradual reduction in the tolar's rate of depreciation. Ultimately, the depreciation policy could be phased out after the ERM II central rate is set. As to potential risks, M. Gaspari expressed his concern that participation in ERM II might complicate the task for interest rate policy as a domestic stabilizator: maintaining the exchange rate within the ERM II fluctuations band might call for an interest rate level that was too low under disinflation considerations.

The governor of the Maltese central bank, Michael C. Bonello, pointed out that the current exchange rate regime of a peg of the Maltese lira to a currency basket had functioned well, delivering exchange rate stability over a period of 30 years. Despite the recent gradual liberalization of capital flows, the maximum variation of the exchange rate of the Maltese lira against the euro had not exceeded 3.5 per cent in the past few years. This low volatility and lack of tension was to a significant extent attributable to strong economic fundamentals and the increased credibility of monetary policy. As to necessary changes to the exchange rate regime, M.C. Bonello said that no major change would be required. The composition of the currency basket, currently consisting of EUR, GBP and USD, would, however, have to be changed to a pure EUR basket by the time participation in ERM II took effect. Turning to the risks of this adjustment, he acknowledged that this change in the basket and uncertainty around the new system, particularly the level of the ERM II central parity, might introduce some volatility into the foreign exchange market. Therefore, he stressed the importance of a sound fiscal policy and of structural reforms to stabilize market expectations. Moreover, the course of fiscal policy would also be decisive for the timing of entry to ERM II, as Malta preferred to participate in the mechanism only for the required minimum of two years.

3. THE ROLE OF POLICY INSTRUMENTS OTHER THAN THE EXCHANGE RATE DURING ERM II MEMBERSHIP

The third question related to limitations to the manoeuvring room for interest rate policy following entry to ERM II. Panellists were asked what challenges they expected for interest rate policy during participation in ERM II and what policy areas they regarded as potential substitutes for interest rates in counteracting domestically generated inflation. Finally, they were asked about necessary adjustments to wage and fiscal policy structures to adapt to the new situation. The question was directed to the representatives of the Czech, Slovene, Cypriot and Latvian central banks.

All panellists highlighted the need for a sound macroeconomic policy mix and the responsibility of fiscal and wage policy for meeting inflation targets.

O. Dědek from the Czech National Bank identified the challenge in the simultaneous task of meeting both the inflation target and satisfying the Maastricht exchange rate criterion, with only one major policy instrument at the central bank's disposal, namely interest rates. He saw only a limited role for foreign exchange interventions, which he qualified as a questionable or even risky instrument that was altogether inadequate to reach a specific exchange rate level particularly in the medium to long run. At the same time, he detected a certain scope for flexibly interpreting the Maastricht exchange rate criterion that might help achieve the dual target. This flexibility could be ensured by an asymmetric interpretation of the ERM II fluctuation bands, tolerating deviations into the strong side from parity and a revaluation of the central rate. If the Maastricht criterion was understood as the exchange rate being maintained in a symmetric narrow band of ±2.25 per cent, he suggested that a close cooperation between national central banks and the ECB would be necessary. This cooperation would increase the efficiency of foreign exchange interventions to achieve lower exchange rate volatility and help mitigate potential tensions between inflation and exchange rate targeting. Outside monetary policy, O. Dědek referred to fiscal policy as the most powerful instrument to stabilize the economy; he stressed that meeting the 3 per cent Maastricht criterion was not sufficient in the medium to long run, but governments should aim at achieving balanced budgets, as prescribed by the Stability and Growth Pact. He named wage policy as the second powerful instrument that was likely to become decisive for meeting the Maastricht inflation criterion. In this respect, he underlined that disciplined wage policy would be particularly important in the second year of ERM II participation as that period would roughly coincide with the reference period for the inflation criterion. Here, he stressed the signal function of public sector wages for the whole economy and potential spillover effects from the public to the private sector.

Similarly, Mitja Gaspari from the Slovene National Bank reiterated concerns that the level of real interest rates might become too low once Slovenia had joined ERM II. He identified sound fiscal and wage policies as the most important instruments to complement, or substitute for, the reduced room for interest rate policy. As to fiscal policy, he stressed that it was not only the level of the budget deficit that mattered, but the structure of budget expenditures as well. He pointed out that currently the share of wages was relatively high in Slovenia. In addition, M. Gaspari underlined the importance of keeping wage settlements consistent with productivity growth. He pointed out the shortcomings of the Maastricht inflation criterion as well. He questioned the formula for calculating the reference inflation value, saying that it did not make sense to use the three best countries in terms of inflation performance as the benchmark, as these very countries might be the worst performers in terms of output growth.

The comments of George Thoma from the Central Bank of Cyprus echoed the chain of arguments presented by his colleagues. He claimed that – given the current ERM II shadowing exchange rate regime in Cyprus – fiscal and wage policy had already taken a central stage in the economic policy mix.

Although considerable success had been achieved in these areas in the past, the recent slippage in fiscal policy suggested that more needed to be done. He welcomed the government's official goal to reduce the deficit to less than 3 per cent by 2005, but characterized it as ambitious and stressed that the goal would have to be pursued vigilantly and with the highest priority by the government. As to wage policy, he highlighted that Cyprus had an almost universal and almost fully indexed wage system, which had not been damaging to the economy because of the relatively low inflation that the economy had enjoyed for many years. Some adjustment towards more flexibility had already been taken in recent years, but as G. Thoma warned, more needed to be done in order to ensure that the system functioned well also in the future, particularly in the context of ERM II participation. To complement sound fiscal and wage policies, G. Thoma also called for ongoing structural reforms. These were necessary to ensure stability and to enhance the economy's competitive position and make the economy ready to face the challenges connected to participation in the euro area in a few years' time.

Arvils Sautins, member of the Board of Governors of the Bank of Latvia, pointed out that interest rates had a minor effect on the price level in Latvia and inflation was largely determined by external factors. Thus the key policy tool to control inflation was the stability of the exchange rate. He identified administrative measures to influence wage developments (like public sector wages or minimum wages) as a policy tool to control domestic inflation pressures. Also, the deliberate policy of administered price setting could have some importance, since administratively regulated goods or services currently accounted for 16.3 per cent of the Latvian CPI basket. A. Sautins was convinced that current wage policy institutions and fiscal policy structures were broadly appropriate in Latvia, as suggested by the development of the country's major fundamental data. At the same time, he saw room for further fiscal consolidation in the medium term and the implementation of counter-cyclical fiscal policy as well as the long-term focus on preserving flexibility in the labour market. Overall, A. Sautins did not see substantial problems associated with his country's participation in ERM II.

4. THE QUESTION OF SEQUENCING

The fourth question explored whether panellists saw any need to correct existing economic imbalances already prior to participation in ERM II, or whether entry to ERM II should be taken as an opportunity to adjust economic policies as ERM II membership might be seen as supporting stability-oriented policies. The question was directed to the representatives of the Estonian, Hungarian, Slovak and Maltese central banks.

Märten Ross from the Estonian central bank expressed his view that any economic imbalances should be corrected early. In the particular case of his country, he referred to the high and growing deficit in the current account. Nevertheless, he did not see any major risks associated, attributing developments to the volatility in the investment cycle, which also generated volatility in import demand. He added that current accounts should also be seen against the background of their financing structure and the role of foreign direct investments. Elaborating further on the importance of cyclical factors, M. Ross called for flexible product and labour markets as an adjustment tool and the creation of such conditions that fiscal policy could respond to cyclical developments, if necessary. In his view, if economic policy in Estonia is conducted with the strategic goal of euro adoption, cyclical problems would be solved in a parallel fashion.

Also György Szapáry from the Hungarian National Bank admitted that further convergence was needed to reap the benefits of ERM II and, later on, euro area membership. Yet he highlighted the difficulty in determining how much convergence was needed prior to participation. He pointed to the United States as an example showing that a monetary union could function well with considerable asymmetric shocks, like the regionally different impact of oil price shocks. At the same time, he stressed that flexible wages and prices and integrated financial markets were necessary to adjust to such asymmetric developments. G. Szapáry, however, pointed out that the example of several accession countries already showed a significant increase in the harmonization of business cycles with the euro area, making the issue of asymmetric shocks and necessary policy adjustment less burning. Turning to Hungary's current economic imbalances, György Szapáry pointed to the huge fiscal deficit and the excessive wage growth over the past two years, which had led to a widening current account deficit and hindered the disinflation process. Furthermore the high share of budget revenues in percent of GDP in Hungary, like in many other acceding countries, was problematic. Nevertheless, the Hungarian government had initiated corrective measures, which should bring the economy back to the equilibrium growth path in the foreseeable future. In this respect, György Szapáry reiterated his optimism that the multilateral surveillance after EU membership took effect in 2004 should strengthen the stability-oriented policies and enhance their credibility.

The deputy governor of the Slovak National Bank, Elena Kohútiková, pointed to the high inflation and budget deficits as pressing economic policy issues in Slovakia. At the same time, she stressed that the current account deficit had been sharply reduced in the course of 2003, though its long-term sustainability would require adequate income and fiscal policies and a balanced overall policy mix. She welcomed that structural reform steps, such as labour market reform, health care reform, public sector reform and education reform, had already been undertaken in Slovakia. Elena Kohútiková expressed her view that participation in ERM II was neither the best way nor the best time to implement deep reforms, as the outcome of deep reforms was usually difficult to predict precisely and a cushion was needed for implementing potential corrections. All this should not be topped by a major change to the country's monetary policy regime. Moreover, if structural deficiencies were not tackled in a timely manner, participation in ERM II might easily be subject to shocks. Therefore, E. Kohútiková considered the stage of ERM II membership rather as a period for fine-tuning policies and for testing their ability, within the given systemic environment and approaching given nominal targets, to ensure the desired exchange rate stability. In her view, the instruments of ERM II could provide a useful and welcome support for this purpose.

Last but not least, Michael C. Bonello from the Maltese central bank highlighted that his country already complied with the Maastricht criteria on inflation and long-term interest rates. The relatively high current account and fiscal deficits represented the major challenge for economic policy. The close relationship between the fiscal and current account deficits called for the budget deficit to be tackled as soon as possible and independently of ERM II. This would then make it possible to use fiscal policy counter-cyclically if necessary and would allow monetary policy to defend the exchange rate peg more effectively. At the same time, the Maltese central bank did not question the potential disciplinary effect of ERM II membership. Ideally the positive effects of corrective measures should, however, become visible prior to entry to ERM II, so that participation in ERM II can be kept as short as possible in order to limit the 'testing period' during which potential speculative attacks can occur.

5. POTENTIAL SOURCES AND CONSEQUENCES OF ASYMMETRIC SHOCKS

The fifth question asked about potential asymmetric shocks to the acceding countries upon accession to the EU and thereafter, and – if these were considered to be a danger – what size and direction those shocks were likely to have. Furthermore, panellists were asked whether they regarded an own currency rather as the source of asymmetric shocks or as a tool helping to absorb such shocks. The question was directed to the representatives of the Latvian, Lithuanian, Polish and Slovak central banks.

Panellists generally agreed that accession to the EU itself should not represent a major source of asymmetric shock. They pointed out that EU membership had been anticipated for a considerable time and liberal trade regimes had been in place for many years. Therefore, economic agents and financial markets could already adjust to and 'price in' the fact of accession. In addition it was highlighted that considerable institutional convergence had also been achieved by the adoption of the *acquis communautaire*, and transitory periods had been granted in areas where adjustments still have to be attained. Therefore, panellists regarded the risk of an asymmetric shock as low; if a shock did occur then it would be small and temporary and limited to particular areas. Transitory negative effects of EU accession were detected in the partially necessary increase in indirect taxes and some prices, while selected import duties towards non-EU countries might have to be raised as well.

However, panellists pointed out positive effects too. Elena Kohútiková from the National Bank of Slovakia indicated that EU accession might bring about an expansion of foreign trade, the positive effects of which might be potentially asymmetric for acceding countries. FDI inflows might also be encouraged through integration into the common market. Similarly, Adam Czyżewski from the National Bank of Poland expressed his optimism about possible positive effects, particularly as EU membership should promote the real convergence process, thereby reducing the likelihood of future asymmetric shocks.

As to shocks at a later stage, Arvils Sautins from the Bank of Latvia said that remaining differences in economic structures might be a cause for asymmetric cyclical developments or shocks. Nevertheless, he expressed his optimism that such disparities in business cycles were unlikely to substantially decelerate economic development in the medium term, particularly as possible asymmetries could be mitigated by the high wage-unemployment elasticity in his country. A. Sautins also pointed to some possible asymmetry on the back of higher wage and price growth in the new EU member states and the resulting real appreciation, but noted that strong productivity growth could be expected to counteract the adverse effect on competitiveness.

This view was shared by the deputy chairperson of the Bank of Lithuania, Ramune Vilija Zabuliene, who added however that due to the openness of the Lithuanian economy any excess domestic demand resulting from stronger wage growth would tend to show up not as higher demand-driven inflation, but as a current account widening. Finally, Adam Czyżewski drew attention to the fact that countries currently recording high fiscal deficits might experience asymmetric cyclical developments in the short-term as governments would have to strive to reduce deficits in the next few years in line with EU legislation.

Views were also mixed as to whether an own currency was a source or an absorber of asymmetric shocks. Ramune Vilija Zabuliene noted that as a tool to adjust competitiveness, the exchange rate had become less and less powerful in the global economy as many countries were aiming at effectively pegging their currencies to those of major trading partners by means of intervention. Turning to the experience of her country, she said that in Lithuania, being a small open economy, exchange rate stability in a world of volatile financial flows by far outweighed potential benefits of a flexible exchange rate, especially given the flexibility of the labour market. She noted that the fixed exchange rate regime of the past several years had prevented nominal shocks from spilling over to the real economy. Therefore, R.V. Zabuliene believed that exchange rate flexibility in the run-up to the euro would be a destabilizing factor for the Lithuanian economy.

Arvils Sautins from the Bank of Latvia noted that he saw the national currency neither as a source of asymmetric shocks nor as a tool to absorb such shocks. He explained that structural measures rather than competitive devaluations were more efficient instruments to raise competitiveness, at least for small open economies with high external financing requirements like Latvia.

Elena Kohútiková and Adam Czyżewski saw the problem in a more differentiated way. A. Czyżewski agreed that a flexible exchange rate can be an effective mechanism stabilizing the economy in the event of asymmetric shocks, if it was responding to changes in the real factors of the economy. E. Kohútiková confirmed that view, adding that the liberalization of capital movements, the integration of financial sectors and the use of hedging instruments could enhance the role of the exchange rate in absorbing and dampening possible asymmetric shocks. At the same time, E. Kohútiková drew attention to potential speculative attacks on the own currency or rapid changes of third exchange rate crosses (like EUR/CZK or EUR/USD), which might have an impact on the exchange rates of the Slovak crown against the euro. She also indicated that following a real economic shock, the exchange rate could stabilize the economy only partially and temporarily. Therefore, she concluded that in the long run an own currency tended to be the source of instability rather than a stabilizing instrument. Similarly, A. Czyżewski saw the own currency as a potential source of instability, especially if exchange rate movements were mainly driven by forces stemming from financial markets, such as changes in the risk premium.

6. CONCLUSIONS

In wrapping up the debate, Barry Eichengreen noted how the assembled policy makers had all agreed that the new EU member states should attempt to join the euro area at an early date. They concurred with his warnings of the risks associated with an extended stay in the ERM II, and urged the European Commission to recognize that the original rationale for making two years of membership in the ERM without involuntary realignments – namely that such realignments might be corrosive of the single market – had been considerably weakened now that the single market was a fait accompli.

Barry Eichengreen also warned against relying too heavily on the so-called 'discipline multiplier effects' of the ERM II requirement. While a commitment to hold the exchange rate within narrow bands may sometimes function as a source of credibility, it is also a source of fragility; confidence in a government's policies can be quickly and significantly eroded if sentiment turns against it and the central bank finds itself unable to defend its band, as will typically be the case given the immense liquidity of international financial markets. Credibility must be grown at home. It would be better for governments, central banks and the Commission to acknowledge this from the start.

16. On the threshold of the 2004 EU enlargement

Gertrude Tumpel-Gugerell[1]

On the threshold of the accession of ten new member states to the European Union, this contribution reviews, in a selective manner, the enlargement process and explores some of the challenges involved in the imminent widening of the European Union. There can be no doubt that enlargement is a major achievement in the history of European integration. In fact, a few years ago, it could not be taken for granted that the accession process would be completed as smoothly as this now appears to be the case.

While accession to the European Union is a fundamental accomplishment, it is clearly not the end of the integration process. In the area of economic and monetary policies, accession marks in fact, in many respects, the beginning of integration. It is therefore obvious that the prospective monetary integration of the new member states is increasingly moving into focus, as enlargement is coming closer. The communication of the ECB and the Eurosystem on this issue has been frequent and encompassing (see for example Padoa-Schioppa, 2003).[2] Most recently, the 'Policy position of the Governing Council of the ECB on exchange rate issues relating to the acceding countries', released in December 2003, has consolidated into a single comprehensive policy text the previous positions of the Eurosystem on the matter. This position paper, which is available at the ECB website in all official Community languages, lays out the key issues for markets and the public at large, both in the euro area and in the acceding countries.

In order to avoid repetition, it is sufficient to highlight three key points, which will guide the approach of the European Central Bank (ECB) in the area of monetary integration of new member states.

First, the basic interest of the euro area is to ensure that the monetary integration of the new member states will be a smooth process that unfolds in line with Treaty provisions.

Second, there is no single path to the euro that would suit all acceding countries. At the current juncture, the ECB does not see the need to take a view on the appropriate timing of a future euro adoption by any new member state. At the same time, the ECB does not discourage any particular strategy, provided that it is based on sound economic reasoning and conforms with the institutional set-up in place.

Third, new member states will have to fulfil the convergence criteria in a sustainable manner in order to qualify for participation in Monetary Union. The equal treatment principle will continue to govern the application of the convergence criteria. There will be no additional criteria, nor will there be a relaxation of the existing criteria.

Obviously, the monetary integration of the new member states will take place within the broader enlargement setting, and it would be facilitated by a successful overall integration process. This raises the question of what enlargement needs to deliver in order to be judged a success in a few years' time. Any future assessment of enlargement will hinge upon two outcomes. First, enlargement will be judged with reference to its impact on the catching-up process in the acceding countries and, in particular, to what extent it accelerates this process. In other words, how instrumental will enlargement be in enhancing the growth differential between the acceding countries and the euro area, which has been at 1.6 percentage points in the last ten years and around 2 percentage points in 2002 and in 2003? And second, the success of enlargement will be underpinned by ensuring that the gains it produces accrue as broadly as possible across all 25 countries.

There is broad agreement in the empirical literature that, at the country level, enlargement is a win–win game, yielding net benefits to both the current and the new member states (see Fidrmuc et al., 2002, for a comprehensive overview). However, to what extent and how quickly the benefits of enlargement will be reaped will critically depend on how well the enlargement process is managed and how conducive policies and structures are to tapping the growth bonus that a wider Union can provide. In other words, the EU is about to complete the accession process for ten new member states, which is quite an achievement in itself. The challenge now is to make enlargement and the enlarged Union work.

The tasks arising in this context are formidable. They range from improving the decision-making process in the European Union to developing EU regional aid schemes further so that they can foster the catching-up process in the most effective way. Furthermore, it will be essential to prepare the labour markets for the free movement of workers, by empowering exposed segments of the labour force, in particular in the current member states, so that economic agents are able to cope and make their living in a wider Union. In this context, a survey undertaken in July 2003 shows that 78 per cent of Austrians do not expect enlargement to endanger their personal employment situation, while 8 per cent are more concerned, considering it 'rather likely' or 'very likely' that their jobs will be put at risk (Sozialwissenschaftliche Studiengesellschaft, 2003).[3] Good judgement and steadfastness will be needed to master all these challenges. While the tasks are daunting, one can be confident that the European Union will fulfil them, as long as it acts in the same spirit that has characterized other key integration projects. Monetary Union is a prime example in this respect.

The ECB is already well prepared for enlargement. Observers from acceding country central banks have participated in the meetings of ESCB committees since spring 2003. This process culminated at the highest level with the General Council meetings in June and September 2003 – the first two occasions when this body met with the governors from the acceding country central banks. Moreover, the ECB has submitted a recommendation on the voting modalities of the Governing Council, the Bank's main decision-making body, which has been accepted by the EU Council and is now under ratification. This will allow the Governing Council to work efficiently even after a marked increase in the number of countries participating in the euro area (for further details see ECB, 2003a and ECB, 2004).

Skilful management of the enlargement process is all the more important given that our knowledge of the economic effects of enlargement is in fact limited. Based on the body of empirical literature on the subject, we know that enlargement will have moderately positive effects for the current European Union. For Austria, which has particularly close trade and financial links with the new member states, these effects may well turn out to be considerably more than moderate. Moreover, they will come on top of the sizeable gains already reaped as a consequence of the opening-up of central and eastern Europe in the last decade (compare Fidrmuc et al., 2002).

We also know that enlargement will be clearly beneficial for the acceding countries. Simple economic reasoning suggests that accession will contribute to lifting the growth prospects for the new member states, not least through full integration into the internal market of the European Union and through net transfers from the EU budget. These transfers, in particular regional aid, can have a considerable effect on income convergence, provided that they take place in an environment that is conducive in terms of macroeconomic stability, functioning markets and efficient institutions. Simulations by the European Commission reported in Hallet (2002) show that the GDP of Greece and Portugal today is around 8 per cent higher than it would have been without Community support for less developed regions ('Objective 1 support') dispersed since 1989. The results show beneficial effects on both the demand and the supply side, the latter arising from gains in productivity and competitiveness, as physical and human capital stocks are increased. Coming back to accession, a positive impact on growth can also be expected from lower risk premia and the greater availability of external finance, stemming from the disciplining effects of economic policy co-ordination and surveillance, which will reinforce incentives to pursue sound economic policies.

However, when taking stock of the empirical studies, it appears that we are not very certain about the size of these growth effects nor about their profile. In fact, the range of the cumulative long-term effects of accession for the new member states is very wide, stretching from 1½ to 19 percentage points of GDP, as a percentage deviation of GDP compared with a non-accession scenario (see Fidrmuc, 2003, for a survey of empirical studies). The dynamics of these gains are even less clear. Will the growth bonus materialize quickly, or will there be a certain delay? In addition to the importance of institutional and policy frameworks, which have already been mentioned, a number of other factors will drive short- to medium-term growth dynamics in the new member states – and there are quite divergent views on their relative importance.

There are different opinions on how much real sector adjustment we will see in the immediate post-accession years in the new member states. Some argue that the Europe Agreements have already brought about a setting that is similar, in terms of competitive pressures, to that of the internal market of the EU. Others, however, maintain that the full inclusion of the new member states in the internal market and the competitive pressures this entails may result in added restructuring needs for some time (see for example Nahuis, 2002).

Likewise, views appear to differ on whether accession will lead to a major positive demand shock for the new member states. Those who argue that it will, refer to increasing inflows from the EU budget, higher private capital inflows due to reduced uncertainty and improved investment opportunities, as well as to added consumption smoothing in the new member states as a consequence of enhanced future growth and income prospects. Those who do not share this view stress the substantial fiscal consolidation needs, especially in central Europe, and the rather gradual increase in inflows from the EU budget over the next few years. Moreover, they argue that a significant part of the demand effects may have already been anticipated, pointing among other things to the buoyant growth of loans to households in a number of acceding countries.[4]

Turning to the growth prospects of the new member states over the next few years, a further point of relevance emerges. While the ten countries, as a group, have seen their economies grow by around 3 per cent in recent years, this average figure masks considerable differences in the growth performance of individual countries and country groupings. In particular, there has been a remarkable growth differential between the Baltic and the central European countries in recent years. While the former have grown at rates of 6–7 per cent annually, the weighted average growth rate in central

Europe has hovered around 2 per cent (picking up to about 3 per cent only in the second quarter of 2003). Clearly, this raises the question of how to explain this divergence in growth performance. How much of this gap is cyclical and how much is due to differences in potential growth rates? And what are the broader lessons to be drawn from these different experiences for promoting the catching-up process of the new member states?

Such questions can be addressed in several ways. One standard approach to examining growth patterns is to decompose overall GDP growth into contributions from factor inputs and from the Solow residual, that is from total factor productivity (compare for instance EBRD, 1997). Following this so-called growth accounting technique, one finds that the contribution of total factor productivity to GDP growth has played a more important role, relative to capital and labour, in the case of the Baltic countries than it has for the central European countries. Differences in production structures may explain part of this divergence, but one can imagine that other factors affecting productivity advances – including differences in policy design and institutions – have also been at work. More generally, for the new member states, the dynamics of total factor productivity gains will be the most important determinant of the pace at which living standards converge with European Union averages.

Enlargement is, however, not only about economics. Much has been said on the wider effects that a Union of 25 will bring about, be it in the area of security policy or with respect to an improved environmental situation in the acceding countries, which will also have a positive impact on neighbouring countries. What should be singled out in this context are the added opportunities and possibilities, especially for younger people, for example in the area of education, where the inclusion of candidate countries in the Socrates–Erasmus programme is already beginning to bear fruit. Such initiatives make a real difference to the lives of all those who take the opportunity, and they foster a sense of togetherness in Europe which cannot be overrated. This kind of interaction will also reinforce the growing support for European integration we are currently witnessing, in particular in the acceding countries. This increasing identification with deeper integration in Europe is, by the way, well documented in the most recent Eurobarometer survey released in September 2003 (Eurobarometer, 2003). One of the most telling results of this survey is that 65 per cent of the citizens in the new member states want the European Union to play a more important role in their daily lives in the future, namely in five years' time.

To conclude, the first few years of enlargement will be formative years for the European Union and for its member states. By completing the accession process, Europe is taking a major step forward. It is now the responsibility of European institutions, policy makers and citizens to make enlargement the success story it has the potential to be. Substantial further efforts will be needed to this end. In particular, perseverance and diligence will be required in times when economic developments are uneven and adjustment is necessary. Expectations are high, particularly in the acceding countries, and it will not always be possible to fulfil them quickly. A blend of realism, diligence and ambition will be key to narrowing the gap between hopes and outcomes. And on the top of this it should not be forgotten that Europe is even larger than just a region of 25 countries. One important challenge in the future will therefore be to intensify the relationship between the enlarged EU and other important European countries like Romania, Bulgaria, Turkey or Russia, just to name a few. In other words, one of the Union's important tasks will be to promote cooperation beyond tomorrow's borderlines of the European Union.

NOTES

1. Member of the Executive Board, European Central Bank.
2. For a review of ECB statements on monetary integration issues relating to new member states, see Backé, Thimann et al. (2004).
3. The precise question of the survey was 'Vermuten Sie, dass Ihr Arbeitsplatz durch eine Erweiterung der EU gefährdet sein könnte?'. 3 per cent answered 'very likely', 5 per cent 'rather likely', 12 per cent 'rather unlikely', 78 per cent 'unlikely', 2 per cent 'don't know/no answer'.
4. Compare Sueppel (2003) for a more detailed discussion of the aggregate demand effects of accession for new member states.

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PART VI

Corporate governance, financial markets and the optimal role of the state

17. Some remarks on good governance and sound finances

Josef Christl[1]

The Central and Eastern European countries have experienced an impressive transformation of their economic system over the past 15 years. This process has provided substantial opportunities for foreign investors, including Austrian firms. Today, Austrian companies belong to the largest investors in the region in terms of the invested capital stock. In some countries, like Slovenia or Croatia, they even rank first.

Over the past 15 years, the acceding countries have also come a long way in reforming their financial systems and improving financial stability. Bank restructuring, recapitalization and privatization have been advanced substantially or even completed. Following the opening up of the sector to foreign ownership, majority foreign-owned banks now account for a predominant share of total bank assets, whereas state ownership of banks has been significantly reduced.

Austrian banks as well have invested heavily in the Central and Eastern European – the CEE – region. For example, in the Czech Republic, Slovakia and Croatia, Austrian banks' market shares reach impressive levels of around 30 per cent of total assets. Altogether, CEE subsidiaries account for around a quarter of consolidated pre-tax profits of Austrian banks, which further stresses the importance of these markets for Austria.

What is important is that the structure of the financial sectors of the new member states differs significantly from that observed in the EU. In particular, the degree of financial intermediation remains below EU levels. Additionally, bank lending tends to be overwhelmingly short term, while interest rate spreads between deposit and lending rates suggest inefficiencies and insufficient competition, especially in retail banking. Similarly, the capital markets of acceding countries are small, not only in absolute terms, but also in terms of their share in GDP.

The state's role in CEE financial markets has diminished over the past decade, and further integration will undoubtedly be based primarily on market mechanisms. However, the authorities will need to assist the process, especially as further financial market integration and the opening up of new business opportunities may entail more and new sorts of risk. This will in turn necessitate efficient financial market supervision structures.

While the acceding countries have already almost completely adopted EU legislation and have introduced provisions which are in line with international standards, they continue to face the task of effective implementation and law enforcement. In addition, legal norms will have to be upgraded permanently to stay in line with further capital market developments and the liberalization of international capital movements. Moreover, intensified cross-border capital flows will require closer cross-border cooperation between supervisory authorities.

Financial market supervision is closely related to the issue of corporate governance – the web of corporate relationships and responsibilities and rules that frame them. In the absence of good governance, that is if the strategic response to risk is inadequate or if transparency and accountability are lacking, economic growth and employment growth may suffer and corruption may be fuelled, and so on. Moreover, weak corporate governance may spill over into weak public governance, potentially establishing a vicious circle.

Corporate governance has also become an issue of systemic stability in the financial markets. Undoubtedly, developments at Enron, WorldCom and other companies have prompted increased action in enforcing corporate governance and restoring public confidence in the capital markets. Consider, for example, how the Sarbanes–Oxley Act of 2002 tightened the regulatory framework significantly in the US.

The acceding countries have made significant efforts to improve corporate governance standards over the past several years. This process has been encouraged by the acceding countries' need to adopt the *acquis communautaire* in the course of EU membership negotiations. Despite their progress, more efforts, albeit to a varying degree in different countries, are still required. Some countries may need to modify existing legislation, whereas most need to ensure the efficient enforcement of existing legislation. Improvements in all related areas are necessary to make longer-term lending more appealing for banks and to ensure that the expansion of business activities does not trigger an excessive rise in associated risks.

Turning to fiscal policy, according to the latest available data, there is growing evidence that most accession countries will miss the budgetary targets for 2003, and the prospects for 2004 do not seem to be reassuring either. Moreover, we have even seen a violation of the 3 per cent deficit ceiling in several euro area countries. While the deterioration of budgetary balances does partly reflect the low economic growth rates, it is worrisome that countries with severe budgetary imbalances have come up with insufficient consolidation measures to address the budgetary slippages.

To put it very clearly, the Stability and Growth Pact is an appropriate framework for maintaining fiscal discipline, which also provides adequate bounds of flexibility. Contrary to the notion of several observers who dubbed the Pact a 'mechanical scheme to constrain fiscal policies', the Pact provides not only agreed-on rules, but also – what may be even more important – adequate time frames and procedures. This is particularly relevant for countries which try to prevent or have to correct severe budgetary imbalances. Furthermore, a country's fiscal efforts and changes in the economic environment are assessed regularly, especially before further steps are taken. In this respect the Stability and Growth pact takes into account two economic findings. First, expectations play a major role in the behaviour of economic agents, and second, negative output effects can be reduced or even avoided by stabilizing expectations.

In addition, abolishing agreed-on rules would certainly result in a severe loss of credibility. Especially nowadays such a violation of the political framework would be counterproductive, above all for growth prospects. Although there is increasing evidence that the economy of the euro area passed the turning point of the cycle in the summer of 2003, and that the speed of the recovery gains momentum, the upswing is still fragile. Therefore I believe that it is of utmost importance that the Pact is respected, since an erosion will ultimately lead to a deterioration of credibility and a destabilization of expectations – which must be avoided.

Compliance with the fiscal policy rules of the European Union will also constitute an outstanding economic policy challenge for most of the Central and Eastern European countries in the years ahead. Upon EU accession, the ten new member states will have to regard their policies as a matter of common concern and conduct their economic policies with a view to contributing to the objectives of the European Union, such as sound public finances. As EU members, these countries will be subject to multilateral surveillance within the EU policy framework. As long as they are member states with a derogation, however, the penalty mechanism that is part of the excessive deficit procedure will not be applicable.

Looking further ahead, EU membership also includes the commitment to the eventual adoption of the euro, which requires the fulfilment of the Maastricht criteria. Most CEE countries' need for further efforts to meet the budget deficit criterion is striking. The deficit in most acceding countries is currently significantly above the 3 per cent benchmark. In many cases we have observed a deterioration in the fiscal balances in 2003, and in individual cases the deficit ratio is expected to increase in 2004. Some countries already had to pay a price for this, namely the loss of confidence among financial market participants and significant deteriorations of exchange rates.

Admittedly, this assessment does not apply to all countries. Some acceding countries are distinguished by deficit ratios well below 3 per cent or well on track towards that level.

The next steps toward further integration of the new member states into the monetary structures of the EU, that is participation in ERM II, are expected to contribute to the stabilization of expectations as well. If the announced central parity is backed by sound economic policies, ERM II could help to reduce exchange rate fluctuations. As a result, import prices would become less volatile. This combination would smooth real exchange rate developments, contributing to the process of real convergence.

Still, it has to be clear that the timing of entry of each acceding country must be well considered, since – and this is the other side of the coin – ERM II participation amounts to a significant limitation on a country's active exchange rate policy, which represents one of the most powerful economic policy instruments.

NOTE

1. Director, Oesterreichische Nationalbank, Vienna.

18. Fiscal cost of state-owned banks in selected economies of Central and Eastern Europe

Khaled Sherif[1]

The aim of this chapter is to determine the fiscal cost of state banks to selected economies in Central and Eastern Europe, as well as to examine some of the most fiscally draining banks in the process. For this purpose we examined state banks in 14 countries, ranging from countries on the verge of acceding to the European Union in 2004 (namely the Czech Republic, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia) to countries that will not accede for many years (namely Albania, Bulgaria, Croatia, Macedonia, Romania, Turkey) or possibly at all (Ukraine). In addition, some data have been included on two CIS countries that have broadly resisted structural reforms to move banking to a more private sector-driven market (Turkmenistan, Uzbekistan), although specific information on their banks is not included.[2]

In the process, nearly 50 state banks were examined, of which 29 were reviewed in fairly thorough detail. These banks required significant amounts of Government assistance to restore them to financial, managerial and operational viability. Among the 29 banks, 10 received at least USD 1 billion in fiscal recapitalization, including five banks that received anywhere from USD 2.4 billion (Bancorex in Romania) to USD 15 billion (Ziraat in Turkey). Among the 29 banks reviewed, only eight received less than USD 250 million in direct fiscal recapitalization, with the lowest amount to date recorded being USD 100 million for Oschadny Bank in Ukraine.

This assistance has generally been provided in two forms: either in additional capital to restore solvency, or the removal of bad loans from troubled banks' balance sheets. In the first case, bad loans have remained on banks' balance sheets to be worked out over time, but also showing the earnings and capital effects of provisions and reserves. In the second case, bad assets have been transferred to a loan recovery institution or asset management company, and given incentives to recover bad debts that have been provisioned but not forgiven.[3] In most cases, the most significant and successful restructurings took place in preparation for or at the time of privatization. Of the banks reviewed, most have been successfully privatized. However, there are still some large state banks to be privatized in countries like Poland, Romania,[4] Slovenia, Turkey and Ukraine.

Thirteen of the countries examined were former communist countries, with the only exception being Turkey. However, Turkey's direct fiscal costs related to state banks amounted to the greatest fiscal cost in dollar terms among the 14 countries. This indicates that systemic and structural problems associated with state ownership, connected lending, political patronage, subsidization, counter-productive forbearance, insufficient accountability and transparency, poor governance, and market volatility resulting from macroeconomic imbalances exist as risks and points of vulnerability for non-communist countries as well. It also points to the impediments in many 'capitalist' societies that fall short of fully functioning market economies that include sound macroeconomic fundamentals, prudential regulatory oversight, and risk-based management systems that are predicated on sound governance, systems and internal controls.

Based on various documents and reports – mainly from central banks and supervisory agencies, banks' own financial statements, multilateral institutions' documentation on costs and sales proceeds, and several articles and press releases detailing individual bank privatizations – the assessment has determined that the direct fiscal costs associated with state bank recapitalization have exceeded USD 50 billion. For the banks examined, the approximate gross fiscal cost is USD 53 billion. This does not include other state banks that may have been earlier recapitalized fiscally, and for which data have not been made available. Likewise, as this excludes several countries, mainly CIS countries apart from Ukraine, the figure may be higher for transition countries in general. For instance, Russia recapitalized state banks after the 1998 crisis, and such figures are not included.

Moreover, this figure does not include additional indirect or hidden costs, such as the cost of forbearance when exercised, losses run through non-bank creditors (such as utilities, power companies), higher interest rates on Government securities to generate income for troubled banks, or generally higher interest rates charged on loans to assist troubled banks with recapitalization from earnings. For instance, the direct fiscal cost of bank restructuring and recapitalization among the largest banks in the Czech Republic was about USD 10 billion, while the total cost of banking system restructuring efforts is reported to have approximated USD 18 billion.

Irrespective of the precise figure, the approximate USD 53 billion in direct fiscal costs is enormous by any standard, particularly when one takes account of the fiscal pressures on these economies, and the scarcity of public resources available for investment in health, education, social services and infrastructure. As a percentage of GDP over the long span of 1991–2002, these costs routinely ranged from 1 to 2 per cent of annualized GDP for about half the countries, and 0.5–1.0 per cent for most of the other countries. Taking a tighter time span (that is, 1995–2002) raises these ratios, reflecting higher costs. With the fiscal and expenditure challenges faced by most transition economies, combined with the task of taming what were high inflation rates at the time, the economic cost of state bank recapitalization proved to be high in most cases.

Given that sales proceeds have generated less than 20 per cent of fiscal recapitalization costs, the overall proposition has been a net loser for virtually all countries. This is reinforced by the very small number of recapitalized banks that sold for more than recapitalization costs. Overall proceeds to governments have approximated USD 10 billion, about 19 per cent of gross fiscal costs of recapitalization. Thus, on a net basis, the 14 countries reviewed have experienced a net fiscal outflow of about USD 43 billion or about 1 per cent per year of GDP. Other costs (monetary, forbearance, and so on) suggest the overall burden has exceeded this figure.

The results need to account for concentration. Turkey's recapitalization of two large state banks accounts for about 44 per cent of the total. As the two banks – Ziraat and Halk – have not yet been sold, the ratios will change when transactions are eventually concluded. Smaller examples, such as Savings Bank in Albania, have also been offered for sale, although proceeds will not be generated until at least 2004. Slovenia's second largest bank – NK Maribor – has also been offered for sale, but like Savings Bank in Albania, the sale has yet to occur. In due time, these proceeds would change the ratios. For instance, it remains to be seen what will happen in Ukraine if it proceeds to offer Oschadny and/or Ukreximbank for sale. Smaller privatizations that will occur in Hungary are not expected to change the balance much.

At the same time, countries like Poland (as with Ukraine) still have comparatively large banks for sale. In the case of PKO BP, there are predictions that future recapitalization costs may approximate USD 1 billion. Likewise, BGZ, which has already been recapitalized with about USD 1 billion, has not been offered for sale. As Poland moves closer to EU accession, it is unclear how long these banks will be retained by the state, and what the net outcome will be. However, given the substantial anticipated recapitalization of PKO BP, Poland's experience with bank recapitalization is expected to be about breakeven when finally concluded. By comparison with the other countries, this is relatively sound performance. On the other hand, there are questions about the opportunity cost of having held on to such banks for so long, including whether retention by the state has also added economic costs in the form of forbearance, delays in what is now a more robust housing finance market (PKO BP), and whether rural finance is as efficient as it could be if BGZ had been resolved more forthrightly.

The assessment evaluated other costs and trends. Key findings are outlined in the following sections.

1. GENERAL MACROECONOMIC TRENDS

The 14 selected economies (plus two CIS countries whose banks were not reviewed in any great detail) have shown improved financial discipline in recent years, particularly in the effort to reduce inflation rates. On the fiscal side, most countries are also showing reasonable levels of financial discipline. Fiscal deficits (as a share of GDP) have either declined or only modestly increased in 10 of 16 countries. Government expenditure (as a share of GDP) has generally decreased or slightly increased, with only three countries showing major increases exceeding 5 per cent. Government debt has increased, partly offsetting the generally tighter fiscal policy. However, even here, only four of 16 countries have shown Government debt to exceed 50 per cent of GDP in 2000–02. As inflation rates decline and stabilize, real GDP growth continues, fiscal bases expand and debt profiles remain stable, the transition economies will have scope for rising fiscal expenditure and borrowings.

2. THE ROLE OF STATE BANKS IN THE SELECTED ECONOMIES

State banks accounted for at least a sizeable share of assets (greater than 40 per cent), and in some cases the majority of banking system assets, in most countries until the late 1990s. Thus, dealing with state banks' costs and losses was more than a policy issue. In several countries, they remained prominent, with high levels of asset and/or deposit concentration.

3. GENERAL COST ESTIMATES OF TROUBLED BANKS

State banks have not been the only problem banks in transition country banking systems. In some cases, state banks have been relatively well managed, while many private banks have been thoroughly mismanaged. However, on the whole, state banks inherited past assets, organizational structures and operating systems from the earlier socialist phase. Even after restructuring efforts (which have been applied to virtually all state banks at some point in one form or another), many have remained uncompetitive, sluggish, weak in terms of risk management, and costly in terms of head count and operations.

Non-performing loan (NPL) figures provide clear support for the benefits of rapid privatization in the banking sector, rather than spending significant time and resources to restructure troubled banks. Where there are low levels of state bank NPLs (as a share of total system capital), this is the result of relatively low levels of state bank ownership. There have been a few exceptions when corrective actions have been taken or reasonably sound governance, management, controls and systems have been in place. However, in most cases, state banks have had a tendency to run up non-performing loans, and be costly to restructure. Thus, in most cases, it appears that long restructuring periods have a tendency to run up fiscal and other costs on a net basis.

4. STATE BANKS' FISCAL COSTS RELATIVE TO TROUBLED ASSETS

Figures indicate that a complete clean-up of state banks' NPLs would have cost USD 61 billion from 1995 to 2001. Rough estimates of fiscal costs over the years have accounted for about 87 per cent of these banks' financial restructuring, often linked to a privatization objective, and sometimes to cover potential losses following a privatization transaction. However, as these apply only to NPLs, the figures do not account for other potential costs, such as (i) reversed income due to *ex post* provisioning for loan losses and reversals of income previously posted but not collected, as well as (ii) revalued assets such as securities and properties that may have been previously overvalued. Thus, estimates of fiscal costs likely account for less than 87 per cent of the total costs associated with state banks.

5. GROSS FISCAL COSTS OF STATE BANKS

Fiscal costs related to the recapitalization and financial restructuring of state banks in selected economies has approximated USD 53 billion in recent years. This has involved a combination of securities issued to recapitalize banks, the transfer of bad assets to asset recovery agencies, guarantees that have been called, and the issuance of guarantees for potential future loan losses following privatization transactions.

6. CONCENTRATION OF FISCAL COSTS

Based on these figures, Turkey has incurred the highest level of direct fiscal expenditure to recapitalize state banks. Turkey's fiscal costs approximate 44 per cent of the total fiscal cost of the 14 countries related to bank recapitalization and restructuring. The fact that it was not a socialist economy like the other countries evaluated also shows that non-socialist economies with high levels of state ownership in the banking system are vulnerable. The Czech Republic has also incurred high aggregate fiscal costs of about USD 10 billion, or about 19 per cent of total for the selected countries. Thus, when reviewing the selected countries, there is a high level of concentration of fiscal costs centred on Turkey and the Czech Republic.

7. DISTRIBUTION AND IMPACT OF COSTS

Relative to average GDP, gross fiscal costs of bank restructuring (prior to any sales proceeds) show a broad distribution of costs, rather than a high level of concentration by country. Of the 14 countries for which data are available, six countries had costs exceeding 10 per cent of average GDP. Most other countries are in the range of 4–9 per cent. Ukraine's figures are the lowest, at less than 0.2 per cent, followed by Poland at 2 per cent. However, these figures may not be entirely accurate. In the case of Ukraine, the Government has incurred more than 0.2 per cent in costs associated with Oschadny Bank, while in Poland the 2 per cent figure does not account for potential fiscal costs associated with the recapitalization of PKO BP (and possible future costs related to BGZ).

Extending the logic on an annualized basis (as these costs are usually not incurred in just one year), the same six countries with the highest gross fiscal costs relative to GDP also had the highest annualized fiscal costs. Each of the six countries incurred fiscal costs of 1–2 per cent of GDP per year on average from 1991 to 2002 as a result of their troubled state banks. In effect, these costs have served as a tax on national output and income.

Considering that most countries faced the above fiscal costs in more concentrated periods, adjusted fiscal impact figures when spread across an eight-year time horizon from 1995 to 2002 show that most countries' gross fiscal costs were higher when measured on a more concentrated time line (of eight years). In general, annualized gross fiscal costs relative to GDP showed a wide range, from as low as 0.03 per cent in Ukraine to as high as 2.26 per cent in the Czech Republic.

8. ESTIMATED NET FISCAL COSTS OF STATE BANKS

Some of the state banks have been restructured under sound management. This has resulted in these banks generating substantial proceeds to Governments upon sale. However, most state banks have generated less in sales proceeds than the funds/securities injected to recapitalize them and to finance their restructuring. Among the 50 banks reviewed (excluding separate asset recovery agencies), only a few have generated proceeds in excess of fiscal costs. Overall proceeds for state bank transactions have approximated USD 9.8 billion, which is only about 19 per cent of gross fiscal costs incurred. This raises the question of whether the recapitalization of state banks has been worth the cost and effort. While other factors enter into the discussion, it is clear that governments should generally not expect to make a profit from the transaction. More often than not, the cost of recapitalization and restructuring far exceeds the proceeds generated.

9. CONCENTRATION OF SALES PROCEEDS AFTER RECAPITALIZATION

There has been a concentration of proceeds in a few countries. Of the approximately USD 9.8 billion generated in the countries reviewed, Poland, the Czech Republic, the Slovak Republic, Hungary and Bulgaria have accounted for most of the proceeds. These five countries have accounted for about 89 per cent of sales proceeds.

10. DISTRIBUTION AND IMPACT OF COSTS AFTER BANK SALES

Net fiscal costs have been in the billions in about half of the selected countries. Given the variation in size of national economies, even smaller amounts often led to higher costs relative to GDP. On the whole, among the 14 countries for which data have been made available, four countries' net fiscal costs approximated or exceeded 10 per cent of average GDP (that is the Czech Republic, Albania, Turkey and Croatia). In the cases of Albania and Turkey, these ratios may ultimately come down after the sale of Savings Bank in Albania and Ziraat and Halk in Turkey. However, as of 2003, these sales had not been achieved, thus the cost ratios stand above 10 per cent. Delays in privatization also raise the risk of additional fiscal costs. Thus, the final net fiscal cost ratio is currently unpredictable.

In the cases of the Czech Republic and Croatia where bank privatization is pretty well finalized, the figures reflect a fairly costly approach to bank restructuring.

At the low end, Ukraine has injected very little in the way of fiscal resources into its two state banks. However, as mentioned elsewhere, Oschadny has particularly benefited from other forms of state assistance. Thus, while not explicitly fiscal, the low ratio of 0.19 per cent probably understates the actual fiscal cost to the Government of Ukraine. In the case of Poland, its success in generating proceeds in excess of fiscal costs is unique, and partly reflects its successful bank privatization programme in the late 1990s (and into 2000). However, the figures do not include anticipated recapitalization costs associated with PKO BP which would bring the ratio closer to zero per cent. It also does not include borrowing costs associated with the restructuring of many of the state banks.

When annualizing the fiscal cost figures, three countries (that is the Czech Republic, Albania and Turkey) show they have incurred an annual average cost of more than 1 per cent of GDP from 1991 to 2002. As noted above, Albania and Turkey may see a change in these ratios when they conclude their bank privatization programmes. Nonetheless, these three countries have incurred the highest fiscal costs. The Slovak Republic is interesting in this regard, as it pursued a similar approach to that of the Czech Republic, yet shows costs just barely more than half the costs incurred by the Czech Republic on an average annualized basis relative to GDP.

As with gross fiscal costs, figures show that net fiscal costs were higher when measured on a more concentrated time line (of eight years). In general, net fiscal costs on an average annualized basis were about 0.5–1.5 per cent of GDP in the selected economies (for which data are available) from 1995 to 2002.

11. INEFFECTIVENESS OF RECOVERY AFTER TRANSFER

Countries that have transferred bad assets to workout agencies have also shown very low recoveries. In Albania, BART has only recovered USD 8 million, or about 3–4 per cent of assets transferred. The Czech and Slovak Republic have received about 5 per cent of the face value of securitized bad assets when taken to market. Turto in Lithuania has recovered about USD 80 million, equivalent to about 10 per cent of bad assets transferred. Thus, efforts to restructure and recover bad assets have generally proven ineffective, and worth little more than a small fraction of the face value of the bad assets.

12. STATE BANK FISCAL COSTS RELATIVE TO FISCAL DEFICITS

The gross and net fiscal costs of state bank recapitalization relative to the general fiscal position of selected governments have varied country by country. From 1991 to 2002, the data show that gross and net fiscal costs were lower as a share of fiscal deficits in almost all of the countries than when they are consolidated from 1995 to 2002. The only exceptions in this regard were Albania and Slovenia. Notwithstanding gradually increasing fiscal rectitude in most transition countries in the latter part of the 1990s and early 2000s (relative to GDP), the higher average deficits suggest that bank recapitalization costs contributed to these deficits. Early denial or non-recognition of problems in the state banks, and the costs associated with resolving these problems eventually culminated in many countries during this more consolidated period, adding to the impact of the cost.

Given the varied time lines of when governments intervened to recapitalize their state banks, there is no set pattern to when direct fiscal costs of state bank recapitalization most severely affected fiscal deficits. However, there is recognition that perpetual non-performance added to these costs, thereby deepening fiscal deficits. At the same time, as countries first stabilized their monetary policies and then began gradually to shrink their fiscal deficits, as occurred by the mid- to late-1990s, the actual costs of bank recapitalization had greater impact due to the hardened budget constraints imposed as a function of macroeconomic and fiscal stabilization.

Meanwhile, the period in which the impact was more direct occurred from 1995 to 2002. On an average annualized basis, gross fiscal costs have been particularly high as a share of 1995–2002 fiscal deficits in Bulgaria, the Czech Republic, Macedonia and Slovenia, exceeding 50 per cent in all these countries. In fact, in Bulgaria, the ratio was nearly 100 per cent, reflecting both the high cost of state bank restructuring in that country along with the fiscal discipline introduced from 1997 following the crisis. Costly programmes also existed in Croatia, Lithuania, Romania and the Slovak Republic, all with costs ranging from 26 to 45 per cent of average annualized fiscal deficits during the same period.

On a net fiscal basis, the Czech Republic has incurred the highest costs, at 51 per cent, followed by Bulgaria at 47 per cent. The difference between gross and net costs for Bulgaria, albeit high in both cases, is that bank privatization generated higher proceeds relative to fiscal deficits than in the Czech Republic. Other countries whose net fiscal costs of state bank restructuring and recapitalization exceeded 25 per cent of average fiscal deficits included Slovenia (33 per cent), Croatia (29 per cent), and Romania and Slovakia (28 per cent).

Interestingly, Turkey's fiscal costs have been fairly moderate despite being the largest to date in recapitalization costs. This is partly due to the substantially larger fiscal deficit that Turkey averaged from 1995 to 2002, one of the many areas that are being brought under tighter control as Turkey stabilizes its economy. In the coming years, the net fiscal ratio may decline if Turkey generates proceeds from state bank sales.

On the other side of the spectrum, Poland actually shows a net surplus of funds. However, this does not take into account the costs associated with ultimately stabilizing or resolving PKO BP. Likewise, other costs to the economy and system (in the form of forbearance) are not captured by these direct fiscal costs. This is likely to be relevant as well for Ukraine, which shows low direct fiscal costs, but whose forbearance, blanket deposit guarantee and other kinds of support for Oschadny are not captured in the fiscal cost data. Hungary also shows a relatively low fiscal cost after the early efforts in 1991–94 to recapitalize state banks. Recognizing the costs associated with the effort, Hungary moved to privatization after 1995, and its fiscal costs ended up being relatively low as a result.

13. STATE BANK FISCAL COSTS RELATIVE TO GOVERNMENT DEBT

Relative to Government debt, gross fiscal costs annualized on an average basis from 1995 to 2002 were highest in the Czech Republic, at more than 14 per cent. This stands out as far higher than all other countries evaluated. As an example, the Slovak Republic's gross fiscal costs were about 5.5 per cent of Government debt on an annualized basis. Several other countries have been in the 3–4 per cent range, including Croatia, Latvia, Lithuania, Romania, Slovenia and Turkey. Countries whose gross fiscal costs have been less than 3 per cent of Government debt include Albania, Bulgaria, Hungary, Poland and Ukraine.

On a net fiscal cost basis after sales proceeds, the Czech Republic still stands out. Notwithstanding some very large sales in recent years, net fiscal costs over the period were still more than 11 per cent of Government debt. Highest after that was Romania at 3.6 per cent, whose net fiscal costs were less than one-third of the Czech Republic's when compared as a share of Government debt. The ratios are fairly similar for Turkey, the Slovak Republic and Lithuania as well. No other countries have had net fiscal costs exceed 2.6 per cent shares of Government debt, and several have been at less than 1 per cent.

Turkey is currently carrying a high debt load, although its debt per capita ratio is far less than that of Hungary and Poland. Ultimately, its 3.5 per cent fiscal cost to Government debt ratio appears to be consistent with practice in Latvia, Lithuania and Romania, and with the Slovak Republic on a net fiscal basis. These countries have all generally stabilized their financial systems and successfully privatized their banks (at least partly in Romania), suggesting that Turkey's ratios are not inconsistent with fiscal cost and debt parameters for effective financial sector turnaround. It remains to be seen what proceeds Turkey will be able to generate when it finally privatizes its remaining state banks.

14. STATE BANK FISCAL COSTS RELATIVE TO BANK CAPITAL

The varied fiscal costs of state bank recapitalization also reflected differently on banking system capital in the selected economies. Annual averages of state bank NPLs ranged from as low as USD 1–4 million in Macedonia and Latvia, respectively, to as high as USD 2408 million in Poland. Several countries have had severe problems with their state bank NPLs, and many of these countries also had undercapitalized banking systems resulting from non-performing loans, other bad/overvalued assets, and large proportions of non-earning assets. In most cases, this has culminated in fairly high fiscal costs to recapitalize banks.

Gross fiscal costs relative to average bank capital have been extraordinarily high in Turkey, a country in the process of correcting its problems of banking sector undercapitalization throughout the 1990s. Such costs have also been very high in seven other countries – Albania, Bulgaria, Croatia, Czech Republic, Lithuania, Romania and Slovakia – all approximating or in excess of average bank capital, and in several cases at least twice the value of bank capital. This has led to significant fiscal costs, sometimes requiring long amortization periods for bonds that add interest expense to annual budgets for years. Spreading average annualized gross fiscal costs over an eight-year time span from 1995 to 2002, the costs relative to bank capital have been highest in Turkey, Romania, Lithuania, Albania and Bulgaria. All of these countries have either faced severe banking sector crises at one point since the mid-1990s and/or have taken long periods to bring bank privatization to a close.

Net fiscal costs follow a similar pattern, with the exception of Bulgaria and, to a lesser extent, Slovakia, where proceeds from bank privatization have been substantial relative to capital. Ratios in Romania and Turkey are expected to diminish in the coming years as these countries sell their state banks. Albania may also experience a change in its ratios, depending on what proceeds it generates from the sale of Savings Bank.

At the other end of the spectrum have been Poland, Ukraine and Slovenia. Poland has generated proceeds in excess of cost, reflecting a positive return. In Ukraine, other methods of support have been provided to Oschadny, but direct fiscal costs have not been high. As neither Oschadny nor Ukreximbank have been privatized, there are no proceeds to record. Slovenia's fiscal costs have been fairly high, with a deficit to date of about USD 900 million. However, Slovenia has also long had a well capitalized banking system relative to regional norms. Thus, fiscal costs (gross or net) relative to capital have not been high.

15. RECAPITALIZATION COSTS OF MAJOR STATE BANKS

In terms of absolute fiscal costs of recapitalization, the major banks in the selected countries were/have been Ziraat and Halk (Turkey), CSOB, Ceska Sporitelna and Komercni (Czech Republic), Bancorex (Romania), VUB (Slovak Republic), Privredna (Croatia), Magyar Hitel (Hungary), and BGZ (Poland). It is also estimated that PKO BP's recapitalization figures will equal or exceed USD 1 billion when that process is ultimately finished. Together, these 10 banks (excluding PKO BP) have accounted for more than USD 39 billion in recapitalization via fiscal means. Using a floor of USD 100 million, there have been at least 29 banks that have been fiscally recapitalized. However, the top 10 indicate that there has also been substantial concentration, with these banks accounting for 74 per cent of gross fiscal costs.

16. RETURN ON INVESTMENT

Troubled banks have generally sold for small fractions of their fiscal recapitalization costs. Only a total of USD 9.8 billion has been generated in sales proceeds against USD 52.7 billion in fiscal recapitalization costs. While a handful of banks have generated more than USD 500 million in proceeds, only five banks among those for which information has been made available – Komercni, Nova Ljubljanska, Slovenska Sporitelna, Bulbank and OTP – have been able to cover more than 50 per cent of their gross fiscal recapitalization costs. (Other banks have also generated comparable levels of proceeds and defrayed at least half and sometimes all recapitalization costs. For instance, this is also likely to be true of Wielkopolski, Handlowy and PKO SA in Poland. These banks generated USD 500 million, USD 1.0 billion and USD 1.1 billion, respectively, in sales proceeds. However, recapitalization costs for these banks have not been made available on an individual basis.) On a net basis, only a few banks (for example, OTP of Hungary, Savings Bank of Lithuania, some of the Polish and Bulgarian banks) have generated more in proceeds than were invested by Government. Thus, apart from these examples, fiscal recapitalization has turned out to be a significant net loss for transition economies.

17. IMPACT OF RECAPITALIZATION COSTS ON GDP

Depending on the time line, the impact of gross and net fiscal costs has varied against average GDP figures. As a general rule, there have been about seven banks that have accounted for major fiscal costs when measured against average GDP. These banks include Ziraat (Turkey), CSOB (Czech Republic), Bancorex (Romania), VUB (Slovak Republic), Privredna (Croatia), Savings Bank (Albania), and Stopanska Bank (Macedonia). All of these banks' gross and net fiscal costs accounted for at least 5 per cent of GDP on average, and reached nearly 9 per cent in certain cases. Meanwhile, an additional eight banks accounted for 2.5 per cent to 5 per cent of average GDP on a gross (and often net) fiscal basis. Among this second group, only Komercni, Nova Ljubljanska, Slovenska Sporitelna and Bulbank were able to generate proceeds that markedly reduced the gross fiscal cost. Thus, only about half of the troubled banks accounted for less than 2.5 per cent of average GDP, and only four of the second group brought their net fiscal costs down to less than 2.5 per cent of average GDP. Thus, about half of these banks have served as major drains on GDP for sustained periods.

18. COMPARED WITH OTHER COUNTRIES . . .

Transition country banking systems are not the only ones to experience major crises and costs. Several advanced economies have experienced major crises, sometimes systemic, and other times not. The range of costs for recapitalization has varied from as low as an average 1.3 per cent in Norway from 1987 to 93 to 12 per cent of GDP in Japan in 1996 and 17 per cent of GNP in Spain from 1977 to 85.

Other countries around the globe have experienced systemic banking crises. Adding Turkey to the list (from its earlier crises in the 1980s), at least 70 other countries have also experienced systemic banking crises, with the costs often more severe than in the transition economies relative to GDP.

Moreover, many of the countries have had recurring crises (two or three times), suggesting that insufficient resolve during crises may serve as a harbinger of more severe crises to follow. In many cases, the recurring crises were more severe in cost than the earlier crises.

NOTES

1. Sector Manager for Finance and Private Sector Development for Europe and Central Asia, World Bank.
2. The full-length version of the paper can be downloaded from the World Bank's website.
3. There are costs and merits to both approaches. This chapter does not endorse specific methods or approaches, but simply seeks to demonstrate to the reader that both kinds of recapitalization and/or resolution are included in the cost estimates if these were based on fiscal means.
4. BCR was recently partly privatized, although a majority of the bank remains in state hands.

19. The Romanian banking sector: progress, problems and prospects

Stephan Barisitz

Compared to other financial markets, the Romanian banking sector is small and not very developed. According to recent estimates, only about one-third of the population is reported to possess a bank account and less than one-fifth of Romanian enterprises take out bank loans. In terms of loan volume to GDP, Romania accounts for less than half of the average level of central European transition countries, which themselves are still substantially behind the EU-15. However, banking activities have been in the catching-up lane since the crisis the country experienced in 1997–99. Today a major share of the assets of the banking sector is in foreign ownership. As a consequence of the swift credit expansion in 2002 and 2003 and of continuing structural problems the risk potential has risen recently, though.[1]

1. BANKING CRISIS AND REFORM MEASURES

Until 1998 the Romanian commercial banking system was overwhelmingly state-owned. Credit institutions were granting loans to a largely unrestructured real sector dominated by large, inefficient, state-owned factories, subject to quasi automatic refinancing by the Romanian National Bank, which conducted an accommodative monetary policy. Inflation rates were very high. For example (year-end) CPI inflation amounted to 62 per cent in 1994 and 57 per cent in 1996. After the election of a more strongly reform-minded government at end-1996, serious macroeconomic stabilization policies and structural reforms were initiated. The Romanian National Bank (Banca Naţională a României, BNR) tightened its hitherto lax banking supervision policies. The quasi-automatic central bank refinancing of loans was discontinued. A number of large state-owned credit institutions thereupon experienced serious financial difficulties and could only be kept afloat with sizeable public financial assistance. This goes particularly for Bancorex, the former state foreign trade bank, and for Banca Agricola, an institution specializing in the financing of agriculture.

In the first half of 1998 the government carried out important legal reforms: a new central bank law and a new banking law were passed, which strengthened the independence and the banking supervision authority of the BNR. On the other hand, the new bank insolvency law encountered difficulties in application. Although in 1998 Romanian bookkeeping standards were largely adjusted to French standards, which themselves resemble IAS, some important differences remained; for instance, loan-loss provisioning requirements have been weaker and consolidated reporting is not obligatory in Romania. A Bank Deposit Guarantee Fund had been established earlier in 1996.

Given the strong initial contractionary effect of the reform efforts, in late 1997 and in 1998 the government partly reverted to stop-and-go macroeconomic policies. The effects of the Russian crisis of 1998 aggravated the unstable economic situation, which contributed to runs on both abovementioned banks, triggering the collapse of Bancorex in 1999. By the time, more than two thirds of Bancorex's loans were reported to be non-performing. The authorities decided to shut down the bankrupt bank. Parts of Bancorex were liquidated, some dubious assets were transferred to the consolidation agency AVAB, created the year before. The BNR absorbed Bancorex's liabilities to foreign-owned banks. Remaining parts of Bancorex were merged with the state-owned Banca Comercială Română, which thus became the largest Romanian commercial bank. Some smaller credit institutions also collapsed in 1999 and 2000. In contrast, Banca Agricola survived due to repeated recapitalization and restructuring measures taken by the authorities. Banca Agricola also ceded large non-performing claims to the consolidation agency.

The financial cost of the various recapitalization and public support schemes for the institutions in distress amounted to about 10 per cent of GDP.[2] The 'shock' of the collapse of Bancorex made banks generally more prudent in granting credits; at the same time portfolios were restructured in favour of lower risk assets (including treasury bills). In late 1999 the BNR established an 'early warning system' for the supervisory authorities: credit institutions were assessed and ranked, and it was specified at which point a licence of a bank in difficulties should be withdrawn and bankruptcy proceedings triggered. The creation of a credit information centre at the BNR in December 1999 aimed at enhancing transparency for lenders. Thus, the legal and institutional environment for banking in Romania had considerably improved by the end of the 1990s.

With hindsight, 1999 proved to be a kind of structural turning point for the Romanian economy. The same year, the authorities carried out the first privatizations of larger Romanian banks to foreign strategic investors: a majority stake in the Romanian Development Bank (Banca Româna pentru

Dezvoltare) was sold to Société Générale. General Electric Capital and Banco Português de Investimento purchased the majority of Banc Post. Later on, parts of Banc Post were acquired by EFG Eurobank Ergasias (of Greece). In addition, a number of smaller credit institutions were liquidated in recent years. After considerable delay the authorities were able to sell Banca Agricola to Raiffeisen-Zentralbank in April 2001. In May 2002 Banca Agricola was merged with the Romanian branch of the RZB and renamed Raiffeisen Bank.

Notwithstanding this progress, a number of serious unsolved problems lingered. The poorly regulated investment funds sector was destabilized by the collapse of the country's largest fund, the National Investment Fund (Fondul Naţional de Investiţii, FNI) in 2000. But the erosion of trust in this case extended much further, since the FNI collapse had repercussions for the state-owned Savings Bank (Casa de Economii şi Consemnatiuni, CEC); the latter was a shareholder in FNI's management company, had invested in FNI certificates and issued a guarantee for investments in the Fund. The chief FNI manager left the country and several officials of the National Securities Commission were arrested. It turned out that, for years, the FNI had been little more than a pyramid scheme.

2. ECONOMIC RECOVERY AND EXPANSION OF BANKING ACTIVITIES

In 2000 the authorities embarked on prudent macroeconomic stabilization efforts. Some political instability was overcome by the election of a new government at end-2000, which sustained the stabilization and reform policies. The same year, the external economic situation, particularly in the EU, brightened and the decade-long conflict in neighbouring former Yugoslavia drew to an end. Inflation and budget deficits slowly came down. But inflation still reached 15.9 per cent in September (year-on-year). With the strengthening of the economic upswing in 2001 and the following years (see Table 19.1, real GDP 2001: +5.7 per cent, 2002: +4.9 per cent, first half of 2003: +4.3 per cent year-on-year) market participants gained more confidence and credit institutions expanded their activities speedily (although proceeding from a modest point of departure).

Certain successes in real sector structural reforms (for example the sale of the country's biggest steel producer, Sidex, to a British-Indian investor in early 2002) supported the development. Private investment in export-oriented consumer goods industries gathered momentum and triggered some gains in competitiveness. Still, the restructuring of the large state-owned and often inefficient and loss-making industries and particularly of the energy utilities

Table 19.1 Romania: macroeconomic and monetary indicators

Year	GDP growth (real) in %	CPI inflation (end-year) in %	Exchange rate (ROL/USD, end-year), ROL	Exchange rate (ROL/EUR resp. ECU, end-year), ROL	Broad money (M2, end-year) change in %	Broad money (M2, end-year) in % of GDP	Budget balance (general government) in % of GDP	Current account balance in % of GDP	Gross foreign exchange reserves (excl. gold, end-year), EUR (ECU) million	Gross foreign debt (end-year) in % of GDP
1996	4.0	56.9	4035	5182	66.0	27.9	−3.9	−7.3	426	23.6
1997	−6.1	151.4	8023	8859	104.9	24.6	−4.6	−6.1	1987	26.9
1998	−4.8	40.6	10951	12814	48.9	24.8	−5.0	−6.9	1175	23.5
1999	−1.2	54.8	18255	18345	45.0	24.6	−3.5	−3.6	1519	25.5
2000	2.1	40.7	25926	24142	38.0	23.0	−3.7	−3.7	2682	28.6
2001	5.7	30.2	31597	28032	46.2	23.2	−3.5	−5.5	4464	29.4
2002	4.9	17.9	33450	35141	38.1	24.9	−2.7	−3.4	5849	33.2
2003[1]	4.3	14.5	33799[2]	37924[2]	35.5		−2.7	−5.5	5621[3]	

Notes:
1. Forecasts or estimates.
2. September 2003.
3. June 2003.

Source: BNR, WIIW, IMF, EBRD.

has remained sluggish overall and has been causally related with the chronic existence of extensive payment and tax arrears.[3] Although the Stand-by Arrangement reached with the IMF in October 2001 has been subject to some intermittent slippages, it has made steady progress recently.[4]

The assets of the banking sector grew from 29.2 per cent of GDP in 2000 to 31.6 per cent in 2002. This corresponds to around EUR 15.1 billion. Loans to enterprises increased from 9.3 per cent of GDP to 11.9 per cent in 2002 (Table 19.2). The year 2002 witnessed a real corporate loan expansion of approximately 30 per cent. In the 12 months to September 2003 the speed of expansion accelerated to 44 per cent, corresponding to a credit boom. Declining interest rates on government debt paper contributed to the relatively enhanced attractiveness of granting credits. This means that with government bond interest rates falling, ceteris paribus, it becomes more attractive for banks (or other financial institutions) to grant loans (than to invest in government paper). The increase of credits has focused on private and privatized firms, whereas lending to state-owned firms has been contained. The maturity structure of loans moved somewhat from predominantly short term to medium term, which *inter alia* reflected increased demand for financing investment projects. Currently about half of all bank loans are short term (that is with less than one year maturity), the other half is medium and long term. Consumer credits, particularly mortgage loans and loans for the purchase of automobiles and consumer durables, have grown extremely fast and even multiplied, however, from a basis of almost zero. Although real deposit interest rates are still in negative territory, deposits of non-banks have grown from 20.0 per cent of GDP in 2000 to 21.7 per cent in 2002. Bank accounts remained largely short-term. The rapidity of the credit expansion has triggered concern on the part of the BNR leadership as well as the IMF, given the structural weaknesses of the economy.[5] Risk analysis and management capacities of credit institutions still seem to be insufficient.[6]

Furthermore, the share of credits denominated in foreign currencies has been on the rise. Whereas loans in foreign currencies had made up almost 60 per cent of the credit volume at the beginning of 2001, they comprised more than 70 per cent two years later.[7] Since it is not at all clear that borrowers dispose of substantial hard currency proceeds, the exchange rate risk can turn into a possible credit risk for banks. The Romanian exchange rate regime is a managed float, more precisely: the BNR conducts a steady and controlled nominal devaluation of the Romanian leu against a reference currency basket (with 60 per cent euro, 40 per cent US dollar weights). The goal is a trade-off between reducing inflation and securing international competitiveness. The inflation rate, albeit on the decline, is still relatively high for a Central and East European setting (Table 19.1). It reached 17.9 per cent in 2002 (end-year) and 15.9 per cent in September 2003 (year-on-year).

Table 19.2 Romania: banking sector-related indicators

Year	Number of banks (of which foreign-owned, end-year)	Total assets of banking sector in % of GDP	State-owned banks in % of total banking sector assets	Deposit rate (average, end-year) in % p.a.	Lending rate (average, end-year) in % p.a.	Deposits of the non-bank sector (end-year) in % of GDP	Credit volume (end-year), change in %	Loans to enterprises in % of GDP	Bad loans in % of total loans	Capital adequacy (capital/risk weighted assets, end-year) in %	ROA (net) in %	ROE (net) in %
1996	40 (19)			38.1	55.8				48.0	14.0		
1997	43 (23)			51.6	63.7		82.1		56.6	13.6		
1998	45 (25)		71.0	38.3	56.9		95.2	16.6	58.5	10.3	0.2	1.3
1999	41 (26)		46.8	45.4	65.9		26.8	10.6	35.4	17.9	−2.0	−15.0
2000	41 (29)	29.2	46.1	32.7	53.5	20.0	7.5	9.3	6.4	23.8	1.5	12.5
2001	41 (32)	30.5	41.8	23.4	40.6	20.4	31.5	10.1	3.9	28.8	3.1	21.8
2002	39 (32)	31.6	40.4	12.8	28.9	21.7	39.9	11.9	2.7	24.6	2.7	19.7
2003	38 (29)[1]		38.2[1]	9.9[2]	25.1[2]				11.0[3]	23.2[2]	2.4[4]	6.9[4]

Notes:
1. August 2003.
2. May 2003.
3. End-June 2003, after revision (see text).
4. End-March 2003.

Source: BNR, IMF, EBRD.

The current account deficit has also been relatively high but has declined in 2002 (2001: 5.5 per cent of GDP, 2002: 3.4 per cent). It began widening again in the second quarter of 2003, on the back of booming credits and rising wages, triggered by a sizeable hike of the minimum wage at the beginning of the year. On the average between one-half and two-thirds of the current account shortfall has been financed by foreign direct investment. Real appreciation and loss of competitiveness do not appear to be a problem so far, given that in recent years the CPI-based real effective exchange rate has appreciated only slightly and that the ULC-based real effective exchange rate has steadily depreciated. This would rather imply improving competitiveness. Gross foreign debt, while relatively low, has been on the rise in recent years. (It came to 29 per cent of GDP in 2000 and 33 per cent in 2002.) Expanding gross foreign exchange reserves reached EUR 6.7 billion in September 2003 (almost four import months). Their expansion was most recently driven by the issuance of a EUR 700 million Eurobond in the summer of 2003. The liberalization of short-term capital movements is not planned before Romania's EU accession (earmarked for 2007 by the authorities). Altogether, there does not appear to be an acute danger of a stronger depreciation looming.[8]

On the other hand, the increase of foreign exchange loans seems to be stimulating particularly import activities and putting pressure on the trade deficit.[9] In 2002 the BNR attempted to rein in the growth of foreign currency credits. For instance, in November 2002 reserve requirements were adjusted upwards for respective deposits. The IMF has repeatedly advised the authorities to increase capital requirements for foreign currency loans.[10] In the first half of 2003 the dynamics of credit expansion changed and leu loans grew more quickly than foreign currency loans. The BNR recently tightened its monetary stance by twice raising the benchmark overnight deposit rate, in August and October 2003, each time by 100 basis points, to 20.25 per cent. It remains to be seen what cushioning effect this will have on bank lending.

3. CONSOLIDATION PROCESS AND GROWING IMPORTANCE OF FOREIGN-OWNED BANKS

The slow consolidation process of the Romanian banking sector went on in recent years. The total number of credit institutions (including foreign bank branches) declined from 41 at end-2000 to 38 in August 2003. Three remain in majority state ownership: Banca Comercială Română (BCR, the largest bank, accounting for around 30 per cent of the country's bank assets), the Savings Bank (CEC, the third-largest bank) and Eximbank

(Banca de Export-Import a României).[11] As of August 2003, the state held majority stakes in institutions comprising 38 per cent of bank assets of the country (Table 19.2), 31 per cent of non-government credit and 42 per cent of non-bank clients' deposits. The state-owned banks' relative strength in the sphere of deposits is due to the prominence of the Savings Bank (Casa de Economii şi Consemnatiuni) in this field.

Twenty-nine banks (including eight branches) or 58 per cent of bank assets are owned by foreigners. Foreign-owned credit institutions account for 65 per cent of non-government credit and 55 per cent of non-bank client deposits. Their strong credit position largely goes to previously state-owned banks equipped with large nation-wide branch networks taken over by foreigners through which these banks lend to domestic firms. Among the most important foreign-owned credit institutions are: the Romanian Development Bank (the second-largest bank as measured by assets, owned by Société Générale), Raiffeisen Bank (the fourth-largest credit institution), ABN Amro Bank (ranked fifth), ING Bank Bucharest, Banc Post (see above), Alpha Bank Romania, Citibank Romania, Bank Austria-Creditanstalt/HVB Bank and UniCredit Romania (see also Table 19.3). *Austrian* investors account for the largest share – namely 40 per cent – of total registered statutory foreign capital in Romanian banking. They are followed by Greece (14 per cent), France (11 per cent), the Netherlands, the USA and Italy.[12]

Six banks, together accounting for a mere 4 per cent of banking assets are in private Romanian hands. Despite intensive efforts, the authorities have so far not found a strategic investor for the BCR. Recently it was agreed to sell a quarter of the share capital of the credit institution to the EBRD and the IFC (12.5 per cent each); 8 per cent of the BCR is reserved for the bank's employees. While EBRD and IFC are expected to stimulate restructuring of the bank, the authorities hope to identify a big investor to take over at least 51 per cent of Banca Comercială Română until 2006. Both CEC and Eximbank are still deemed to be in need of substantial restructuring measures; there are currently no privatization plans for these two banks.[13] The recent collapse of two smaller credit institutions – the Romanian Discount Bank (Banca Română de Scont) and the Investment and Development Bank (Banca de Investiţii şi Dezvoltare) – revealed the weakness of their ownership structure and their susceptibility to fraud.[14] Recurrent bank failures and feeble governance practices have contributed to subduing confidence in the system.

The BNR has been striving lately to further improve banking supervision practices. Loan classification and loss provisioning rules were tightened in early 2003. Sub-standard loans were included in the category of non-performing loans, as is good international practice. This moved Romanian accounting rules nearer to IAS. Today the BNR can be said to possess a solid banking supervision framework that is compliant or

Table 19.3 Romania's top ten commercial banks (as of 30 September 2003)[1]

	Name of bank	Total (on-balance sheet) assets (in ROL billions)	Total share capital (in ROL billions)	Major owners (percentage share in total registered capital, >5 %)	Aggregate share of registered capital owned by foreigners (in %)
1	Banca Comercială Română S.A.	164907	7925	State	0
2	Banca Română pentru Dezvoltare – Groupe Société Générale S.A.	73584	4181	Société Générale (51.0), State (33.2)	58.4
3	Casa de Economii şi Consemnatiuni S.A.	37843	1497	State	0
4	Raiffeisen Bank Romania S.A. (former Banca Agricola)	35003	6961	Raiffeisen International Beteiligungs A.G. (99.2)	99.2
5	ABN AMRO Bank Romania S.A.	32538	740	ABN AMRO Bank N.V. Netherlands (99.7)	99.7
6	ING Bank N.V. – Bucharest Branch	25564	320	ING Bank N.V. Netherlands (100)	100
7	Banc Post S.A.	22323	665	EFG Eurobank Ergasias S.A. (36.3), State (30), Banco Português de Investimento	62.1

Table 19.3 (continued)

	Name of bank	Total (on-balance sheet) assets (in ROL billions)	Total share capital (in ROL billions)	Major owners (percentage share in total registered capital, >5 %)	Aggregate share of registered capital owned by foreigners (in %)
8	Alpha Bank Romania S.A. (former Bucharest Bank)	18441	1452	Alpha Romanian Holdings A.E. Greece (53.9), Alpha Bank A.E. Greece (41.5)	100
9	Citibank Romania S.A.	17086	641	Citibank Overseas Investment Corporation (99.6)	100
10	Banca Comercială 'Ion Tiriac' S.A.	16347	1047	Ion Tiriac Group (72.3), of which: Ion Tiriac (28.3), REDRUM T.V. International B.V. (43.4); EBRD (5.7)	83.0

Note: 1. According to prudential reports.

Source: Banca Naţională a României.

largely compliant with the majority of the Basel Core Principles.[15] Due to increasing competition, interest rate spreads have been declining, but they are still high. (In 2002 spreads between deposit and lending rates amounted to approximately 16 per cent, in July 2003 they came to 14.5 per cent.) Bank liquidity is generally satisfactory. Given the economic upswing and the wave of credit expansion, the profitability of Romanian banking has steadily risen in recent years, although it slightly declined again in 2002 in the wake of the narrowing of spreads and increased provisions (see Table 19.2).

Capitalization of banks is quite high. In May 2003, capital adequacy stood at the very favourable level of 23 per cent. This is partly the result of the ongoing phased adjustment of minimum capital requirements to around EUR 10 million. The share of non-performing loans in total loans was reported to have fallen to only about 2 per cent at the beginning of 2003. However, this share has recently been revised upward to 11 per cent (June 2003), as a result of the tightening of provisioning rules.[16] Such a level still seems to be manageable for a transition economy. Romania intends to come into full compliance with International Accounting Standards by 2005. As of early 2003, nine banks (including BCR, Romanian Development Bank, BACA-HVB Bank, Citibank Romania) reported according to IAS. Of course there is a likelihood that in an economic upswing like the one Romania currently witnesses, doubtful loans pose a lesser problem, only to loom larger once business prospects start to deteriorate.

All in all, financial intermediation in Romania – notwithstanding expansionary tendencies – is still on a comparatively modest level. Provided that framework conditions do further adjust, there remains ample growth potential in the medium and long term, just as the growth and catching-up potential of the entire Romanian economy remains large and promising. As a sign of hope and optimism, in mid-October 2003 Romania successfully concluded its IMF Stand-by Arrangement – the first such programme that the country fully carried through. To give just one illustration of the scope for catching up: with 22.4 million inhabitants and a territory of approximately the size of former West Germany, Romania is the second-largest of the current candidate countries for EU accession after Poland (if one disregards, for the moment, Turkey). If banking sector assets *per inhabitant* in Romania reached the same level as they presently have in Poland, this would imply a medium-term expansion potential of close to 400 per cent.

4. MOST IMPORTANT CURRENT CHALLENGES/ PROBLEMS AND RECOMMENDATIONS

Apart from the above discussed exposure to a possible depreciation of the domestic currency and the inherent credit risk, some of the most pertinent risks/problems for the Romanian banking sector appear to be:

- the danger of a mismatch between increasingly medium-term credits and predominantly short-term deposits;

- insufficient risk analysis and management capacities at banks;
- the persisting lag in restructuring the real sector, particularly state-owned enterprises, sluggish privatization, weak corporate governance, loss-prone firms, lack of financial discipline;
- continuing limited contract enforcement capacities and weak de facto recoverability of claims, inefficient and partly non-transparent insolvency procedures, inadequate creditor protection;
- despite some progress, still unfavourable overall investment climate, still sprawling bureaucracy, pervasive corruption.[17]

Confidence building in the banking sector would inter alia require the following measures:

- upgrade bankers' risk analysis and management capacities through training;
- step up privatization and restructuring enterprises and banks to foster a more competitive business environment and adjust financial discipline;
- raise transparency and reliability of accounting and auditing practices, apply IAS;
- improve contract enforcement and effectiveness of the court system through provision of sufficient resources, strengthening of financial expertise and training for judges and judicial personnel, and through avoiding budgetary cuts in these areas;
- simplify and clarify legislation where possible, combat corruption and fraud.

The overarching Romanian national goal of joining the EU as soon as possible (now earmarked for 2007) may be seen as a catalyst giving a clear direction of and reinforcing reform efforts of the authorities.

NOTES

1. IMF (2002, p. 19); Banca Naţională a României (2002, p. 31); Economist Intelligence Unit (2003); National Bank of Greece S.A. (2003, p. 8).
2. Compared to other transition countries, this corresponds to a medium level. Public financial cleaning-up costs for the banking sector (as a percentage of GDP) in Poland have been below those in Romania; respective costs in the Czech Republic, Hungary and Bulgaria have been above Romanian costs (Isărescu 2003).
3. Daianu (2002).
4. Wagstyl and McAleer (2003).
5. Ministry of Finance, Banca Naţională a României (2003), p. 56.

6. Economic Intelligence Unit (2003); National Bank of Greece S.A. (2003), p. 8.
7. About half of all foreign currency loans are denominated in US dollars, the other half is denominated in euros.
8. IMF (2003a, pp. 14, 18).
9. Rompress (2003).
10. IMF (2003a, p. 15).
11. For the first two mentioned banks – see Table 19.3.
12. Banca Naţională a României (2003).
13. National Bank of Greece S.A. (2003, p. 10); 'Strong but not Equal' (2003, p. 106); EBRD (2001, p. 183).
14. 'The Rebirth of Banking' (2003, p. 113).
15. IMF (2003b, p. 18).
16. IMF (2003b, p. 5).
17. For the last three points see OECD (2002); EBRD (2002, pp. 186–87); EBRD (2003, pp. 180–81); IMF (2003a, p. 17).

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PART VII

Stabilization of expectations – macroeconomic and structural policies in an enlarged euro area

20. Fiscal discipline and the adoption of the euro for new members of the European Union

Fabrizio Coricelli[1]

1. INTRODUCTION

Although achieving macroeconomic stability was not a requirement for EU entry, the candidate countries (CEECs from now on) have made remarkable progress in this field on the path to accession, as effectively summarized by the convergence of inflation rates to EU levels (see Figure 20.1).

However, in the run-up to EU entry some clear inconsistencies have become evident in the policy frameworks followed by several candidate countries. Specifically, budget deficits soared as fiscal policies were loosened in several CEECs (see Table 20.1).

At the same time, there is an increasingly favourable attitude towards postponing the adoption of the euro. The timing of euro area entry and fiscal discipline are related, as there is a widespread perception that a later

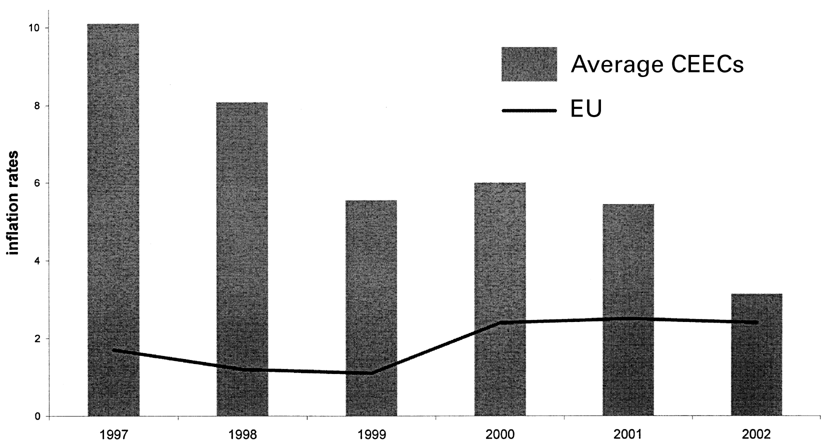


Figure 20.1 Convergence in inflation rates

Table 20.1 Consolidated general government balance (in % of GDP)

	2001	2002
Bulgaria	−0.86	−0.65
Croatia	−6.80	−4.80
Czech Republic	−5.11	−6.74
Estonia	0.68	1.19
Hungary	−4.70	−9.19
Latvia	−1.95	−2.70
Lithuania	−1.96	−1.19
Poland	−5.50	−6.70
Romania	−3.50	−2.70
Slovak Republic	−7.30	−7.20
Slovenia	−1.14	−3.21

Source: EBRD.

entry into the euro area will result in fewer restraints being put on fiscal policy. Furthermore, EU institutions, such as the European Central Bank and the European Commission, in fact seem to support the view that CEECs would be better off postponing entry in the euro area and not focusing too much on fiscal restraints. This view seems to imply that nominal convergence and fiscal discipline are an obstacle for faster growth. This approach does not bode well for future scenarios. Lack of fiscal discipline in a context of open capital accounts will lead to high domestic interest rates and pressure for a strong appreciation of exchange rates – until the unsustainability of the process becomes apparent and a costly adjustment will be forced by a reversal of capital flows and a slowdown of growth.

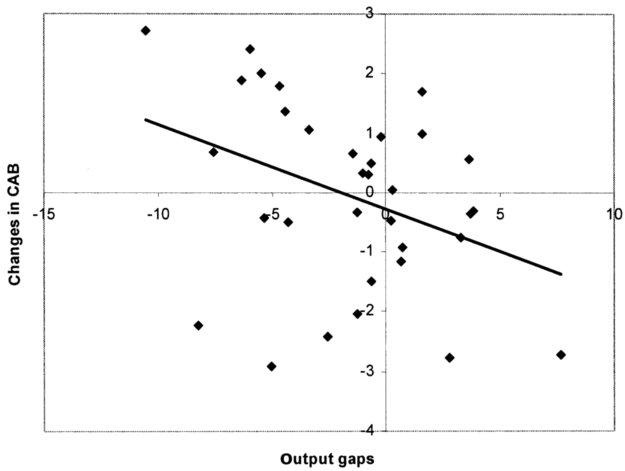
In sum, we argue that fiscal policy and the path chosen for entering the Economic and Monetary Union (EMU) are closely linked. The choice of the exchange rate regime is important, but the imposition of fiscal discipline is even more important.

2. FISCAL FRAMEWORK FOR CANDIDATE COUNTRIES

Several candidate countries are approaching EU entry with large budget deficits that have a structural nature.

During the 1990s, the positive effects of economic growth on the budget were more than compensated by an increasing imbalance in the structural budget. Figures 20.2a and 20.2b clearly illustrate the pro-cyclical stance of fiscal policy in CEECs during the 1990s. Figure 20.2a displays an inverse

a) Changes in structural budgets and output gaps



b) Structural budgets and GDP growth

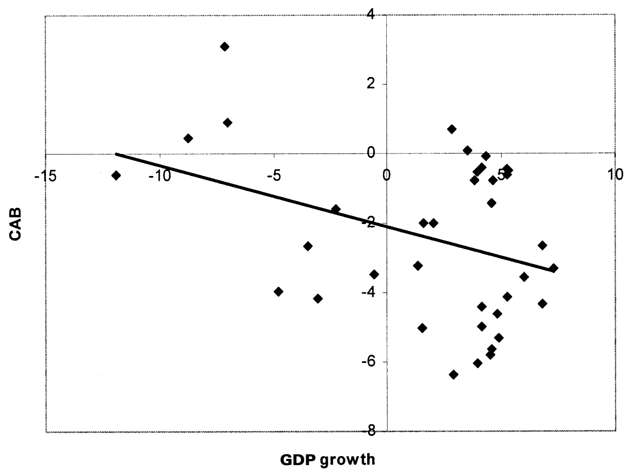


Figure 20.2 Fiscal stance, 1990–2000

relationship between the structural budget as a ratio of GDP and output gaps, indicating that in periods of growth below trend fiscal policy was tightened, while it was eased in periods of growth above trend. Figure 20.2b confirms the above result, by linking structural budgets to the rate of growth of GDP. The structural deficit remained high during periods of growth. During the sharp economic downturn of the early 1990s, lack of access to borrowing induced a significant tightening of fiscal policy. For countries like Slovenia, in which the cyclical volatility of GDP growth has been low, the latter figure seems more relevant. Budget deficits were on average well above 3 per cent of GDP, except for Slovenia.

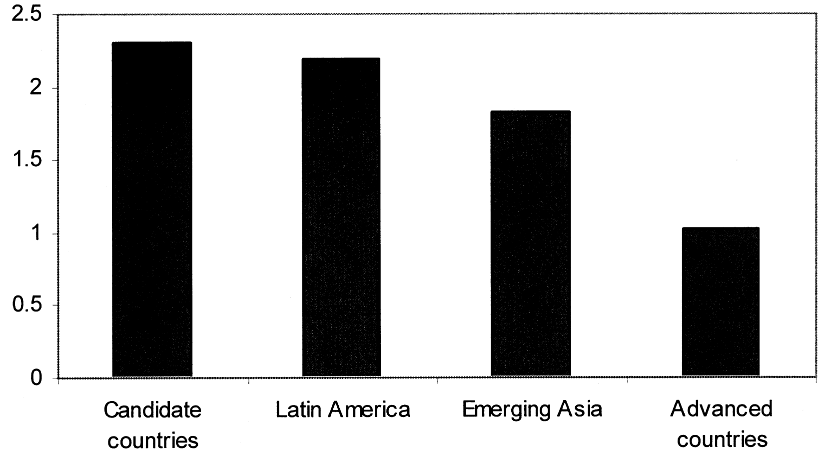
A pro-cyclical stance has been found also for emerging countries, especially for Latin America (IMF, 2002). By contrast, industrial countries seem to have had a counter-cyclical stance. However, according to some studies a pro-cyclical stance characterized the EU countries at least during the period 1970–95 (Buti et al., 1997). This effect seems due to the presence of an expansionary fiscal policy during periods of positive output gaps, more than compensating for the positive effects of automatic stabilizers (Buti and Sapir, 1998). Regarding the fiscal stance during recessions, the evidence is less clear-cut. Nevertheless, a robust result seems to be that developing and emerging economies display a pro-cyclical stance during bad times, as they lose their ability to finance deficits.

An implication of a pro-cyclical fiscal stance is the absence of tax smoothing. Indeed, in CEECs and Latin American countries, the volatility of revenue-to-GDP ratios was much higher than in advanced economies during the 1990s (see Figure 20.3).

Will the adoption of existing EU rules overcome the pro-cyclical stance of fiscal policy displayed by CEECs? As discussed in the next section, the answer is negative. Indeed, we argue that the 3 per cent limit on the budget deficit tends to induce pro-cyclical adjustments of the budget, by requiring countries to reduce the deficit during a marked slowdown of the economy. Recent developments in EU countries are a case in point. This problem is going to be even more serious for candidate countries as they are more likely to hit the 3 per cent ceiling than the present member states, given much higher output volatilities.

3. NEW FISCAL RULES FOR AN ENLARGED EUROPEAN UNION

Table 20.2 illustrates three main features of CEECs: (1) very large structural deficits (combined with high output volatility, this implies major difficulties in satisfying the limit of 3 per cent on the budget deficit that



Note: *1993–2001 for candidate countries.

Source: Own calculations for candidate countries; IMF (2002) for other regions.

*Figure 20.3 Volatility of government revenues, 1991–2000** (*standard deviation of revenue-to-GDP ratios*)

Table 20.2 Budgetary indicators and volatility of output (2000) (% of GDP)

	Volatility of economic cycle*	Budget balance	Total revenue	Total expen-diture	Interest expen-diture	Public invest-ment
Hungary	3.7	−3.5	40.6	45.1	6.1	7.1
Poland	4.5	−3.2	39.4	42.6	2.7	3.1
Romania	6.2	−3.7	31.5	35.1	4.9	3.1
Slovenia	0.4	−1.3	42.8	44.1	1.5	4.1
Euro-zone	1.5	−0.2	46.8	47	3.7	1.0

Note: *Standard deviation of cyclical component of GDP, calculated with Hodrick–Prescott filter.

applies to EU members); (2) a pro-cyclical fiscal policy; (3) high expenditure for public investments relative to current EU member states.

What will happen when CEECs become EU members? They will be immediately subject to the excessive deficit criterion of 3 per cent of GDP, although pecuniary penalties will apply only when they become members of the euro area, that is, once the rules of the Stability and Growth Pact become binding for them. However, failure to satisfy the criterion on the excessive deficit may trigger the interruption of payments for cohesion funds, although there is little clarity on this issue in official documents of the European Commission.

What would the rationale be for the 3 per cent deficit ceiling for new members? Among other factors, the justification of the *ex post* 3 per cent limit is associated with two main elements. First, 3 per cent was roughly the ratio of public investment to GDP of the present EU members during the period 1960–90 (Buiter and Grafe, 2002). Second, and more relevant for the current debate, given the estimates of output volatility in the EU countries, breaking the 3 per cent ceiling would be rather exceptional for countries running deficits of around 1 per cent of GDP. Indeed, with a budget sensitivity to the cycle of 0.5, in order to hit the ceiling a country should have a negative output gap of 6 per cent if it has a balanced structural budget. How can one reconcile this view with the experience of several EU countries, including Germany and France, during the current slowdown of their economies?

The point is rather trivial. With a GDP elasticity of revenues equal to one, the decline in revenues will equal the shortfall in growth in the short run. By contrast, expenditures are planned *ex ante* on the basis of expected growth, irrespective of any value of output gap. A contraction in output that is not anticipated may lead to a deficit above 3 per cent irrespective of the output gap, which in extreme cases can even be positive. Buti and Van den Noord (2003) share this idea and used it as a way to compute the fiscal stance. One cannot blame a country for misbehaviour when a deficit emerges because of a forecast error. Asking the country to make the adjustment after having observed *ex post* the higher deficit makes fiscal policy pro-cyclical. The argument is very simple, but reveals a basic drawback in the *ex post* rule, namely the contradiction between the *ex post* evaluation and the expenditure plan that is based, by necessity, on an *ex ante* forecast. The drawback of the rule also reveals the flaw in the view that 3 per cent represents a wide margin of flexibility during economic cycles. In other words, given the GDP elasticity of revenues equal to one, and the largely exogenous expenditures, what matters in the short run is the actual change in GDP rather than the level of output gap, which is affected by the past behaviour of output. This line of reasoning is even more relevant in the case of candidate countries. It suffices to refer to the case of Estonia, which during the Russian crisis displayed a swing in the GDP growth rate of 10 percentage points in a period of two years. The implication of such a swing for the budget is dramatic, irrespective of the level of the output gap.

One solution could be, for a transition period, to make new members an exception and thus tolerate deficits above 3 per cent of GDP. However, making exceptions to a rule may be dangerous, as other countries can claim exceptional circumstances to justify their excessive deficits. Furthermore, the idea of considering new members as 'special' is dangerous, as it can create a two-tier European Union. Excusing new members for fiscal indiscipline may in fact harm their economies, increasing current account deficits, macroeconomic volatility and, in the end, economic growth.

We argue that existing fiscal rules in the European Union can be improved, with benefits applying not to candidate countries alone, but to all member states. The existing rules are inefficient in two main areas. First, the *ex post* limit of 3 per cent of GDP induces pro-cyclical adjustments of fiscal policy during a marked slowdown. At the same time, it does not exert sufficient pressure for adjustment during good times. Second, public investments are treated like any other expenditure and are subject to the overall limit on the budget deficit. The new fiscal rule we suggest tackles especially the issue of the pro-cyclical bias of existing rules, but it can also accommodate the so-called 'golden rule'.

The main feature of the suggested rule is that it is a binding commitment that is by construction counter-cyclical. The counter-cyclical effect goes well beyond the traditional effect of automatic stabilizers, which operate mainly through unemployment benefits. The new rule implies that total expenditures will significantly increase (decrease) the contribution to aggregate demand in phases of growth below (above) trend.

3.1 Transparency and 'De-politicization'

Furthermore, focusing on nominal expenditure, the new rule is transparent and is not subject to interpretations. Finally, the rule makes fiscal policy consistent with the underlying potential growth of the different countries and with inflation targets. Specifically, for euro area members the inflation target will be that of the European Central Bank.

Note that our suggested rule is a steady state solution. Given large structural deficits, we deal initially with convergence towards a balanced structural budget, amended eventually with some form of golden rule. This implies realistically a framework for gradual adjustment, as is already the case for member states. The recent proposal of the European Commission suggests an adjustment in the structural deficit of 0.5 per cent of GDP per annum for the countries that do not comply at present with the Stability and Growth Pact (European Commission, 2002c).

3.2 The Mechanics of the Rule 'Structural Close to Balance'

Specifically, we suggest an *ex ante* balanced budget rule of the following form:

$$sR_t(1+\pi^*_{t+1}) + cR^s_t\left\{1+\varepsilon_{cR;Y}\left[\left(1+\Upsilon^{r*}_{t+1}\right)(1+\pi^*_{t+1})-1\right]\right\} = R^f_{t+1} = E^f_{t+1}$$

where:
cR^s_t = structural component of revenues linked to the cycle at time t
sR_t = revenues not linked to the cycle at time t (capital revenues)
Υ^{r*}_{t+1} = percentage change of potential output, or

$$\Upsilon^{r*}_{t+1} = \frac{Y^{r*}_{t+1} - Y^{r*}_t}{Y^{r*}_t}$$

π^*_{t+1} = inflation target (that of the ECB for euro area members)
R^f_{t+1} = nominal value of total structural revenues for $t + 1$, announced at time t
E^f_{t+1} = nominal value of total expenditures (excluding unemployment benefits) for the year $t + 1$, announced at time t

Therefore, the rule fixes expenditures to match the following aggregate revenue measures for the year $t + 1$: revenues not linked to the cycle of the year t updated on the basis of targeted inflation; the structural component of revenues linked to the cycle of the year t, increased by the growth rate of potential output and the targeted rate of inflation.[2]

Once the level of nominal revenues has been established, the rule defines the amount of expenditure, excluding unemployment benefits: in this way, the cycle cannot influence public expenditure. This amount should be consistent with the medium-term fiscal framework endorsed by all member countries of the European Union. Both the estimation of potential output and the inflation target have to be agreed with the European Commission. The European Commission, in a sort of European Union budgetary framework, should also approve the amount of expenditures and revenues planned by the national states.

At the end of year $t + 1$ actual outcomes are observed. Denoting with R_{t+1} the nominal value of total revenues actually collected during the year $t + 1$ and with E_{t+1} the actual nominal value of total expenditures (excluding unemployment benefits) at year $t + 1$, a balanced budget rule is satisfied if:

a. $E^f_{t+1} = E_{t+1} = R^f_{t+1} = R_{t+1}$, if and only if actual GDP coincides with the estimate of potential output and the inflation target is met.

b. $E^f_{t+1} = E_{t+1}$, but $R^f_{t+1} \neq R_{t+1}$, when either actual output deviates from potential, or inflation is different from target, or both.

The rule is not satisfied if:

$E^f_{t+1} \neq E_{t+1}$ and/or $R^f_{t+1} \neq R_{t+1}$, but none of the conditions in (b) are verified. In this case penalties are automatically applied.

Note that in equation (b) there will be a budget deficit when the actual rate of growth of output is lower than the potential rate of growth, and a surplus when the actual rate of growth is above potential growth.[3] However, as long as the country has followed the announced rule, no corrective action is required and no penalty applies. Fiscal policy is fully counter-cyclical. The budget is by construction balanced on average, and thus government debt is also constant in the medium run. Therefore, the rule is an authentic 'structural close-to-balance rule'.

The rule satisfies two main objectives. First, it is fully consistent with the philosophy of the Stability and Growth Pact that establishes that a common monetary policy has to be underpinned by common targets on fiscal policy, but not necessarily the same level of budget deficits. This is achieved by assuming a target on the structural budget balance and a behaviour of the budget over the cycle consistent with underlying potential output and inflation targets of the ECB. Second, the rule is counter-cyclical by construction. In this way, the rule avoids the undesirable outcome of forcing countries to make an adjustment during an economic downturn, worsening the economic outcome for the EU as a whole. At the same time, the rule induces the necessary adjustment during good times, forcing the countries to run surpluses in those periods.

Another interesting feature of the rule is that countries with higher growth rates in potential output can run higher deficits during recessions. To illustrate the statement, consider two countries, with different potential growth, but suffering a recession of the same intensity. Assume that the GDP elasticity of revenue is 1. As planned expenditure is set according to the rate of growth of potential output, the country with higher potential growth will display a larger deficit as its expenditure will increase faster, while its revenues will decline in the same proportion as in the other country. In sum, the rule accommodates different regional realities. This may be particularly relevant for candidate countries that are characterized by higher rates of growth of potential output.

Moreover, the suggested rule is not subject to the traditional criticism of expenditure rules, according to which the spending norms do not refer to the fiscal variables, namely budget deficits, which produce negative externalities (Buti et al., 2003). With a 'structural close-to-balance rule' the budget, by construction, is balanced on average, and thus negative externalities are reduced to minimal levels.

One could object that the suggested rule is more difficult to implement than the current rule. In fact, this can hardly be true. On the revenue side, the calculation of the cyclical revenues necessary to establish whether a country deviated from the neutral tax policy is exactly the same as the one currently used by the European Commission for computing the cyclically adjusted deficit, except for the fact that we use the actual rate of GDP growth instead of the output gap. Regarding the expenditure side, there is no implementation problem. The supervisory body only needs to check whether the nominal amount announced at time t has actually been spent at $t+1$. No interpretation problem can arise. This kind of rule is in fact the kind of rule normally used in the budgetary process in most countries, like for example the UK (H.M. Treasury, 1998). It would thus also become EU standard. This latter point would appear minor but it has important implications from a political economy point of view. Indeed, fiscal rules will be transferred to the national authorities, as it should be in a European Union that is an economic and monetary union but not a political union. Auditors that are approved by all member states will control the budgetary process. The role of the European Commission and other European bodies will be limited to coordinating the process and verifying the auditors' reports.

Deviations from the rules should automatically trigger a punishment procedure. A by-product of the auditing process of expenditure is that the budgetary process and all centres of expenditure will become more transparent, and this will reduce the scope for creative accounting. National authorities will be responsible and accountable for the fiscal policy. They cannot blame 'Brussels' for their own inefficiencies.

4. CONCLUSIONS

The analysis in the chapter raises several doubts on the efficiency of existing EU fiscal rules in the light of the forthcoming enlargement. Notwithstanding data limitations, the conclusions about the large structural deficits and the high share of public investment in GDP for candidate countries seem rather robust. Similarly, evidence on the pro-cyclical stance of fiscal policy is quite convincing. Existing rules in the European Union have the unfortunate property of reinforcing the pro-cyclical stance during bad times but providing little incentive for surpluses during good times. Moreover, the existing rules are likely to adversely affect candidate countries, by applying a common limit to budget deficits irrespective of the stage of development of countries, their potential growth rates and the need for public investment.

Whatever the outcome of possible revisions of fiscal rules will be, it is of great importance that fiscal discipline is strengthened for CEECs. An early adoption of the euro appears a mechanism to induce such discipline, as euro area entry will subject new members to the Maastricht criteria and the Stability and Growth Pact. Of course, it is to be hoped that such rules will be made more efficient.

NOTES

1. University of Siena and CEPR.
2. The assumption of constant structural level of revenues is consistent with the theory of 'optimal tax smoothing' (Barro, 1979). Of course, adjustments to tax rates could be easily introduced, although they should be approved by the supervisory authority on the budget.
3. It should be stressed that the rule refers to the growth rate of output, not to the output gap. This line of reasoning underlies the working of the DP indicator (Discretional Policy Indicator) built to detect possible discretional behaviour in fiscal policy (Buti and Van den Noord, 2003).

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21. Fiscal convergence before entering EMU

Luca Onorante*

1. INTRODUCTION

The monetary integration of the acceding countries will proceed in several distinct steps, starting with membership in the European Union (EU), followed by participation in the so-called Exchange Rate Mechanism (ERM) II and ultimately entry into the euro area.

Already the first step, accession, implies full acceptance of the actual and potential rights and obligations that constitute the third stage of EMU, as well as its institutional framework. The new member states will have to consider their economic policies as a matter of common concern, avoid excessive government deficits and adhere to the relevant provisions of the Stability and Growth Pact. The new member states will have to be committed to the medium-term budgetary objective of close-to-balance or in-surplus positions and to meeting the objectives of their convergence programmes. Their budgetary policy and outcomes will become subject to the Excessive Deficit Procedure and to the non-sanctioning parts of the Stability and Growth Pact.

As far as fiscal policies are concerned, these commitments imply that further progress needs to be made before the new member states can apply to enter the euro area. In 2002, only the Baltic countries and Slovenia had a deficit ratio below the Treaty reference value of 3 per cent of GDP. The other countries recorded deficit ratios as high as 9.2 per cent of GDP.[1] Yet the process of reduction of public deficits seems to have stopped. The public deficits in most acceding countries have recently been increasing, mainly in their structural component, and expenditure pressures are expected to mount over the next few years, among other reasons because of the expenditures related to EU accession.[2] It can then be expected that the Maastricht deficit criterion could delay the adoption of the euro by the acceding countries.

This chapter addresses precisely the question of whether a reduction of public deficits, such as that imposed by the Maastricht fiscal criteria, is a necessary or useful step on the road to the adoption of the euro.

Some authors favour a rapid enlargement process of the euro area and argue that the Maastricht convergence criteria are not necessary and should be loosened to facilitate this objective. The assumption underlying this position is that fiscal consolidation is equally painful before and after entry in monetary union, and the decision on whether to consolidate before or wait until the entry can then be left to each country. Others believe that after entry it will be more difficult to keep public finances under control. Such an eventuality would be particularly dangerous inside a monetary union, where the inflation caused by loose public finances implies an appreciation of the real exchange rate, and a loss of competitiveness. This second group argues against the adoption of the euro by countries that have not previously reached a high level of sustainable convergence.

The question is addressed by examining the interaction of monetary, fiscal and wage policies and their effects on prices in a monetary union hit by economic shocks. The theoretical model shows that fiscal activism is related to both entry in monetary union and to structural differences in the national labour markets, and analyses in detail the effect of both factors. As for acceding countries, the conclusion is that the process of deficit reduction should be completed before entry, as suggested by the Maastricht criteria. The chapter also suggests that fiscal constraints on government deficits appear essential in a monetary union when the wage formation is taken into due consideration. Finally, it is shown that different structures of national labour markets make monetary policy more difficult in a monetary union than in the one-country case.

More specifically, this chapter argues that:

- First and most important, fiscal activism is always increased by entry in monetary union. This conclusion does not depend on any switch in preferences, and should be considered as an inevitable fact for any country joining a monetary union.
- The capacity of the central bank to keep inflation close to targets without continuous interventions is much smaller in a monetary union than in the one country case. The most conservative central bank can reduce, but not eliminate, this problem. Therefore, a process of previous reduction of public deficits and inflationary pressures by new members also favours a monetary policy oriented to price stability.
- The effects of the common monetary policy are influenced by the structure of the national wage-setting process. As in Calmfors and Driffil (1988), decentralized wage bargaining produces higher wage inflation and unemployment in a country. Mechanisms to eliminate the externalities in the wage setting process could be beneficial.

- In a monetary union, constraints on the national fiscal budgets are effective in re-establishing monetary dominance. They also ensure an *ex-post* policy mix of stability-oriented monetary policy, sustainable fiscal policies and moderate wage inflation.
- From the methodological point of view, the chapter takes into account the structural break of EMU and provides an analytical and conceptual framework for assessing the potential causes for asymmetry in a monetary union.

The structure of the chapter is as follows. Section 2 presents and describes the model in detail. The solution of the game between fiscal, monetary and wage-setting authorities is provided in section 3, both with explicit expectations and with backward induction. Section 4 presents the main results and deals with the policy implications of the model. Finally, section 5 summarizes the findings.

2. THE MODEL

2.1 Description of the Model

The illustrative model is a simple linear-quadratic, one-shot game. My choice of a game theory model is motivated by the relevance of the Lucas critique in the context of the chapter. One important implication of the Lucas critique is that any structural change in a part of an economic system also changes the behaviour of all other agents. In the case of a monetary union, the transfer of monetary policy to a supra-national level implies that one cannot expect the unions and the government to behave in the same way as before, even if their preferences remain exactly the same. I consider a Barro–Gordon type of model and concentrate on a country belonging to a monetary union. The basic hypotheses of the model are described here.

I assume some structural parameters of labour markets as given, because there are no signs of a very rapid change of the national labour market as a consequence of EMU, and even less of the creation of an EU-wide labour market.

The model focuses on stabilization of the cycle, not on systematic biases. Therefore, I assume that the long-run targets are agreed among the different players and that tastes differ on stabilization only. Even under this optimistic scenario the dynamics are quite rich, and several problems arise.

The central bank of a monetary union reacts to union-wide economic indicators, and its actions may propagate shocks to one country to the others. Similarly, fiscal policy has spillovers on neighbouring countries. I am neglecting both monetary and fiscal externalities in order to allow a simple treatment of the strategic interaction of the players. For a paper taking into account the 'Domino effect' of fiscal policies caused by monetary externalities, see Onorante (2004).

In the model, both workers' unions and fiscal authorities have a larger preference for output stabilization than the central bank. I believe this hypothesis is justified in Europe by the statute of the ECB. To ensure a simpler model I assume that the governments have totally delegated the objective of inflation stabilization to the central bank. This parametrization is not restrictive, as its relaxation does not alter the qualitative results of the model.

Finally, and purely for explanatory purposes, the chapter uses a reduced-form description of the economies and explores the case which is most perceived to be problematic: an asymmetric shock to output that cannot be dealt with by the common monetary policy.

The common monetary policy is decided by a federal central bank. The central bank is interested in union-wide inflation $\tilde{p}$ and (possibly) output $\tilde{y}$, both expressed as deviations from targets, and seeks to minimize the following loss function:

$$\min_{\tilde{r}} L_{CB} = (\tilde{p}^2 + \beta\tilde{y}^2) \tag{21.1}$$

The parameter β expresses the relative aversion of the central bank to inflation and unemployment.

The central bank chooses a union-wide policy variable $\tilde{r}$, such as a nominal interest rate, after observing the deviations from targets of inflation and output of the whole union. Variables with a tilde (~) denote union-wide aggregates. A union-wide variable is defined as the weighted sum of the corresponding national variables with the weights ϕ denoting the size of each country in the monetary union: $x = \Sigma_i \phi_i x_i$, $\{\phi_i : \Sigma_i \phi_i = 1\}$.

The national fiscal policy is decided by the government, seeking to minimize a loss function including national (without tilde) output y and deficit g arising from discretionary fiscal policy:

$$\min_{g} L_G = (y^2 + \gamma g^2) \tag{21.2}$$

conditional to the observed shocks and wage policies, and backward inducting on the central bank. The parameter γ expresses the relative preference for deficit stabilization. The target variable p is not included because the goal of price stability has been assigned to the central bank for the whole union. I will explicitly model only one country, with weight ϕ in the monetary union.

The national wages are determined as the outcome of a decentralized bargaining process. For tractability, I suppose that in the country there are $1/\psi$ identical unions, each of them representing a fraction ψ of workers. Each union $j = 1, 2, ..1/\psi$ minimizes a loss function of the form

$$\min_{w_j} L_{Uj} = (y^2 + \omega(w_j - p)^2) \tag{21.3}$$

including deviations from target unemployment y and real wage inflation $(w_j - p)$ of the workers it represents. The collective outcome (symmetric Nash equilibrium) of the decentralized wage negotiation is the level of wages w in the country:

$$\begin{aligned} w &= \textstyle\sum_j \psi_j w_j \\ &= w_j \ \forall j \end{aligned} \tag{21.4}$$

The national macro variables (inflation and output) are linearly related to the output shock (η), the growth rate of wages (w) and the policy instruments (g, $\tilde{r}$). Expectations are set in advance, therefore the aggregate supply curve is upward sloping. As a consequence, monetary, fiscal, and wage policies affect output and inflation by moving aggregate demand. The reduced form equations are:

$$\begin{aligned} y &= g - \tilde{r} - \lambda w - \eta \\ p &= g - \tilde{r} + \lambda w \end{aligned} \tag{21.5}$$

where $\tilde{r}$ is the union-wide interest rate chosen by the central bank, g is the fiscal policy stance of the national government, w is the national wage level, η an observable shock to revenue and $\lambda < 1$ is a structural parameter describing the effect of wage inflation on price inflation. The Appendix shows that the equations are compatible with a standard AS–AD model.

The assumption that fiscal and monetary policy are perfect substitutes follows Nordhaus (1994). The assumption is obviously a simplification and ignores relevant second-order effects such as the different effect that fiscal and monetary policy have on interest rates, exchange rates and sectoral prices. However, I have shown in Onorante (2003) that a more general setup would not change the qualitative conclusions.

The order of the moves has been chosen in a way that most reflects the actual setup of EMU. In a game between unions, fiscal and monetary authorities, the participants come to some understanding of the strategy of the others. As a consequence, at each step of the game the players will take as given the preceding decisions and form expectations (backward induct) on the following ones. I will then discard the simplest case, the Nash equilibrium, in which each authority takes as given the decisions of the others, because I consider it little more than a theoretical case.

Instead, I chose the following order of the moves: the shock η comes obviously first, the workers' unions determine (each of them playing Nash to the others) the national wage level w, then the national fiscal policy g is decided, finally the central bank observes the union-wide aggregates and chooses $\tilde{r}$ accordingly.

The choice of letting the central bank move last is quite common in the literature, and easy to justify.[3] First, in most monetary unions monetary policy makers have a coherent and understandable strategy that explicitly depends on macro variables, while fiscal policy tends to be more erratic and depend on elections, personalities and coalitions, but hardly on moral suasion by the central bank. Also, monetary policy is fast in reacting to external changes in the economy, including changes in the fiscal stance of member states, while fiscal policy is the result of a long process of negotiation by policy makers and hardly qualifies as a variable that the central bank can directly influence in the short run.

The choice of letting the unions play before the fiscal authority comes from similar considerations: first, there may be (and normally there are) many unions in a country, and their reactions are therefore more difficult to anticipate than those of the fiscal policy. Second, wages are normally determined for years and the contracting process is much more dispersed and slower than the one leading to fiscal policy.

3. SOLUTION OF THE MODEL

3.1 The Role of Expectations

The central bank reacts to the effect on union-wide variables. In case of an asymmetric shock in a country with weight $\phi \in (0,1)$ the aggregate variables react as:

$$\begin{aligned} \tilde{y} &= \phi(g - \lambda w - \eta) - r \\ \tilde{p} &= \phi(g + \lambda w) - \tilde{r} \end{aligned} \tag{21.6}$$

Solving the central bank's minimization problem gives the following expression for r:

$$\tilde{r} = \phi(g + \alpha_1 \lambda w - \alpha_2 \eta) \tag{21.7}$$

with $\alpha_1 = \dfrac{(1-\beta)}{1+\beta}$, $\alpha_2 = \dfrac{\beta}{1+\beta}$. The interest rate is decreased in the event of a negative output shock unless the central bank is a pure inflation targeter ($\beta = 0$) and it is always increased in response of a fiscal expansion. The response to an increase in the wage level is theoretically ambiguous, but positive for normal values of the parameters ($\beta < 1$), that is unless the central bank cares more about output than about prices. Finally, the reaction of the central bank is proportional to the size of the country in the monetary union.

The national government targets the national aggregates

$$\begin{aligned} y &= g - \tilde{r}^e - \lambda w - \eta \\ p &= g - \tilde{r}^e + \lambda w \end{aligned} \tag{21.8}$$

and the resulting fiscal policy is

$$g = \frac{1}{1+\gamma}\left(\tilde{r}^e + \lambda w + \eta\right) \tag{21.9}$$

The fiscal authority faces a cost in changing the fiscal stance. Hence, the multiplicator outside the parentheses is less than one, and decreasing in γ, the parameter that indicates the cost of discretionary fiscal policy moves. The fiscal policy stance is eased if a negative shock hits the economy, in order to compensate for the additional unemployment coming from an excessive wage inflation, or to smooth the domestic real effects of an expected monetary tightening.

Finally, wages are set by unions playing Nash with each other. The Nash equilibrium describes the solution under no cooperation: each union in the country plays as if the other unions had decided their wages already. As a consequence, the effects of a wage increase on macroeconomic variables perceived by the average union are given by $\lambda\psi$: the smaller the size ψ of the union, the less the effect of a wage increase on prices and unemployment will be taken into consideration.

$$\begin{aligned} y &= (g^e - \tilde{r}^e) - \lambda\psi w - \eta \\ p &= (g^e - \tilde{r}^e) + \lambda\psi w \end{aligned} \tag{21.10}$$

the resulting wage inflation is

$$w = \frac{(\omega - \omega\lambda\psi + \lambda\psi)(g^e - \tilde{r}^e) - \lambda\psi\eta}{(\lambda\psi - 1)^2\,\omega + (\lambda\psi)^2} \tag{21.11}$$

3.2 Results with Backward Induction

This section shows the solution of the model when expectations are formed by backward induction. The central bank moves last, after observing the moves of all the other players:

$$\tilde{r} = \phi(\tilde{g} + \alpha_1\lambda\tilde{w} - \alpha_2\tilde{\eta}) \tag{21.12}$$

For all possible values of ϕ (excluding 1) the federal central bank lowers interest rates in response to a negative shock and increases them in response to wage inflation and public deficit. The size of the intervention is proportional to ϕ.

The government observes η and w and backward inducts on the ECB. Substituting (21.12) into the expectations of (21.9) one obtains the expression for fiscal policy:

$$g = (1-\phi)\,\frac{(1+\phi\alpha_1)\lambda w + (1-\phi\alpha_2)\eta}{(1-\phi)^2+\gamma} \tag{21.13}$$

For all possible values of ϕ (excluding 1) the backward-inducting government eases the fiscal stance in response to both a negative shock and an increase in nominal wages. In the one country case ($\phi = 1$) the central bank was able to discipline the fiscal authority and to influence the expectations of the wage setters; in a monetary union part of this power is lost.

The unions backward induct on both the central bank and the government, therefore (21.12) and (21.13) are substituted into (21.11) in order to obtain the expression for the wages:

$$w = \frac{(1-2\phi+\phi\alpha_2\gamma+\phi^2)\omega B + (-\phi\alpha_2\gamma+\gamma)A}{((1-\phi)^2+\gamma+\lambda\psi(\gamma(\phi\alpha_1-1)-2(\phi-1)^2))\omega B - \lambda\psi\gamma(1+\phi\alpha_1)A}\,\eta \tag{21.14}$$

with

$$A = \frac{dy}{dw} = -\lambda\psi\gamma\,\frac{(\phi\alpha_1+1)}{(1-\phi)^2+\gamma}$$

$$B = \frac{d(w-p)}{dw} = 1+\lambda\psi\,\frac{\gamma(\phi\alpha_1-1)-2(\phi-1)^2}{(1-\phi)^2+\gamma}$$

Equations (21.12, 21.13 and 21.14) constitute the complete solution of the model with backward induction. In order to provide better insights into the economic implications of this model, the next section highlights some specific issues.

4. RESULTS AND POLICY IMPLICATIONS

4.1 Entering Monetary Union

Before entering monetary union, the country can be thought of as belonging to a monetary union with itself only. The outcomes are thus described by (21.14) and (21.13) under the assumption that $\phi = 1$.

$$\begin{aligned} w &= \frac{(1+\lambda\psi(\alpha_1-1))\alpha_2\omega + (\alpha_2-1)\lambda\psi(1+\alpha_1)}{(1+\lambda\psi(\alpha_1-1))^2\omega + (\lambda\psi)^2(1+\alpha_1)^2}\eta \\ g &= 0 \\ \tilde{p} &= (1-\alpha_1)\lambda w + \alpha_2\eta \end{aligned} \tag{21.15}$$

Comparing the previous equations with (21.13), one can immediately see that the structure of policy interaction differs fundamentally. Before entering the monetary union, the national central bank is always able to 'discipline' fiscal policy according to its own preferences (in this case, $g = 0$). An even stronger result holds: if the national central bank is a pure inflation targeter, both government and wage setters have to adapt their policies in such a way that the inflation target is attained. This result follows from equations (21.15), where $\beta = 0$ (pure inflation targeting) implies $\alpha_1 = 1$, $\alpha_2 = 0$. Substituting into the third equation, one obtains $p = 0$. Neither result holds after entrance in the monetary union, and both fiscal and monetary targets are missed after a shock.

One can conclude that, despite the agreement of the long-run targets between the different authorities, the statement of Dixit and Lambertini (2001, 2003) that 'fiscal discretion destroys monetary commitment' is confirmed even in the short-run perspective of this chapter. The incentives to the active use of fiscal policy increase in a monetary union, where every individual country is tempted to take advantage of the common monetary policy by running deficits with much of the costs in terms of higher interest rates affecting the other member countries. The new element is that the wage setters internalize the new fiscal behaviour in their expectations and tend to exploit the new framework in a similar way, further increasing the incentives to the use of discretional fiscal policy.

4.2 Size of the Country and Structural Differences

The complexity and non-linearity of the expressions for the variance of fiscal policy and prices make the close-form solution (21.12, 21.13, 21.14) cumbersome. Thus, I prefer a graphical representation. Figure 21.1 illustrates the size of the average fiscal expansion after a negative output

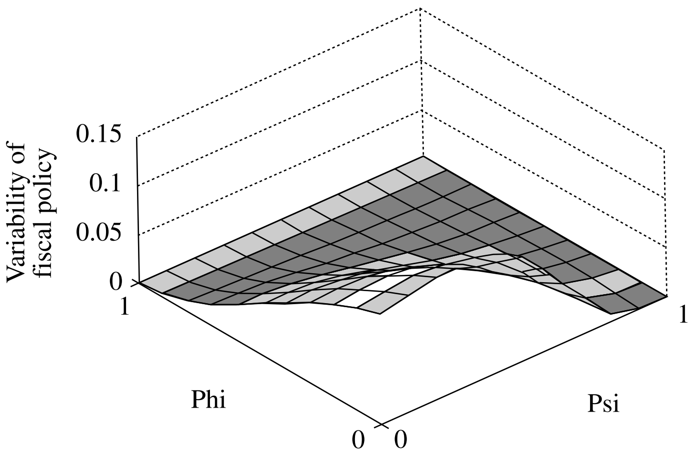

Figure 21.1 Variance of fiscal interventions after unit shock

shock for all values of ϕ and ψ. The other parameters have been chosen in order to illustrate the results, different values have been tried and they do not change the qualitative conclusions. The colour of the surface depends on the value of the data point, and two lighter bands have been imposed at $\phi = 1$ and $\phi = 0.1$ to highlight respectively the one-country case and the average-sized member of a monetary union.

The results for the one-country case (equation 21.15) are confirmed by the simulation: for every level of centralization of wage bargaining, the central bank is able to fully control the fiscal policy, and the variability is then zero. When the country enters the monetary union (lighter band at $\phi = 0.1$) this effect of discipline is maintained only if wage bargaining is centralized ($\psi = 1$) so that wage setters internalize the effect on prices of higher wages. The more wages are determined by decentralized bargaining, the more fiscal policy intervenes actively to offset the unemployment that arises as externality.

The results on price variability are consistent with the previous findings. In the one-country case, the variance of prices is extremely limited (Figure 21.2; see again the $\phi = 1$ lighter stripe). In a monetary union, prices are driven by two different forces: on the one hand, fiscal policy takes advantage of the reduced capacity of the central bank to respond, and this increases prices. On the other hand, a centralized wage setting is able to limit the inflation of wages (and thus prices) accordingly, while this is not true of decentralized bargaining. The interaction of these two forces produces the u-shaped stripe at $\phi = 0.1$. The variance is minimal when the two forces offset each other, maximal if wages are reduced (one union, $\psi = 1$)

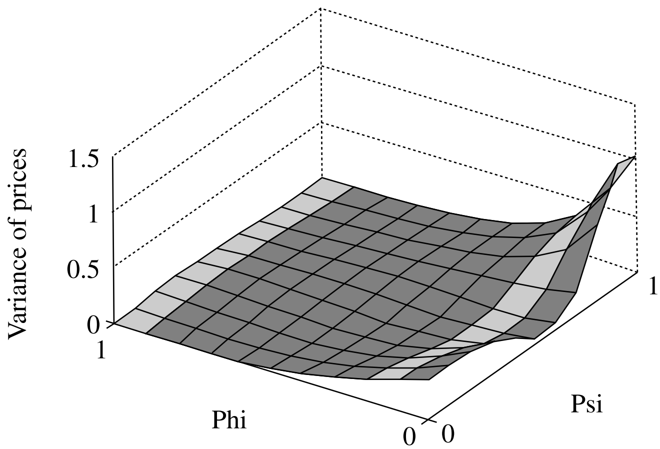

Figure 21.2 Variance of prices after unit shock

or if fiscal policy is expanded in order to preserve employment after a high wage increase ($\psi = 0$).

A general conclusion could be that the federal central bank of a monetary union has more problems in controlling inflation than a national central bank. The possibility of free riding by the national governments and the incapacity of the federal central bank to target individual national imbalances makes interventions less efficient and increases the variability of inflation.

4.3 The Effect of Fiscal Constraints

In Europe, the consideration that a monetary union may multiply the effects of any deficit bias led to the establishment of the fiscal criteria in the Stability and Growth Pact. The budgetary rules aim at tying the governments' hands and insulating central banks from possible pressures arising from undisciplined members of the union. The Pact states that the medium-term budgetary position must be of 'close to balance or in surplus'; automatic stabilizers would be allowed to float, but discretionary fiscal policy will not be possible. Hence, $g = 0$ in our model.

Are fiscal constraints really necessary in a monetary union? The answer provided by Figure 21.3 shows that the final effect on inflation of a shock can vary from the necessary flexibility (in case of a centralized labour market) to the very opposite, an increase in the final prices that further deteriorates the competitive position of the country affected.

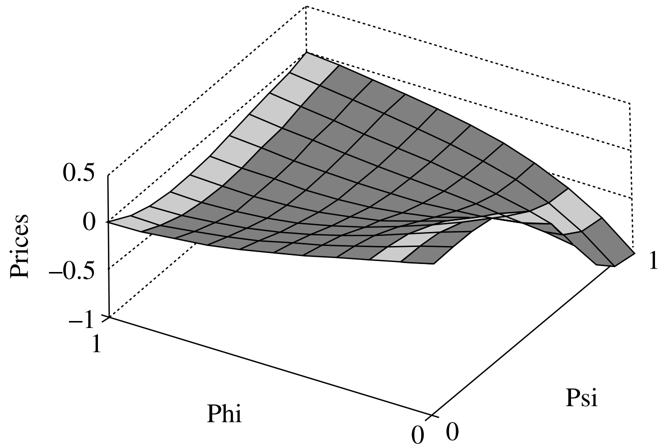

Figure 21.3 Effect on prices of a unitary shock

Figure 21.2 confirms that the inflation is more difficult to control in a monetary union than in the one-country case. The answer seems therefore decidedly positive.

Are fiscal criteria really helpful? Consider how fiscal policy affects the dynamics of wages (with backward induction on the central bank) and *ex-post* monetary policy: from (21.11) and (21.7) and imposing $g = 0$ one obtains for every $\psi, \phi < 1$ that

$$\begin{aligned} &\frac{dr}{dg} = \phi > 0 \\ &\frac{dw}{dg^e} = \frac{(\phi - 1)(-\omega + \omega\lambda\psi - \lambda\psi)}{(\omega - \omega\lambda\psi + \lambda\psi)\phi\alpha_1\lambda + \lambda^2\psi^2 + (\lambda\psi - 1)^2\omega} > 0 \end{aligned} \tag{21.16}$$

Equations (21.16) show the fundamental role played by the constraints to fiscal policy in allowing the central bank to control inflation. Removing the fiscal bias influences the *ex post* monetary policy and disciplines the *ex ante* wage dynamics; the effect is even larger if one considers that an unconstrained fiscal policy would respond positively to wage inflation. One should notice that even though the model has been built on symmetric loss functions for all the players, the fiscal constraints become binding only on the inflationary side, and they never impede budget consolidation when necessary. The result of the fiscal constraints is implicit coordination characterized by lower deficits, low interest rates and controlled inflation. Once again there is not an explicit welfare analysis in this chapter, but there is a strong consensus in the literature (for example Nordhaus, 1994) that an equilibrium of sustainable fiscal policies and loose monetary policy is better than a combination of loose fiscal and tight monetary policy.

5. CONCLUSIONS

The chapter develops a model of policy interactions in a monetary union, focusing on wage dynamics, fiscal and monetary activism and their consequences on inflation. The simple and 'optimistic'[4] model is capable of grasping and making explicit the strategic interactions of the different policy makers, and shows that lower deficits are easier to obtain before entrance in a monetary union. The following conclusions emerge:

- First and most important, fiscal activism is always increased by entry in monetary union. This conclusion does not depend on any switch in preferences, and should be considered as an inevitable fact for any country joining a monetary union.
- The capacity of a central bank to keep inflation close to targets is much smaller in a monetary union than in the one-country case. Furthermore, the model shows that the single monetary policy can lead to very different price dynamics in different countries of the union. A conservative central bank can reduce but not eliminate this problem.
- The former two points imply that a strategy of convergence in public finances prior to entry in a monetary union may be preferable both for the acceding country and the stability of the existing monetary union. Entry in a monetary union should not be 'forced' for political reasons, but should be a decision that the candidate countries take on the basis of economic fundamentals. For Europe, the Maastricht deficit criterion provides the appropriate incentives to achieve low levels of public deficit before entry in the EMU.
- The effects of the common monetary policy are also influenced by the structure of the national wage-setting process. The model shows that some convergence in the structure of labour markets could be useful. Mechanisms to eliminate the externalities in the wage setting process could also be beneficial.
- Fiscal constraints should remain after entry in the monetary union, as they are effective in re-establishing monetary dominance. They also ensure an *ex-post* policy mix of stability-oriented monetary policy, sustainable fiscal policies and moderate wage inflation.

- From the methodological point of view, the chapter takes into account the structural break of entry in EMU and provides an analytical and conceptual framework for assessing the potential causes for asymmetry in the monetary union.

The goal of this chapter was not to take into account all possible factors, but to disentangle a relevant mechanism of interaction among players which is typical of a monetary union. The conclusions cannot be considered as absolute statements, as they may not be valid in the context of a different modelization. There are, furthermore, several ways in which the chapter could be developed. First, the analytical framework is extremely simplified and could be enriched by adding systematic biases for the national governments and the unions, in order to obtain results that are valid for the steady state and not only for cyclical fluctuations. Alternatively, the asymmetry in the preferences of the governments in responding to a positive or a negative shock could be explicitly modelled. Other relevant phenomena, such as international spillovers, the exchange rate of the common currency, differences in tastes between the countries, may affect the results in various ways. These are interesting topics for future research.

6. APPENDIX 21A

Here I show the derivation of a simple AD–AS framework with some prices set in advance and rational expectations formed before the shocks are observed.

Demand and supply can be represented as:

$$\begin{aligned} y^d &= -p + \phi(g - r) + e^d \\ y^s &= (p - p^e) - \lambda w - e^s \end{aligned} \tag{21A.17}$$

where all the variables are expressed in difference from targets (m, g, w) or long-run levels (y, p). The demand and supply shocks are e^d and e^s, λ is a fixed parameter, which shows that wage inflation is reflected on inflation (with a parameter $\lambda < 1$), since wages are only one of the production factors in the economy.

The reduced form is obtained by solving for the equilibrium ($y^d = y^s$), fixing the expectations (p^e=0) and rescaling the equations:

$$\begin{aligned} y &= \phi(g - r) - \lambda w + (e_d - e_s) \\ p &= \phi(g - r) + \lambda w + (e_d + e_s) \end{aligned} \tag{21A.18}$$

After renaming the parameters, one obtains the final equations (21.5). For expositional purposes, the shock in the second equation is dropped in the chapter.

NOTES

* European University Institute and European Central Bank. I would like to thank Mike Artis for useful comments and discussion. Peter Backé and Ludger Schuknecht also gave me very useful suggestions. All mistakes are those of the author. The views expressed in this chapter are solely those of the author and do not necessarily reflect those of the European Central Bank.

1. The debt criterion is less problematic as in 2002 only Malta and Cyprus exceeded the 60 per cent reference value for the debt ratio.
2. On the revenue side, EU membership will entitle acceding countries to structural funds and other EU financing. However, this will also imply higher direct expenditure, notably because of the payment of contributions to the EU institutions and of national co-financing of EU investment projects. It can be expected that the net impact of EU membership in the initial years, together with the additional expenditure due to the NATO membership, would imply a worsening of the budget balances in the acceding countries between 0.5 and 2 per cent of GDP over the period from 2004 to 2006.
3. This is often referred to in the literature as fiscal dominance. Monetary dominance of a single central bank over many fiscal authorities in a monetary union is even less realistic than the Nash Equilibrium. In EMU, monetary dominance is ensured by the SGP.
4. The model is optimistic simply because the agents agree on the long-run targets and their preferences differ on the degree of stabilization only.

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22. International risk sharing in Europe: has anything changed?

Gabriel Moser, Wolfgang Pointner and Johann Scharler[1]

1. INTRODUCTION

It is well known that developed financial markets allow investors to efficiently pool idiosyncratic risk. Agents can protect themselves against stochastic fluctuations in their incomes through trading in assets with appropriate payoff structures. Open and integrated financial markets allow them to choose from a larger set of assets and to pool risks across borders.

However, the usual finding in the literature is that international risk sharing is rather limited.[2] Backus et al. (1992) demonstrate that cross-country consumption correlations are too low to be consistent with a model characterized by complete markets and perfect capital mobility. In addition, French and Poterba (1991) report a large home bias in equity holdings and consequently only a small degree of international diversification. Moreover, various authors have empirically tested for risk sharing using consumption data and find that the implications of complete market models are largely rejected.[3] In particular, a common result is that the cross-country correlations of output growth rates are higher than those of consumption growth rates, which indicates that the opportunities for international risk sharing are not fully exploited. Moreover, consumption is usually found to react to country specific shocks, which is inconsistent with perfect risk sharing.

However, the ongoing process of globalization and financial market integration has increased the amount of international financial transactions. Tesar and Werner (1998) present some evidence that the home bias, although still substantial, has somewhat declined over time. Thus, one might expect risk sharing to have improved over time.

Europe appears to be a particularly interesting case in this context, since the creation of the EU and EMU were to a great extent motivated by the idea to promote the integration of financial and goods markets. Blanchard and Giavazzi (2002) for instance report that the famous Feldstein and Horioka (1980) puzzle has basically disappeared in Europe over the last decades, suggesting that capital mobility has indeed increased.

The purpose of this chapter is to test whether the continuing process of European integration coincides with an increase in the extent of risk sharing among European countries. In particular, we search for breaks in risk sharing relationships. Our analysis is closely related to Obstfeld (1994), who explores risk sharing patterns among the G-7 countries and finds some evidence that risk sharing has increased after the end of the Bretton Woods era in 1972. We run regressions similar to those in Obstfeld (1994) with data from the EU-15 countries and perform the tests for parameter stability developed in Bai and Perron (1998b). Thus, the innovation of this chapter is to apply a formal test to detect breaks in risk sharing relationships rather than assuming stability or comparing sub-samples chosen on an ad hoc basis.

Of course, various authors have explored before to what extent consumption risks are pooled between European countries and regions.[4] A general conclusion of this literature is that risk sharing among EU countries is limited and that risk sharing opportunities are exploited to a smaller extent than in the US.

Our main result is that risk sharing does not appear to have improved among European countries. For a few countries we even find indications for declining risk sharing over time, which suggests that these countries have become less financially integrated with the rest of the EU.

The remainder of the chapter is organized as follows: section 2 briefly summarizes the history of capital account liberalizations in Europe. Section 3 describes our empirical strategy. Section 4 discusses our data and presents the results, and section 5 concludes the chapter.

2. MEASURES FOR FINANCIAL MARKET INTEGRATION IN EUROPE

We consider capital controls the main obstacle for financial integration and, consequently, risk sharing in Europe. Therefore, we will sketch the ups and downs in the liberalization of capital accounts from the beginning of the European Economic Community (EEC) to the creation of EMU.[5] Additional obstacles to financial integration in Europe are the remaining differences in national financial regulations and the segmentation of retail markets for financial services. Therefore, measures implemented to remove these barriers to a single financial market are described at the end of this section.

2.1 Capital Account Liberalization

Already in 1957, the freedom of capital movements was codified in the Treaty of Rome, the founding text of the EEC. The Treaty states that 'to the extent necessary to ensure the proper functioning of the Common Market, member states shall progressively abolish between themselves all restrictions on the movement of capital' (Art. 67.1). The commitment to liberalization was admittedly weak, as the operational agreements asked only to abstain from introducing new restrictions. The Treaty also contained safeguard clauses which allowed deflection from the path of liberalization. In the early 1960s two Directives were adopted that aimed at specifying the obligations from the Treaty for intra-Community flows. For the rest of the 1960s, the momentum for liberalization was lost, as countries like France and Italy feared exchange rate devaluations caused by speculation and therefore resisted further attempts to liberalize short-term capital movements.

When in May 1968 political disorders upset France and caused considerable capital movements abroad, France invoked the safeguard clause of the Treaty and introduced stringent capital controls. In general, the maintenance of exchange rates was one of the goals of economic policy and whenever measures of liberalization posed a threat to that goal, they were taken back. Such a threat arose in the early 1970s from the massive capital flows out of the USA and into European countries. The governments of EEC member countries tried to avoid the economic consequence of such flows, the appreciation of their currencies, for they feared a loss in competitiveness. The oil crisis of 1973 confronted most EEC members with the risk of large current account deficits, prompting them to impose stringent controls on capital outflows. The accession of Denmark, Ireland and the UK can be seen as a further drawback for the liberalization of capital accounts in the EEC, as these countries not only had not taken part in the liberalization process of the 1960s, but had their own traditions of restraining capital movements. The lost momentum for liberalization was also reflected in the Commission's attitude towards capital controls. Being a strong advocate of liberalization during the 1960s, the Commission now called for measures to control undesirable capital flows. This changed position led to the codification of derogations from the First Directive.

The effectiveness of capital controls was undermined by the lack of legal enforceability and new financial instruments. Also the growing influence of cross-border operating market participants exacerbated the maintenance of capital controls in all EEC member states. In 1979 the UK under its newly-elected conservative government implemented a rapid liberalization of capital movements. In the same year the European Monetary System

(EMS) was founded. Aiming at the enhancement of European integration by creating monetary stability, the EMS neglected capital liberalization at the beginning. In the event of downward pressure on a member's currency, countries with stable exchange rates should support them by intervening. Not later than 1982, Germany and the Netherlands began to question that mechanism and proposed capital account liberalization as a solution.

The reluctance to give up controls stemmed partly from institutional reasons: maintenance of capital controls required a large bureaucratic apparatus; once abandoned the controls might not be reimposed easily. But then France joined the liberalization movement as it found the very strict measures imposed in 1983 to be relatively ineffective.

Also, by the mid-1980s the Commission re-assumed a pro-liberalization attitude and paved the way for the Single European Act of 1987. Equally emphasizing the freedom of capital movements and that of goods and services, the single European Act led to the adoption of the Directive of 1988, which aimed at the establishment of a fully liberalized financial market until 1990. The Directive contained concessions in the form of longer transitional periods for member states which were not ready to give up controls in the near future, especially the newly acceded Mediterranean countries. From 1988 on, EEC member states abandoned their controls successively, Greece being the last to do so in 1994 (see Table 22.1).

Table 22.1 Date of abolition of capital controls in EU countries

United Kingdom	1979	Luxembourg	1990
Germany	1981	Austria	1991
Netherlands	1986	Finland	1991
Denmark	1988	Spain	1992
France	1989	Portugal	1992
Sweden	1989	Ireland	1993
Italy	1990	Greece	1994
Belgium	1990		

Source: Bakker and Chapple (1998).

2.2 Regulations on Financial Services

Besides the capital account liberalization, other obstacles to financial integration were abolished during the period in consideration. Concerning financial services, the freedom of establishment was granted in 1973 by Council Directive 73/183. The first banking coordination Directive, established in 1977, aimed at the harmonization of rules and administrative provisions concerning the operations of credit institutions. But the impact of these Directives was limited due to the capital account restrictions still in place at that time. A breakthrough occurred after the Single European Act, when the second banking coordination Directive was implemented in 1993. The second Directive established the principle of a single licence allowing banks and other financial institutions to offer their services throughout the Community. It relies on three pillars, namely the further harmonization of regulations governing the financial sector, the principle of home-country control (that is the supervision of a financial institution operating in any member state by the supervising bodies of its country of origin) and the mutual recognition of regulations in the countries of origin of banks operating in other member states by the supervising bodies in those member states.

The rules harmonized by the second Directive include regulations on the preparation of annual accounts, the definition of a solvency ratio, the monitoring of market risks, the prevention of money laundering or the limitation of large exposures. For Romero de Ávila (2003), the codification of some minimum standards together with the principle of mutual recognition 'opened up a process of competitive deregulation (what has often been called a "race to the bottom") in the range of banking activities permitted in EU countries', as any more stringent national regulation would mean a competitive disadvantage for the national financial institutions. In the aftermath of the implementation of the second Directive, there has been a substantial increase in cross-border branching.

To sum up, the easing of capital controls was already on the European agenda in the 1960s, in the aftermath of the Treaty of Rome. The collapse of Bretton Woods and the oil crises in the 1970s changed the political priorities and led to an increase in restrictions of capital mobility. The intensification of economic integration in Europe as well as the growing awareness of the controls' declining effectiveness within a changed financial landscape convinced the policy makers of the necessity to integrate financial markets, too. Beginning with the Single Act of 1986, capital controls were abolished in all member states of the EEC to pave the way for EMU. Approximately about the time capital controls had been abolished in the last member state, the establishment of a single market for financial services was begun, leading to an intensified competition among European banks and other financial institutions. But one has to keep in mind that other factors that are of clear importance to the integration of financial markets, like taxation, corporate laws or the judicial enforcement of investor rights which are subject to national standards still represent informal barriers to perfect financial integration within the EU.

3. EMPIRICAL STRATEGY AND ESTIMATION ISSUES

Empirical studies of risk sharing are usually based on two central implications of the theory:[6] (1) Under full risk sharing, the individual country consumption growth rates should move one for one with aggregate consumption growth and (2) consumption growth rates should not be correlated with idiosyncratic shocks, in particular income shocks. Obstfeld (1994) tests these theoretical implications by running time series regressions of individual consumption growth on world consumption growth and finds some evidence for partial risk sharing and a trend towards an increase in risk sharing for most of the G-7 countries after the Bretton Woods era. Following Obstfeld (1994), we estimate the following regression for each country i in our sample:

$$c_t^i = \alpha^i + \beta^i c_t^a + \gamma^i (y_t^i - y_t^a) + u_t^i, \tag{22.1}$$

where c_t^i and c_t^a denote consumption growth in country i and aggregate consumption growth, y_t^i and y_t^a denote individual and aggregate income growth. The error term u_t^i is assumed to follow a stationary process and will in general be a function of unobservable taste shocks and measurement errors. Under complete markets, agents are able to completely eliminate any idiosyncratic risk. Thus, individual consumption should move one for one with aggregate consumption and should not depend on idiosyncratic variables, as for instance idiosyncratic income. Thus, testing the joint hypothesis that $\beta^i = 1$ and $\gamma^i = 0$ constitutes a test of perfect risk sharing. Under incomplete markets, individual consumption will also depend on the realization of idiosyncratic shocks, as for instance income shocks. Hence, in this case the coefficient γ^i would be significantly different from zero. The situation, where country i cannot share any consumption risks corresponds to $\beta^i = 0$ and $\gamma^i > 0$. Note that in the specification in (22.1) the term $(y_t^i - y_t^a)$ is used as a proxy for idiosyncratic income. This is done for two reasons. First, subtracting aggregate income should eliminate aggregate movements in individual income and second, it helps to remove multicollinearity between the right-hand side variables.

Bayoumi and MacDonald (1995) propose an alternative test based on the assumption that a fraction λ_i of the agents in country i cannot take advantage of financial markets to smooth their consumption paths due to liquidity constraints and therefore base their consumption decisions on the current realization of income. Equation (22.1) is a special case of their model where the fraction of liquidity-constrained agents is equal across countries. Without this restriction, y_t^i and y_t^a would enter separately, leading to substantial multicollinearity. Thus, we proceed with the specification in (22.1).

A potential problem with equation (22.1) is that $(y_t^i - y_t^a)$ might be correlated with u_t^i. Such a correlation might arise for various reasons. As pointed out by Obstfeld (1994), unobservable preference shocks that lead to an increase in c_t^i might also lead to an increase in y_t^i. A similar point is made by Bayoumi and MacDonald (1995). They emphasize that as long as the stochastic process for income displays some persistence, a high realization of current income leads to the expectation of higher future income and thus higher current consumption according to the permanent income hypothesis. Such a correlation leads to an upward biased estimate of γ^i and at the same time a downward biased estimate of β^i, as long as $(y_t^i - y_t^a)$ and u_t^i have positive covariance.[7] One way to deal with this problem is to use instrumental variables as in Bayoumi and MacDonald (1995). However, the drawback is that it appears difficult to find good instruments. Therefore we estimate equation (22.1) for each country by OLS but we plan to pursue this issue in future work.

In section 2 it was demonstrated that the international capital flows were more restricted in the 1970s and early 1980s than in the 1960s. The late 1980s and 1990s were again characterized by more liberal regimes. Nevertheless the individual country experiences displayed considerable heterogeneity, in particular with respect to the dating of deregulation/reregulation. In principle it would be possible to test for the impact of changes in the capital account regime on risk sharing by applying the standard Chow test for parameter stability to equation (22.1). There are several disadvantages to such a strategy. First, the dating of liberalization measures is difficult in some cases since measures were implemented gradually. Second, if risk sharing relationships respond with a lead or a lag to changes in capital account restrictions, the Chow test for a break at a known date may have low power. Finally, while in theory changes in the degree of capital account restrictions should result in changes in the degree of risk sharing, many other factors might be important too.

One way to deal with the resulting specification problem is to choose a data-driven approach which does not impose a priori knowledge of the break dates. The procedure proposed in Bai and Perron (1998a, 1998b), hereafter referred to as BP, to identify multiple structural breaks at unknown dates appears to be well suited for this purpose.

Consider the following refined version of equation (22.1) which allows for m breaks and therefore for $m+1$ regimes

$$c_t^i = \alpha^i + \beta_j^i c_t^a + \gamma_j^i (y_t^i - y_t^a) + u_t^i \quad t = T_{j-1}+1, \ldots, T_j \tag{22.2}$$

for $j = 1, \ldots, m+1$ and $(T_0 = 0, T_{m+1} = T)$. u_t^i is a disturbance term which may display serial correlation and/or heteroscedasticity. The goal is to estimate the break dates $\{T_j\} = (T_1, \ldots, T_m)$ together with the coefficients of the equation, $(\alpha^i(\{T_j\}), \beta^i_j(\{T_j\}), \gamma^i_j(\{T_j\}))$. Note that this is a partial structural change model since the intercept α^i is not allowed to switch while the slope coefficients β^i_j and γ^i_j differ across regimes.

In order to assess whether risk sharing has changed over time, we analyse the evolution of the slope coefficients across different regimes. Recalling the discussion from section 3 that perfect risk sharing entails $\beta^i_j = 1$ and $\gamma^i_j = 0$, an improvement in risk sharing corresponds to β^i_j moving towards 1 while γ^i_j simultaneously moves to 0 as idiosyncratic consumption becomes more correlated with aggregate consumption and idiosyncratic income shocks matter less for idiosyncratic consumption. Conversely, a movement of β^i_j away from 1 while γ^i_j simultaneously moves away from 0 indicates a reduction in the degree of risk sharing. Note that this approach entails the possibility of parameter changes that do not allow for an interpretation in terms of more or less risk sharing among the countries under consideration. This is the case if β^i_j moves away from 1 and γ^i_j simultaneously moves towards 0 or alternatively, if β^i_j moves towards 1 and γ^i_j simultaneously moves away from 0.

With respect to the identification of the causes of changes in the degree of risk sharing it is important to note that changes in the degree of capital account liberalization and regulations on financial services are neither necessary nor sufficient to trigger changes in risk sharing. However, we believe that at least in the sphere of economic policy it is in these areas where the most important changes took place. It is therefore of interest whether observed changes in risk sharing are consistent with changes in the policy regime, at least with respect to the general trends across Europe.

4. DATA DESCRIPTION AND RESULTS

4.1 Data

We use annual data for the levels of population, real private consumption and real GDP (measured in national currency) for the current 15 EU member countries for the period from 1960 to 2002. The data are taken from the European Commission's AMECO database. The outliers in the German GDP and consumption series caused by reunification were removed by replacing the growth rate in 1991 with the mean growth rate of a symmetric ten-year window around 1991. The break in the population series occurred in 1990 and 1991. The growth rates in these two years were also replaced by the mean growth rate of a symmetric ten-year window. Aggregate consumption and aggregate GDP were computed as in Obstfeld (1994). Here for each country the per capita growth rates of all 14 other countries are added up with their respective population share as weight.

4.2 Results

The first step in the application of the procedure of BP consists of estimating the break dates, $\{\hat{T}_j\} = (\hat{T}_1, \ldots, \hat{T}_m)$ and the coefficients of the model $(\hat{\alpha}^i(\{\hat{T}_j\}), (\hat{\beta}^i_j(\{\hat{T}_j\}), \hat{\gamma}^i_j(\{\hat{T}_j\})$ for a given number of breaks m, a given minimum distance between two succeeding breaks and a trimming parameter, that is the number of observations at the beginning and the end of the sample.[8] These three parameters define the set of all possible partitions of the sample space. For each partition the model is estimated by OLS. The break dates are given by that partition of the sample space that has the smallest residual sum of squares. Since our sample consists of 42 observations we chose a maximum of two breaks, a minimum distance between succeeding breaks of 10 observations and a trimming of 0.25. This choice is mainly motivated by the need to preserve degrees of freedom. Thus, we allow for up to two breaks in the period between 1970 and 1992, a specification that is consistent with the discussion in section 2.

We follow BP's recommendation to determine the existence of at least one break via the *UDmax* and *VDmax* statistics and then to sequentially test for an additional break using the sup $F(l,l+1)$ where l is the number of breaks. The test statistics account for serial correlation and heteroskedasticity in the errors of equation (22.2) using the HAC-covariance matrix in Andrews (1991) and Andrews and Monahan (1992).

Table 22.2 shows the results. The tests indicate that there are five countries (Denmark, Finland, the Netherlands, Ireland, Sweden) in our sample for which parameter stability cannot be rejected. Note that for Denmark and Ireland the *Sup*(2,1) statistic is significant while the *UDmax* and *VDmax* are not. This implies that a model with two breaks is more appropriate than a model with one break and that a model with no breaks is better than either of the two. For seven countries (Austria, Germany, Spain, France, UK, Greece, Italy) two regimes (that is one break) are found and the remaining three countries (Belgium, Luxembourg, Portugal) are characterized by three regimes (that is two breaks).

Having identified the break dates, we proceed by estimating equation (22.2) and imposing the break dates from Table 22.2. The results in Table 22.3 indicate that for the five countries for which parameter stability cannot be rejected during the 42-year period perfect risk sharing can be rejected, since for all countries consumption behaviour is sensitive to idiosyncratic income shocks. However, autarky can also be rejected since aggregate consumption matters too.

Table 22.2 Break test statistics

	UDmax	VDmax	Sup F(2,1)	Sign. Breaks	Dates
Austria	26.3*	36.6**	6.3	1	70
Belgium	50.5**	70.4**	36.9**	2	70, 82
Germany	11.4**	11.4**	5.9	1	72
Denmark	4.5	5.8	11.5**	0	–
Spain	10.2**	10.2*	1.5	1	76
Finland	4.2	5.3	1.0	0	–
France	22.5**	31.3**	0.4	1	78
UK	8.9	11.3*	8.3	1	77
Greece	11.1**	15.4**	0.1	1	79
Ireland	8.2	8.5	11.0*	0	–
Italy	65.9**	63.9**	7.4	1	78
Luxembourg	16.0**	22.3**	14.1**	2	74, 87
Netherlands	7.7	7.7	5.3	0	–
Portugal	36.5**	50.8**	39.4**	2	75, 85
Sweden	4.0	5.1	0.3	0	–

Notes:
The Sup F(2,1), UDmax and VDmax statistics allow for the possibility of serial correlation and heteroskedasticity. The HAC-covariance matrix is constructed following Andrews (1991) and Andrews and Monahan (1992).
* and ** denote rejection of the Null of parameter stability at the 10 per cent level and at the 5 per cent or better level.
Test statistics, critical values and break dates are calculated using the GAUSS code of BP.

Table 22.3 Countries with no breaks

	Netherlands	Sweden	Ireland	Finland	Denmark
$\beta(60,02)$	1.38	1.07	1.23	1.20	0.77
	(0.36)	(0.30)	(0.62)	(0.28)	(0.24)
$\gamma(60,02)$	0.91	0.55	0.66	0.86	1.19
	(0.32)	(0.20)	(0.26)	(0.18)	(0.30)
Adj.R^2	0.68	0.54	0.42	0.84	0.62
DW	1.38	1.80	2.18	1.83	1.79

Notes:
Parenthesis contain 2 * Newey-West HAC Standard Errors.
Numbers in parenthesis after β and γ denote start and end dates of regimes.
Numbers in the Adj.R^2 and DW rows denote the adjusted R^2 and the Durbin–Watson statistic.

Next, consider the countries characterized by one break in Table 22.4. For Germany, Spain, Austria and Great Britain, where the test detected parameter instability occurring in the 1970s the changes in parameters do not allow for a straightforward interpretation in terms of an increase or decrease in risk sharing after the break. For France, Greece and Italy, which display a break at the end of the 1970s, changes in parameters indicate that the degree of risk sharing was lower after the break.

The countries which display two breaks in equation (22.2) are somewhat similar with respect to the dating of the breaks but heterogeneous with respect to changes in coefficients, as can be verified by inspection of Table 22.5. In Belgium, the breaks occur in 1970 and 1982. For neither

Table 22.4 Countries with one break

Germany		France		Spain		Greece	
β(60,72)	1.02	β(60,78)	1.00	β(60,76)	1.31	β(60,79)	0.96
	(0.30)		(0.14)		(0.30)		(0.42)
β(73,02)	0.61	β(79,02)	0.66	β(77,02)	1.13	β(80,02)	0.47
	(0.40)		(0.18)		(0.26)		(0.72)
γ(60,72)	0.98	γ(60,78)	0.36	γ(60,76)	0.80	γ(60,79)	0.30
	(0.24)		(0.34)		(0.24)		(0.20)
γ(73,02)	0.90	γ(79,02)	0.77	γ(77,02)	1.04	γ(79,02)	0.35
	(0.16)		(0.36)		(0.20)		(0.16)
Adj.R^2	0.74		0.83		0.91		0.60
DW	1.87		2.17		2.35		1.80
Austria		**Italy**		**UK**			
β(60,70)	0.68	β(60,78)	0.84	β(60,77)	0.17		
	(0.18)		(0.34)		(0.44)		
β(71,02)	0.75	β(79,02)	0.48	β(78,02)	0.56		
	(0.30)		(0.28)		(0.62)		
γ(60,70)	−0.03	γ(60,78)	0.67	γ(60,77)	0.69		
	(0.20)		(0.20)		(0.42)		
γ(71,02)	0.99	γ(79,02)	1.34	γ(78,02)	1.02		
	(0.30)		(0.36)		(0.46)		
Adj.R^2	0.70		0.60		0.46		
DW	1.89		1.56		1.02		

Notes:
Parenthesis contain 2 * Newey-West HAC Standard Errors.
Numbers in parenthesis after β and γ denote start and end dates of regimes.
Adj.R^2 and DW denote the adjusted R^2 and the Durbin–Watson statistic.

Table 22.5 Countries with two breaks

Belgium		Luxembourg		Portugal	
β(60,70)	0.68	β(60,74)	0.79	β(60,75)	0.66
	(0.28)		(0.34)		(0.42)
β(71,82)	1.29	β(75,87)	0.86	β(76,85)	−1.09
	(0.18)		(0.46)		(0.50)
β(83,02)	0.72	β(88,02)	0.45	β(86,02)	0.38
	(0.20)		(0.58)		(0.60)
γ(60,70)	0.11	γ(60,74)	0.56	γ(60,75)	0.53
	(0.50)		(0.18)		(0.16)
γ(71,82)	0.20	γ(75,87)	−0.27	γ(76,85)	0.76
	(0.24)		(0.22)		(0.26)
γ(83,02)	0.67	γ(88,02)	0.42	γ(86,02)	0.62
	(0.56)		(0.30)		(0.28)
Adj.R^2	0.68		0.43		0.53
DW	2.00		2.24		2.29

Notes:
Parenthesis contain 2 * Newey-West HAC Standard Errors.
Numbers in parenthesis after β and γ denote start and end dates of regimes.
Numbers in the Adj.R^2 and DW rows denote the adjusted R^2 and the Durbin–Watson statistic.

change is it possible to draw conclusions for a change in the degree of risk sharing. For Luxembourg, after 1974 risk sharing appears to have improved, while after the second break in 1987 risk sharing worsened. In Portugal, where the breaks occur in 1975 and 1985, the changes in parameters imply that the degree of risk sharing deteriorated after 1975. However, after 1985 it improved again compared to the previous sub-sample.

At this point, a summary of the results for all 15 countries in the light of the discussion in section 2 is in order. First, we find that for a number of countries there was no change in the degree of risk sharing during the period under consideration. This suggests that the numerous policy initiatives in the field of capital account deregulation were not sufficient to produce a material impact on the degree of risk sharing.

Second, we find a considerable number of countries where the change in the degree of correlation in national consumption with aggregate consumption and the change in the degree of responsiveness to idiosyncratic income shocks does not allow for a clear interpretation in terms of a change in the degree of risk sharing. These examples therefore suggest that the relationship of idiosyncratic consumption with aggregate consumption and idiosyncratic income shocks is at least not only driven by risk sharing considerations.

Third, taking together the evidence from those countries and time periods where changes in the coefficients β_j^i and γ_j^i allow for an interpretation in terms of risk sharing we find that in four countries (Italy, France, Greece, Portugal) the degree of risk sharing deteriorated after the 1970s, which is broadly consistent with an adverse influence of the reregulation of capital accounts in these countries after the Bretton Woods regime. However, contrary to our expectation, with the exception of Portugal the degree of risk sharing in Europe did not recover in the 1980s and 1990s. In fact, Portugal after 1985 is the only example where intra-European risk sharing has improved as measured by changes in β_j^i and γ_j^i.

It should be noted that our results may be influenced by the presence of a time-varying bias in the estimates of β_j^i and γ_j^i. Obstfeld (1994) shows that if there is a positive correlation between idiosyncratic income shocks and the residuals in equation (22.2) then the estimate of γ_j^i will be biased upwards. If there is also a positive correlation between idiosyncratic income shocks and aggregate consumption, β_j^i will be biased downwards. It is conceivable that these correlations change in such a way that an underlying improvement in risk sharing is not reflected in our parameter estimates. The time-varying bias problem can potentially also explain those examples in our sample where the parameters change in such a way that an interpretation in terms of changes in the extent of risk sharing is not possible. An instrumental variable estimator could resolve the uncertainty over our results caused by this problem. However, as noted above, it is difficult to find suitable instruments for idiosyncratic income shocks.

5. SUMMARY AND CONCLUSION

This chapter has dealt with the issue of whether risk sharing among European countries has improved along with the integration of the European economies. In some sense this is equivalent to asking the question of how integrated the financial markets in Europe really are. Our results indicate that risk sharing does not appear to have improved over the last decades.

Our analysis does not allow us to draw conclusions about what exactly causes the rejection of risk sharing and the lack of improvements. However, we can conclude that the increase in capital mobility, and more generally the tighter links between the economies in the EU, have not been enough to lead to a more efficient allocation of consumption risk and thereby increased economic welfare.

Alternatively, it can be argued that legal barriers are only one friction that prevents the integration of international financial markets. Indirect barriers such as differences in institutional aspects including investor protection and accounting standards, which are reflected in transaction and information costs, might be even more important than capital account restrictions. Thus, another interpretation of our results is that despite the recent decline of barriers to capital mobility, these indirect barriers to international asset trade remain in effect.

Our results may have far-reaching implications for EMU, since how to deal with asymmetric shocks is an important question for a monetary union. It is usually found that macroeconomic shocks are less synchronized among European countries than among US states. However, as long as international financial markets provide insurance against regional shocks, these asymmetries may not be problematic.

Nevertheless, one might argue that the introduction of the single currency occurred only at the end of our sample and that it is therefore not adequately reflected in our analysis. It might be the case that the single currency has a profound impact on international trade in goods and assets which is not present in our sample.[9] Similarly, Mélitz and Zumer (1999) have argued that the single currency will promote risk sharing among EMU countries. Moreover, the effects of recent policy initiatives, as for instance the Financial Services Action Plan of the European Commission, might result in more risk sharing in the future.

Nevertheless, without having identified the sources of the apparent lack of an improvement in risk sharing, the effects of EMU as well as of other recent policy initiatives on intra-European risk sharing are hard to judge. Thus, a detailed analysis of potential explanations for the limited extent of risk sharing appears to be an interesting and important topic that warrants further research.

NOTES

1. We would like to thank the participants at the 'East–West Conference 2003' of the Oesterreichische Nationalbank in Vienna and seminar participants at the Oesterreichische Nationalbank for helpful comments and discussions.
2. For recent surveys see Obstfeld and Rogoff (2001) and Lewis (1999).
3. See for instance Obstfeld (1994), Canova and Ravn (1996), Lewis (1996).
4. See among others Mélitz and Zumer (1999), Sorensen and Yosha (1998), Bayoumi and MacDonald (1995) and Atkeson and Bayoumi (1993).
5. The main arguments for capital controls and their design are summarized by Mathieson and Rojas-Suarez (1994), Neeley (1999) and Bakker (1996).
6. See Obstfeld and Rogoff (1996) chapter 5 for a review of the theory.
7. See also the discussion in Obstfeld (1994).
8. The estimation of the break dates and the computation of the test statistics were performed by the GAUSS programme provided by BP.
9. Hartmann et al. (2003) report that bond and equity markets have integrated considerably since the creation of EMU.

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PART VIII

Economic and Monetary Union – a leading indicator for political union?

23. European integration and *finalité politique*

Johan Verhaeven[1]

The concept of political union is hard to pin down: does it mean a traditional state-based model of governance, with strong central institutions and a single external identity, or does it refer to a looser form of common policies and institutions, without necessarily conforming to the characteristics of a nation state? Do we define political union through institutions, policies, the political system? Through the ability to raise taxes and make budgetary transfers?

The EU remains, in the words of Jacques Delors, 'an unidentified political object'. If we define political union in terms of supranational or federal level institutions and integrated policies, the EU has evolved to show several of these features:

- a federal, directly-elected parliament – the European Parliament (although it shares legislative power with the Council);
- a federal executive – the European Commission (although the Commission is still far from being a 'government', and has to share executive power with member states);
- a legal order which gives European instruments primacy over national legislation, and a judicial authority resembling a constitutional court to enforce this – the European Court of Justice.

In terms of policies, the EU is a hybrid system: the Community (federal) method is applied in some cases, while other issues are dealt with intergovernmentally, although the historical trend has been towards communitarization (Commission initiative; increased use of co-decision; Qualified Majority Voting in Council) of policy areas (Single Act, Maastricht, Amsterdam, Nice, Justice and Home Affairs in the Constitutional Treaty).

In fiscal terms, the EU has few resources of its own, and has always been primarily dependent on national contributions, yet it has some ability to make fiscal transfers via the structural funds, however small the budget may be in relative terms.

At the same time, the EU can never be a political union in its purest form: nation states remain the key actors in the EU system. Though they may have transferred part of their powers, they are not about to vanish. The EU remains a union of peoples and states with national languages, cultures, traditions, which will not disappear.

The EU is also far from becoming a 'super-state': its budget remains minuscule (at around 1 per cent of EU GDP), its staff is tiny (equivalent to a medium-sized city authority) and the volume of legislation it produces remains broadly stable.

1. EU, EMU – HEADING FOR POLITICAL UNION?

The history of European integration has been one of step-by-step integration and almost constant constitutional evolution, with no pre-defined end goal or *finalité politique*. Instead the Treaties have included the ambition of 'ever closer union', suggesting deeper political integration as an end in itself, without explicitly stating the final political or constitutional destination.

Integration has mostly occurred in a functionalist manner:

- Successful pooling of sovereignty over coal and steel in the 1950s led the founding members to go further and establish an economic community and customs union in the 1960s ('spillover' phenomenon).
- The insufficiencies of the common market as it was then gave an impetus to the creation of a genuine single European market in the 1980s, by tackling and removing remaining obstacles to trade.
- The economic logic behind EMU, finally, was to maximize the benefits of the single market by completing it with a single currency.

There were, nevertheless, undeniable political motivations behind each of these developments as well. Commission President Jacques Delors made clear at the time of relaunching the EMU project in the 1980s that he saw the project as a political one. At the same time, his 1989 blueprint for EMU stated that 'even after attaining EMU, the Community would continue to consist of individual nations with differing . . . political characteristics. . . . For this reason it would not be possible simply to follow the example of existing federal states; it would be necessary to develop an innovative and unique approach'.[2]

Different political actors saw integration in different ways, for example, British Prime Minister Margaret Thatcher and Jacques Delors had contrasting views on the single market process. Thatcher saw it as a purely economic project and an end in itself whilst Delors considered it to be a big step forward for political integration and rather as a means to an end.

At the same time, some integration has occurred as a response to external factors. Globalization has been a key pressure accompanied by the growing salience of political issues, for example environmental policy has become one of the most important and undisputed areas of EU competence (albeit shared with member states and regional and local government) in a very short space of time, largely as a response to public concern for environmental issues and their growing weight on the political agenda. Moves to integration in foreign and defence policy have to some extent been a response to increased US unilateralism, particularly following the collapse of the former Yugoslavia and the resulting conflicts in the Balkan region.

2. DOES MONETARY UNION REQUIRE POLITICAL UNION?

Examples of monetary unions without political unions have existed in the past: Belgium-Luxembourg, UK–Ireland, Scandinavia and the Latin Monetary Union. All of these were temporary and often involved a leader–follower approach, for example, with the smaller country adopting or maintaining the currency of a larger neighbour. Nevertheless, several of these experiments worked successfully and did not require an equivalent political union to be established. Conversely, political unions have also existed without monetary unions: the USA or Italy are a case in point.

Historically, monetary unions between sovereign governments have only been sustainable in the long term where member countries maintain close political links with one another (not necessarily economic integration). There has also been a need to maintain a commitment to a common objective such as price or exchange-rate stability.

An own currency is of course highly symbolic and considered an expression of national 'sovereignty'. Thus the decision to give up one's currency is therefore indisputably a political one (without mentioning the economic aspects). Nevertheless, there is no specific commitment of euro members to join a potential political union.

3. HOW WILL OPERATIONAL EXPERIENCE WITH EMU INFLUENCE FUTURE DEVELOPMENTS?

EMU is a unique experiment for a number of reasons: all participants gave up their currencies and replaced them with an all-new common currency. The euro involves a complete monetary union (single currency, single federal central bank), but not full economic integration (the conduct of economic policies remains a national competence). Instruments for economic coordination are currently under discussion (debate over the Stability and Growth Pact, Eurogroup vs. Council, limited role of supranational institutions (the Commission and especially the European Parliament). Furthermore EMU fiscal policy remains under national control and the EU lacks the ability to make large-scale budgetary transfers.

The future integration of economic policies will depend on how EMU evolves in practice.

- Monetary unification is an evolutionary process, just as most steps in European integration have been.
- This means that it is also a policy learning process, whereby the EU will learn from its shortcomings and may consequently propose institutional and policy changes in the future.
- The EMU regime has already proved flexible and open to evolution: new provisions introduced in the Constitution, changes to the ECB's statutes, expansion of euro area membership.
- Finally, there is an ongoing discussion about stronger economic coordination and governance.

4. THE WAY FORWARD FOR EUROPEAN INTEGRATION: ENLARGEMENT AND ENHANCED COOPERATION

How to reconcile a Union of increasing size and diversity with further integration?

Past enlargements have not necessarily impeded integration efforts: Spain, Portugal, Finland and Austria were among the strongest supporters of the euro, while the UK was a key backer of the single market process. However, there are already examples of areas of integration where not all member states wished to join in: euro, Schengen, defence.

Pressure is likely to grow with the next enlargement, not just because of the large number of new member states (ten out of a total of 25 members after enlargement) but also their growing economic and cultural diversity (including former Communist bloc countries, small Mediterranean islands, and the future prospect of Turkey as the EU's first Muslim member).

An important way forward seems to be the inevitable growth of enhanced cooperation among groups of member states in specific policy areas.

It is already clear that some members intend to go ahead with closer integration in certain areas (for example in defence) where others will not. The EU needs to make sure that these processes take place within the EU structure and avoid the risk that they move outside.

NOTES

1. Head of Unit: Transition issues related to EMU, Directorate General Economic and Financial Affairs, European Commission. Views expressed in this chapter represent exclusively the position of the author and do not necessarily correspond to those of the European Commission.
2. Committee for the Study of Economic and Monetary Union (1989), 'Report on economic and monetary union in the European Community', European Council, p. 13.

24. The European Union and social policy

Gerda Falkner[1]

This brief statement will first outline the division of social policy competences between the European Union and its member states. I will then analyse the incremental development of EC/EU[2] social regulation and activities to highlight that there are indicators for a kind of 'political union' even far beyond 'economic and monetary union'.

1. THE DISTRIBUTION OF COMPETENCES BETWEEN THE EEC AND ITS MEMBER STATES

The founding fathers of European integration apparently intended social policy competences to basically stay a national affair.

The 1957 EEC Treaty did not provide for an outright Europeanization of social policies since too many delegations had opposed this. Nevertheless, the Treaty contained a small number of concessions for those delegations who argued for more political 'intervention' in the area. These were mainly the provisions on equal pay for both sexes (Art. 119 of the EEC Treaty), maintaining 'the existing equivalence between paid holiday schemes' (Art. 120 of the EEC Treaty), and the establishment of a 'European Social Fund' (Art. 123–128 of the EEC Treaty). Two of the three above-mentioned concessions (that is equal pay and the Social Fund) rose in importance during the process of European integration while the issue of equivalent paid holiday schemes was not taken any further. The other provisions of the original Treaty's Title III on 'social policy' included some solemn social policy provisions, yet without empowering the EEC to act.

Yet in other areas of EEC activity the Commission was empowered to submit proposals for binding EC legislation to the Council for deliberation. The Commission should only act in close contact with member states by conducting studies, delivering opinions, and arranging consultations both on problems arising at the national level and on those of concern to international organizations in the social area. In legal terms, Art. 118 of the

EEC Treaty therefore represented a confirmation of national (as opposed to European) responsibility for social policy.

The sole clause in the original EEC Treaty establishing Community competence for social policy regulation was actually not part of the social policy chapter. It was a reference in Part II (Foundations of the Community) with regard to the free movement of goods, labour, services, and capital. Articles 48 to 51 of the EEC Treaty provided for the establishment of the freedom of movement for workers, as part of the Treaty's market-making activities. This entailed the abolition of any discrimination based on the nationality of workers of the member states regarding employment, remuneration, and other conditions of work and employment (Art. 48 of the EEC Treaty). In order to 'adopt such measures in the field of social security as are necessary to provide freedom of movement for workers' (Art. 51 of the EEC Treaty), the Council was mandated to secure, for migrant workers and their dependants, the aggregation of all periods taken into account under the laws of the several EEC countries, for the purpose of acquiring and retaining the rights to benefits and of calculating the amount of benefits.

2. THE RE-INTERPRETATION AND EXTENSION OF THE TREATY PROVISIONS OVER TIME

The EU's capacity for action was incrementally increased, both in day-to-day politics, and in several Treaty reforms.

Although there were almost no explicit social policy competences in the original EEC Treaty, an extensive interpretation provided room for action, in practice. This was possible because, where necessary or functional for market integration, intervention in the social policy field was *implicitly* allowed in the 1957 Treaty, in the so-called subsidiary competence provisions. Laws in the member states, which 'directly affect the establishment or functioning of the common market', could be approximated by unanimous Council decision on a Commission proposal (Art. 100 of the EEC Treaty). Also, if 'action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures' (Art. 235 of the EEC Treaty). These provisions provided, from the 1970s onwards, a loophole for social policy harmonization at the EC level. The necessary unanimous Council votes, however, constituted high thresholds for joint action. Each government could veto social measures.

In 1987, the *Single European Act* came into force as the first major EEC Treaty revision, putting the Internal Market Programme solemnly on track. Like in the 1950s, an economic undertaking was at the heart of a fresh impetus for European integration. Again, social policy constituted a controversial issue: how much social state-building should go along with even more far-reaching market integration? In various so-called 'flanking' policy areas, notably environmental and research policy, EEC competence was formally extended (see Art. 130r-t and Art. 130f-q of the EEC Treaty). Not so with regard to social policy: the delegations were not willing to give the EEC a greater role in this field.

However, an important exception was made. Art. 118a of the EEC Treaty on minimum harmonization concerning health and safety of workers should in the future provide an escape route out of the unanimity requirement. It allowed, for the first time in European social policy, for directives[3] based on a qualified majority of the Council members only. The provisions adopted following this article were minimum regulations introducing a lower floor of standards only. Nevertheless, reluctant member states could under this provision be forced to align with the majority of the EU member states, even against their will. This was only agreeable to all delegations because occupational health and safety issues were closely connected to the Internal Market project. At the time neither the Thatcher government nor other governments expected this perceivedly 'technical' issue to significantly facilitate social policy integration, but in the end this provision was extensively used in the following decade. Three EU Treaty reforms of the 1990s have since introduced further changes of European social policy provisions.

The Inter-Governmental Conference preceding the *Maastricht Treaty* negotiated a reform of the social policy provisions under the EEC Treaty. However, under the requirement of unanimous approval by all 12 member states, the social provisions could not be significantly altered because of the strong opposition from Great Britain. At the end of most difficult negotiations, which even threatened the rest of the Inter-Governmental Conference's compromises, the UK was granted an opt-out from the social policy measures agreed by the rest of the member states. In the *Protocol on Social Policy* annexed to the EC Treaty,[4] the 11 (after 1995: 14, that is all except the UK) were authorized to have recourse to the institutions, procedures and mechanisms of the Treaty for the purposes of implementing their 'Agreement on Social Policy'. The innovative social policy provisions of the Social Agreement brought about an extension of the Community competence into a wide range of social policy problems. These include working conditions, the information and consultation of workers, equality between men and women with regard to labour market opportunities and treatment at work (as opposed to only equal pay before), and the integration of persons excluded from the labour market (Art. 2.1 of the Social Agreement).[5] Additionally, qualified majority voting was extended to many more issue areas than before, including for example the information and consultation of workers.[6]

In the 1996–97 Inter-Governmental Conference preceding the *Amsterdam Treaty*, social policy reform was not a major issue (except for, if one chooses a wide notion of social policy, employment promotion). Because of the fierce reluctance against social policy reforms of the UK Tory government (in office until May 1997), the Inter-Governmental Conference indeed decided to postpone the topic until the very end. Under the new Labour government, the UK's opt-out from the Social Agreement was ended in the Amsterdam Treaty. Apart from this, the only significant innovation (compared with the provisions of the Social Agreement) was the new employment policy chapter in the EC Treaty (now Art. 125–130). While excluding any harmonization of domestic laws, it provides for the coordination of national employment policies on the basis of annual guidelines and national follow-up reports. Furthermore, a new Art. 13 of the EC Treaty on Community action against discrimination on grounds of sex, race, ethnic origin, belief, disability, age, and sexual orientation was inserted.

Finally, the *Nice Treaty* of 2001 did not bring much innovation in the social provisions chapter either. In some fields, the Council may in the future unanimously decide to render the co-decision procedure (with qualified majority voting) applicable. This concerns worker protection where employment contracts terminated, representation and collective defence of collective interests, and third-country nationals' interests (see Art. 137.2 of the EC Treaty). Furthermore, EC measures[7] can now be adopted on all social issues, not just concerning social exclusion and equal opportunities, as was already the case in the Amsterdam Treaty.

To sum up, important extension of EC Treaty bases in the social realm have occurred since 1957.

3. THE DEVELOPMENT AND THE FIELDS OF EC SOCIAL POLICY LEGISLATION

On the level of social legislation, a number of important sub-fields can be distinguished, most importantly: labour law, health and safety at the workplace, and gender equality.

During the early years of European integration, social policy consisted almost exclusively of securing the free movement of workers and was rather non-controversial. In a number of EC regulations,[8] the national social security systems were coordinated with a view to securing the status of internationally mobile workers and their families. During the late 1960s, however, the political climate slowly became more favourable to a wider range of European social policy measures. Several of the legislative measures proposed under a 'Social Action Programme' (1974) were adopted by the Council up to the early 1980s, and further Social Action Programmes followed.

There was a rather steady growth in social policy directives from 1974 on. By the end of 2000, 51 social directives, 13 reforms of existing directives, and 7 geographical extensions of directives (to the former GDR, to new member states, and to the UK after Amsterdam) had been adopted. The total number of decisions on social directives was 71. These directives typically fall within what is at the national level called labour law, not within social security. The main fields are three: health and safety, other working conditions, and equality between women and men at the workplace (data: Falkner et al., 2004).

Concerning *gender equality*, it should be mentioned that the European Court of Justice became a major actor since it interpreted Art. 119 of the 1957 EEC Treaty on domestic measures to ensure equal pay in an extensive manner, hence opening the way for EC directives on that end on the basis of the subsidiary competence provisions (see above). Matters such as equal pay for work of equal value, the equal treatment of men and women regarding working conditions and social security, and even the issue of burden of proof in discrimination law suits were finally regulated at the EU level (Hoskyns, 1996; Mazey, 1998).

In the field of other *working conditions*, a number of directives were adopted during the late 1970s, for example on protection of workers in case of collective redundancy, transfer of undertaking, or employer insolvency. Many more directives followed during the 1990s, including those on worker information on conditions of work contract, on the equal treatment of atypical workers, and on parental leave.

With regard to *worker health and safety*, EC action was based on a number of specific action programmes. Directives include the protection of workers exposed to emissions and loads, as well as protection against risks of chemical, physical and biological agents at work (for example lead or asbestos).

4. THE EUROPEAN SOCIAL FUND

It has long been common knowledge that Community interventions are largely regulatory, notably in the social field. However, the relative importance of regulation has in the meantime declined since both funding and 'soft' forms of governance (employment policy) have increased.

Already the original EEC Treaty of 1957 provided for a 'European Social Fund' (ESF). Its goal was to make the employment of workers easier, to increase their geographical and occupational mobility within the Community, and to facilitate their adaptation to industrial changes and to changes in production systems, in particular through vocational training and retraining (Art. 123 of the EEC Treaty, now Art. 146 of the EC Treaty). Initially, the ESF reimbursed the member states for parts of their expenses for such measures. It did not have any controlling capacities with this quasi-automatic transfer of money to the member states' employment services. Against the intentions to rectify specific Italian problems after the opening up of market borders, this led to the fact that the most well-funded and well-organized domestic labour market administrations received the most refunds (for example, Germany).

This prompted the first major reform of the ESF in 1971. A definition of target groups was agreed upon, in order to co-fund only domestic projects considered appropriate according to EC-level policy considerations. After a number of further reforms, the ESF now co-finances, under the title of development of human resources (goal 3 of the EC structural funds policy 2000 to 2006), mainly projects for youngsters seeking employment, for long-term unemployed, for disadvantaged groups, and for promoting gender equality on the labour market. In sum, one may therefore conclude that the EU's social dimension is nowadays less exclusively regulatory than often expected.

The Social Fund's share of total EC spending was 1.1 per cent by 1970; 4.4 per cent by 1980; 7.3 per cent by 1990; and 8.6 per cent by 2000. The share of all Structural Funds has grown even higher: from 2.8 per cent in 1970 to 35.7 per cent in 2000 (that is EUR 31 957 million). This increase cannot hide, however, that the Guarantee Section of the Agricultural Fund is still much larger, that is EUR 41 493.9 million (data from European Communities, 2000).

5. CONCLUSIONS

European social policy has been considerably extended and differentiated over time. Treaty bases were reformed several times to include more competences for the EU. The European Social Fund has multiplied its means as well as extended its practical impact on national employment promotion projects. The number of social directives has increased over time, with the 1990s being by far the most active decade. It should also be mentioned that the EU's Court of Justice in Luxembourg has been influential on several social policy issues and has at times significantly increased the practical impact of EU social law. A full evaluation of the success of EU social law is undermined by the lack of knowledge about the practical effect in the member states.[9]

The forthcoming further enlargements of the EU are certainly a main reason why the new method of 'softly' influencing national social policy has been developed at all. Although agreement on legislation has been impossible in a number of social fields among the existing EU members, it seems fair to conclude that in the future, agreement on binding standards (in particular, costly ones) will certainly be even more difficult.

The implementation of adopted laws might get even more difficult, as well. It should be mentioned that compliance has by no means been good, even in the EU-15. Data from the first in-depth research project on the transposition of six labour law Directives in all 15 EU member states show that out of 90 cases only nine were handled in a timely manner.[10]

NOTES

1. Institute for Advanced Studies (IHS), Vienna.
2. Before the Maastricht Treaty of 1992, the 'European Community' (EC) was the 'European Economic Community' (EEC), and the overall name of 'European Union' (EU) for all three communities did not yet exist. Note that the European Coal and Steel Community and the European Atomic Energy Community only adopted a few sectoral social provisions for worker and citizen protection, however without cross-sectoral significance. Therefore, the 'EC social policy' (as studied in this contribution) basically conforms with the 'EU social policy'.
3. A directive is an EU-level legal act that sets goals to be specified in national transposition legislation (see Art. 249 of the EC Treaty).
4. At Maastricht it was decided to change the name of the 'European Economic Community' to 'European Community'. The EEC Treaty (whose contents were at the same time reformed) has since been called the EC Treaty (Treaty establishing the European Community).
5. Some issues were, however, explicitly excluded from the scope of minimum harmonization under the Maastricht social policy provisions: pay, the right of association, the right to strike, and the right to impose lock-outs (Art. 2.6.).
6. Unanimous decisions were restricted to social security and social protection of workers; protection of workers where their employment contract is terminated; representation and collective defence of interests of workers and employers, including co-determination; conditions of employment for third-country nationals legally residing in Community territory; and financial contributions for promotion of employment and job creation (see Art. 3 of the Social Agreement).
7. 'The Council, … may adopt measures designed to encourage cooperation between Member States through initiatives aimed at improving knowledge, developing exchanges of information and best practices, promoting innovative approaches and evaluating experiences …' (Art. 137 of the EC Treaty).
8. A regulation is a legal instrument containing provisions that are directly binding in the member states so that no transposition into domestic law is needed (see Art. 249 of the EC Treaty).
9. A research group at the Max Planck Institute for the Study of Societies in Cologne analysed the implementation and significance of a number of social directives in

all 15 member states. For more information see http://www.mpi-fg-koeln.mpg.de/fo/multilevel_de.html#Proj5. For results see Falkner et al. (2005).

10. Actually, a tenth case had no misfit from the outset (our single case in this study, that is the Netherlands with the Part-Time Work Directive). For results see Falkner et al. (2005).

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25. Is EMU a leading indicator for political union? A discussion of five theses

Fritz Breuss[1]

Generally, economic and monetary union (EMU) is seen as the endpoint of economic integration. However, in the case of the European Union, EMU implies an asymmetric economic policy-making architecture with a centralized monetary policy regime but decentralized economic (primarily fiscal) policies that remain the responsibility of the member states (see Breuss, 2002a). This requires a complex process of policy coordination. As the recent practice indicates this architecture has been fragile even in the context of the EU-15; it is therefore not farfetched to forecast that it will become even more unstable and complex in an enlarged EU (see Breuss et al., 2003). To sketch the problems connected with enlargement and EMU, I will discuss five theses in the following.

1. IS THE EMU PROJECT AN EXAMPLE OF A NEW 'JEAN MONNET EFFECT'?

At the onset, EMU was apparently seen as a project with a so-called 'Jean-Monnet effect': instead of directly establishing a political union or even the United States of Europe, one hoped for its indirect enforcement through the euro. This, however, would imply that the constraints to coordinate economic policy broadly would induce an ever stronger centralization of economic policies in many areas. The short experience with EMU shows that apart from the centralized monetary policy, the economic policy areas have a long way to go towards a properly working European harmonization. Even the delineation of competences in the draft treaty establishing a Constitution for Europe suggested by the European Convention (18 July 2003) echoes just the present state of this architecture (see Breuss and Eller, 2003).

The major instrument of fiscal policy coordination, the Stability and Growth Pact (SGP) is more and more questioned because of the straitjacket character it has in times of recession. Ironically, even the architect of the SGP, Germany, is unable to fulfil its obligations in the present phase of weak economic performance. In the case of Germany and France, the ECOFIN council decided to suspend the 'excessive deficit procedure' on 25 November 2003. This step was interpreted by many observers – for example by *The Economist* – as the death of the SGP. At any rate, the SGP has failed its litmus test. We can start from the beginning to coordinate fiscal policy either with a reformed SGP or without such a device. Interestingly, the current strong increase of the euro against the US dollar indicates that there is no simple link between budgetary stability and the strength of a currency. Or to put it more precisely, the foreign exchange markets do not bother whether only one or two of the euro area countries temporarily run high budget deficits as long as the euro area as a whole is pretty stable.

2. EU ENLARGEMENT IN 2004 – MORE INTEGRATION OR DISINTEGRATION?

After the accession of ten new member states to the EU in May 2004, the EMU 'ins' will be in a gridlock – at least for some years to come – with the EMU 'outs'. This situation will in fact be worse than the status quo because the number of 'outs' (13; three 'old' EU members and all the newcomers) will outweigh the number of 'ins' (12). This extreme form of a 'flexible integration' is far from being a positive 'leading indicator for political union'. In contrast, the EU enlargement round of 2004 will thwart the EU's integration ambitions.

Not only will we have a divided Union as far as economic and monetary integration is concerned, integration *à la carte* will also go on in many other fields. One area where the EU member states will or cannot proceed in synch is the defence policy. Britain, France and Germany have agreed plans to reinforce the EU's military capabilities. A ground-breaking agreement on EU defence cooperation has been reached by the big three during the EU foreign ministers' meeting in Naples on 28–29 November 2003 and seems to pave the way for finalizing the Union's new constitution. The agreement holds out the prospect of the EU acquiring its own capability to plan and conduct military operations independently of NATO. The deal stems from proposals to include a mutual defence clause in the EU Treaty. The idea raised objections among neutral EU members (Ireland, Finland, Austria and Sweden), who want to limit defence issues to peacekeeping and civil emergency tasks. The mutual defence clause set to appear in the EU's constitution would recognize NATO as the foundation of collective defence for the member states. How many of the new member states can follow such ambitious proposals remains to be seen.

Other areas of flexible integration are the Schengen accord, where the new member states are not yet ready to follow. In many other areas – including the free movement of persons, agricultural policy, social policy, environmental protection policy – where transitional arrangements were negotiated in the accession treaty, the full adoption of the *acquis communautaire* will be delayed for years and hence may lead to a setback in the functioning of the single market.

3. THE EURO IN THE NEW MEMBER STATES – RAPID OR SLOW INTRODUCTION?

What solutions are conceivable to overcome the major split of the EU in the field of monetary integration? One way would be to start with an immediate 'euroization' (as is propagated by Gros 2000). That would imply that the newcomers would enter EMU simultaneously with gaining EU membership. The other way is to agree very narrow fluctuation bands to provide for a strong integration of the newcomers into ERM II. According to the official 'road map' of the European Commission, the Council and the ECB, option one is not possible. The 2004 EU enlargement will be a two-step integration. The newcomers first enter the single market, and may join EMU only later.

Only after having participated in ERM II for two years without devaluating its currency is a new country eligible to enter EMU (provided that it fulfils the usual Maastricht convergence criteria). The problem with ERM II is that – on the UK's request – participation was not made compulsory. That means that any newcomer to the EU not willing to enter EMU can take the same adverse position *vis-à-vis* the euro as the UK and Sweden currently do. This, however, would be bad news for the coherence of an integrated EU.

The other problem – touched upon and heavily criticized by Eichengreen (2003) – is the statement by Commissioner Pedro Solbes that the new EU members are expected to adhere to the narrow bands of ERM II, namely to ± 2¼ per cent bands *vis-à-vis* the euro in the transition period before entering EMU. This however could endanger stability and might lead to speculative attacks causing financial crises (for example, see Begg et al., 2003). At least the newcomers should be allowed to enter ERM II with broad bands (± 15 per cent) in order to avoid instability. At any rate, at least until 2007 we can expect to have a divided EU and not one with a common currency.

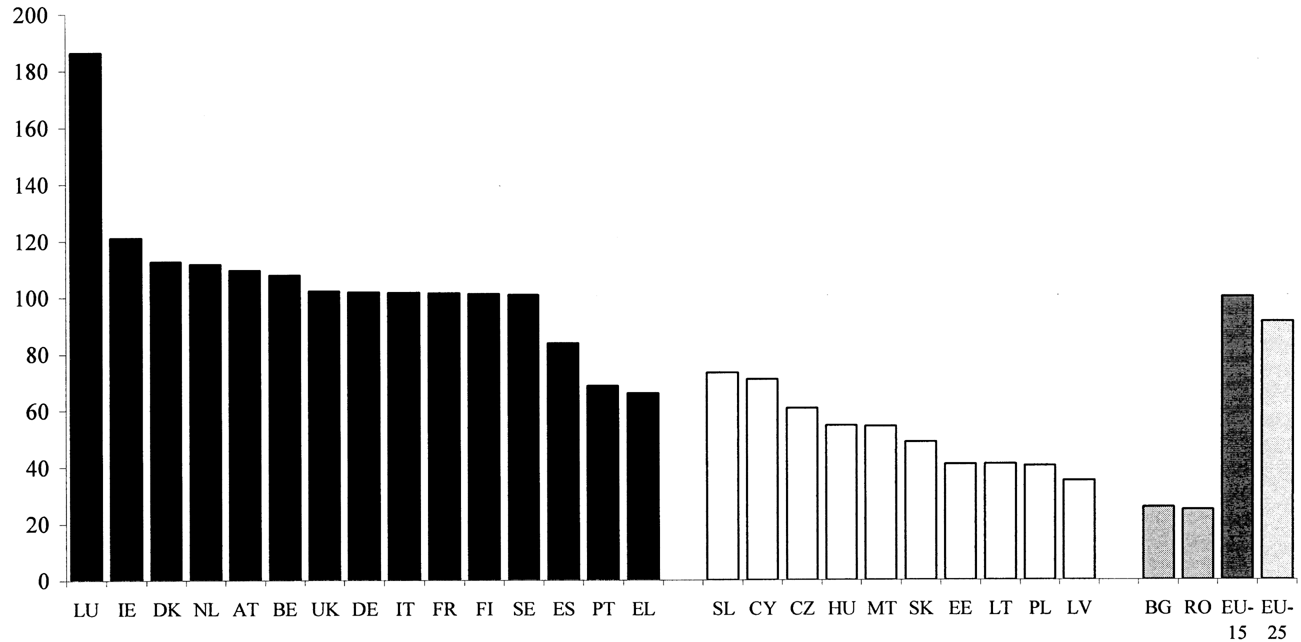
Whereas it would be good for the EU as a whole to have as many members as possible join EMU as fast as possible, it is an open question whether a speedy adoption of the euro would not choke the economies of the new member states due to detrimental effects of international competitiveness. So there is a dilemma for the enlarged EU in the coming years. EMU would have been a vehicle for faster political integration for the EU in its present dimension; in an EU with 25 or even more countries a political unification will – if desired at all by Europe's citizens – be delayed for decades.

4. BALASSA–SAMUELSON EFFECTS – AN OBSTACLE FOR JOINING THE EMU?

EU enlargement in 2004 is an integration step linking a bloc of 'rich' EU member states with a bloc of relatively 'poor' new member states (see Figure 25.1). Compared with the EU-15, the EU-25 will be larger by 23 per cent (in terms of area) or 20 per cent (in terms of population). With a population of 454 million the EU will in fact be the largest economy in the world (USA: 278 million, Japan: 127 million). However, the concomitant increase in economic potential (measured by absolute GDP) will range between just 5 per cent (at current exchange rates) and 9 per cent (at PPP). On average, the EU will become even poorer: measured in PPP, GDP per capita will be lower by 9 per cent.

Similar to developing countries, the transition economies in the East are characterized by a huge divergence between actual and PPP exchange rates. Measured in PPP, the GDP per capita of the ten acceding countries accounts for 45 per cent of that of the EU-15, but reaches only half this ratio when measured at actual exchange rates. Against this background, the CEECs' currencies tend to appreciate in the transformation and catching-up process due to the Balassa–Samuelson effect.

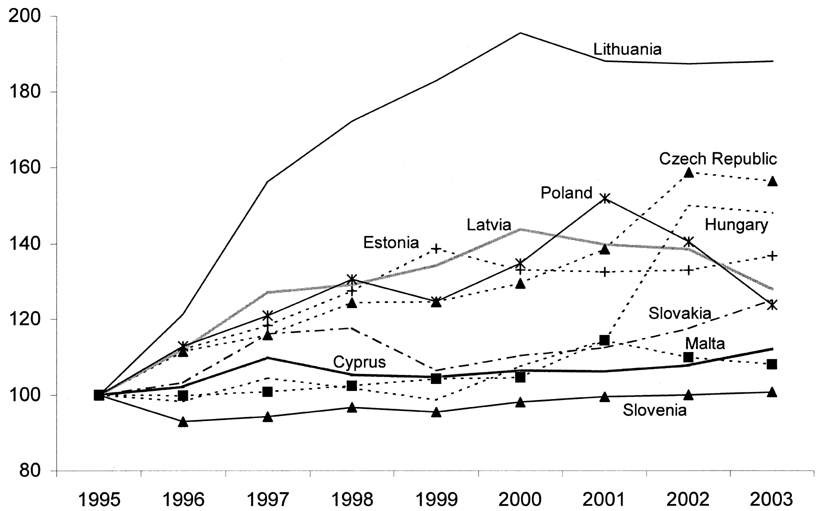
Weighing all arguments of the possible caveats and chances connected with the Balassa–Samuelson phenomenon one can conclude (see Breuss 2003) that real exchange rate appreciation reflecting productivity gains in the tradable sector (due to the Balassa–Samuelson effect) is an equilibrium phenomenon and does not erode competitiveness. The important policy conclusion then is that in transition economies, such appreciation is part of the process of becoming fully-fledged market economies – and as such does not require a policy response. Furthermore, the official EU doctrine for accepting the new member states in EMU does not explicitly consider the Balassa–Samuelson effect but mainly looks at the fulfilment of the Maastricht convergence criteria, which are primarily price, interest rate and budgetary criteria, and at the behaviour of the nominal (depreciation is actually only seen as a hindrance), not the real exchange rate. Real appreciation is the equilibrium outcome of a successful transformation. In fact,



Source: AMECO database, European Commission.

Figure 25.1 GDP per capita in the EU-25, 2002 (EU-15 = 100) transformation will be completed when the real appreciation stops. One must take into consideration that the economic catch-up distance the new entrants need to overcome is much larger than the gap facing any previous entrants to the EU. In the case of the largest acceding country, Poland, the scope for catching up is about twice as high as that facing Greece or Portugal when they joined. When the acceding countries enter the EU's single market in 2004, they will have moved ahead, and even further ahead when they may enter the EMU in 2007–08. Previous accessions allowed for a larger menu of options. ERM membership was not required, EMU was not yet established. Even if the transition economies elect to move slowly, the fact that they must first join ERM II, and then EMU, is an important constraint which affects both the behaviour of forward-looking financial markets and the authorities. Furthermore, at the time of previous accessions capital controls were not actively disallowed. Greece, Portugal and Spain all made extensive use of this possibility. A sizeable real appreciation will characterize the transition countries for a long time to come, and most likely for a long time after they have joined EMU. Halpern and Wyplosz (2001, p. 15), based on their calculations 'guesstimate' that the Balassa–Samuelson effects were responsible for an average annual rate of real appreciation of around 3 per cent. During the two-year ERM membership period which is required prior to EMU entry there will be a trade-off between exchange rate stability and the inflation target. Keeping the nominal exchange rate stable, as required for accession to EMU, could lead to an inflation rate 3 percentage points above that in the euro area. Preventing such an inflation rate, which is also required for entry into EMU (Maastricht convergence criterion), will require the nominal exchange rate to appreciate each year by 3 percentage points. Over two years, this would represent about half of the ERM II bandwidth. The tendency for real appreciation could be reinforced by capital inflows. In fact, the inflows will affect the real exchange rate both via the nominal rate and via the Balassa–Samuelson effect as FDI has been found to significantly raise productivity growth more in industry, and less in the services sector. Such an outcome could absorb the remaining half of the bandwidth for ERM II. Halpern and Wyplosz (2001, p. 15), and similarly Begg et al. (2003) conclude pessimistically: 'The risk of currency crises in the acceding countries is therefore far from negligible'.

Although the tendency to real appreciation (with the exception of Slovenia, which targets a constant real exchange rate of the tolar) still continues (see Figure 25.2), recently there has been a trend to more price stability (see Figure 25.3). This leads to the optimistic conclusion that it is possible also for the CEECs to meet the Maastricht price stability criterion in the near future. However, one cannot deny that there is a price to pay in terms of competitiveness. Among the most pressing problems in the



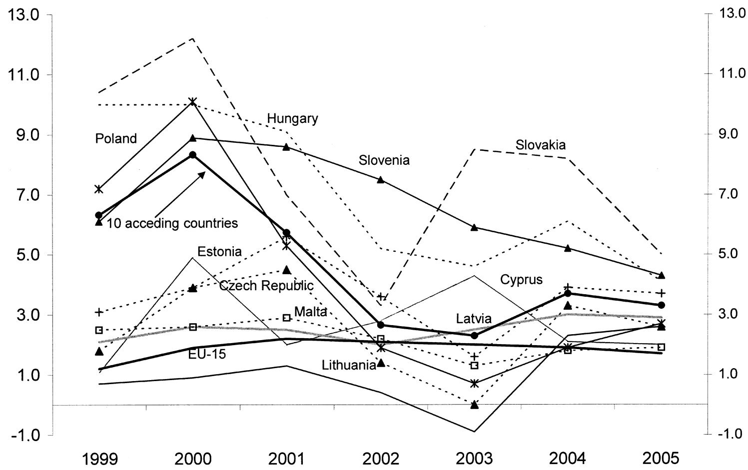
Source: European Commission, Economic and Financial Affairs, Price and Cost Competitiveness, 3rd quarter of 2003, Brussels.

Figure 25.2 Real effective exchange rates (REER) in the acceding countries (unit labour costs relative to the EU in a common currency), 1995–2003

acceding countries are their huge current account deficits. Whether they are sustainable depends on the capital inflows, which in the recent past consisted primarily of FDI inflows. On the one hand FDI inflows are necessary to finance the current account deficits and on the other they also help to build up productive capacities in the CEECs. Whether FDI inflows always enhance economic growth is an open question. Mencinger (2003) even finds a strong negative relationship between FDI inflows and GDP growth in eight CEECs. Anyhow, as Figure 25.4 shows there is a strong negative relationship between real effective appreciation and deterioration of the current account.

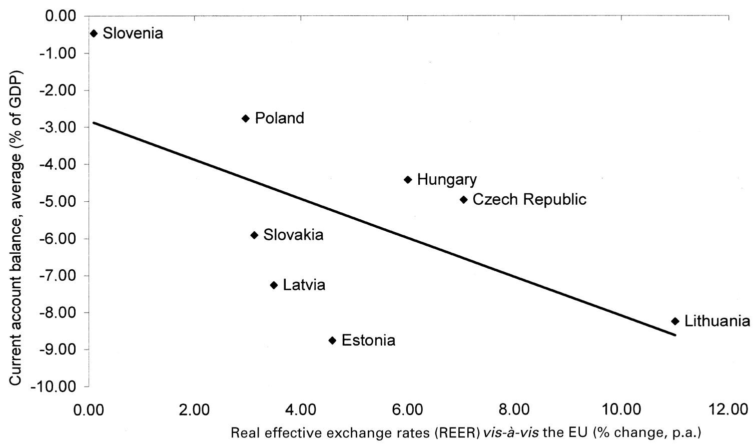
5. EU ENLARGEMENT IS A SOUND POLITICAL PROJECT RATHER THAN AN ECONOMIC PROJECT

There is no doubt that the enlargement of the EU in 2004 is a historic event. Enlargement will end the political separation in Europe. Although being a



Source: Autumn 2003 Economic Forecasts, European Commission, European Economy, No. 5/2003, 29 October 2003.

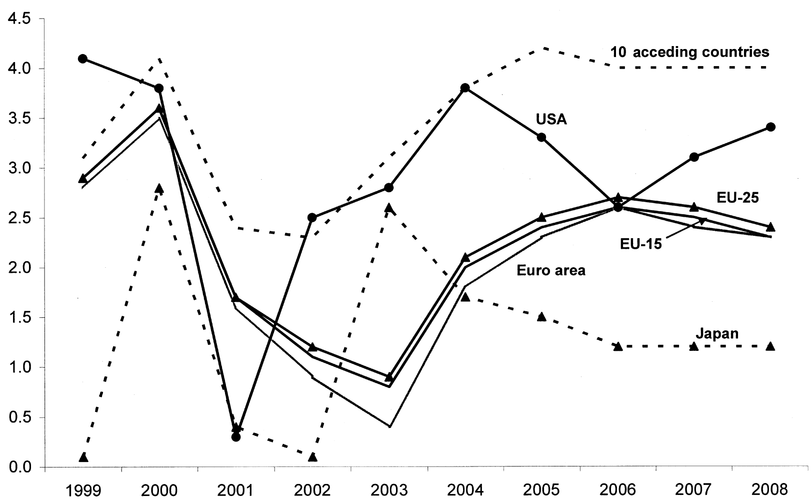
Figure 25.3 CPI inflation rates in the ten acceding countries, 1999–2005



Source: Own calculations with the following data: Current account: Autumn 2003 Economic Forecasts, European Commission, European Economy, No. 5, 2003 and EBRD: Transition Report 2003; REER: European Commission, Economic and Financial Affairs, Price and Cost Competitiveness, 3rd quarter 2003.

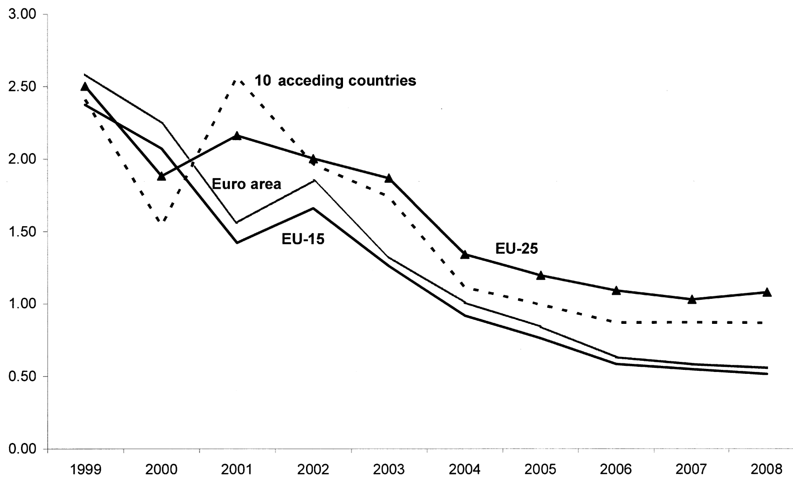
Figure 25.4 Real effective exchange rate development and current account position, eight CEECs, 1995–2003 great political step for Europe, economically it is fraught with many dangers and risks (see Breuss, 2002b). There will be an integration bonus for both the present and the new EU member states, but the growth potential created by EU enlargement will be around ten times larger in the new member states. Whereas integration into the single market will lead to an additional growth of real GDP of around 1 per cent per annum in the new states, it will only add one tenth of a percentage point each year to GDP growth in the present EU states. Furthermore enlargement will have only a temporary level impact in the latter countries, whereas it will generate a longer lasting growth impulse for the newcomers (see Breuss, 2002b). The latest economic forecasts taking into account such estimations of the integration bonus of enlargement imply that the EU-25 will grow faster than the EU-15 by only one-tenth of a percentage point in the near future (see Figure 25.5).

However, as the new member states have already grown faster in their catching-up process than the EU-15 countries and as their growth is more dispersed than that of the euro area, the EU-25 will show less coherent cyclical developments than the EU-15 or the euro-12 area. The dispersion (measured by the standard deviation of real GDP growth rates) is higher in the enlarged EU than in the present one (see Figure 25.6). That means that



Source: Autumn 2003 Economic Forecasts, European Commission, European Economy, No. 5, 2003 and Oxford Economic Forecasting, November 2003.

Figure 25.5 How big is the enlargement bonus? Growth of the EU-25 and EU-15 compared to growth of the USA and Japan



Source: Own calculations with data from Autumn 2003 Economic Forecasts, European Commission, European Economy, No. 5, 2003 and Oxford Economic Forecasting, November 2003.

Figure 25.6 Endangered 'European business cycle' due to enlargement? (Standard deviations of real GDP growth rates)

we can start from scratch in creating a 'European business cycle'. That, however, would be urgently needed for a euro-area-wide consistent monetary policy. On top of that, integrating a large number of countries with very heterogeneous fiscal policies will be a huge challenge for coordinating economic policy. Nevertheless, even when the new member states will not yet belong to the EMU, they 'shall regard their economic policies as a matter of common concern and shall coordinate them within the Council' (Art. 99(1) EC Treaty).

Overall that means that the economic integration of a bloc of 'poor' countries into a bloc of 'rich' countries leads to a setback in economic integration. The EU has to start anew with 'digesting' a bunch of countries – all having level-one status in the definition of the structural funds policy and all creating high additional costs for the CAP. The new countries – with the exception of Cyprus and Malta – are transition economies which have barely completed the process of systemic transformation (that is, they have not yet completed the task of building up EU-like institutions and implementing the EU rules of law) and those of catching-up to EU income levels. The latter process, implying higher growth, renders those countries into emerging markets within the borders of the EU.

NOTE

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