Preface

Gertrude Tumpel-Gugerell

This volume comes out of the Oesterreichische Nationalbank's East–West Conference 2001 which took place in Vienna from 4 to 6 November and was entitled 'Convergence and Divergence in Europe'. Experience with convergence and divergence in the European Union as well as the challenges raised by the convergence of Central and Eastern European countries with the European Union are central to this volume. The chapters focus not only on convergence at the country level, but also deal with the development of regions within individual countries.

The Introduction sketches important issues illuminating the background to this volume. The income-per-capita levels of the Central and Eastern European countries are generally far lower than those in the European Union and at the same time far from homogeneous among these countries themselves. Moreover, in recent years real growth rates in the accession countries have stood at relatively moderate levels; unemployment rates are still high or have increased even further in some countries. It is stated that economic policy should aim at fostering real growth in a stability-oriented environment and warned against premature efforts to comply with the Maastricht nominal convergence criteria.

Part I starts with an overview of the history of convergence and divergence in Europe, by Ivan T. Berend. The author stresses that, as a result of the industrial revolution, the gap between the locomotive-driven cores and horse-driven trudging peripheries widened tremendously during the first 60 years of the nineteenth century. After eradicating illiteracy, Scandinavia was the only former peripheral region to gain economic power during the last third of the nineteenth century. In recent decades, in the case of Spain and Ireland, the participation of multinational corporations in economic activity has been decisive for the catching-up process, with the EU Structural and Cohesion Funds helping to eliminate regional lags. Ivan T. Berend is optimistic that a united Western and Southern Europe is in the making. With successful systemic changes, with macroeconomic stabilization and privatization, the western rim of Central and Eastern Europe, that is Estonia, Poland, the Czech Republic, Slovakia, Hungary and Slovenia, made good progress in restructuring its economies and introducing modern technology, and is likely to be able to join the European core in 10 to 25 years.

Vítor Gaspar, Director-General of the European Central Bank, and Francesco Mongelli, Adviser at the European Central Bank, write on 'Monetary unification and the single market'. They single out three key areas of interest, namely trade, prices and financial markets. With respect to the impact of EMU on trade, strong increases in intra-euro area trade are predicted by gravity models, which show that the impact of a common currency is an order of magnitude larger than the effect of reducing a moderate exchange rate volatility to zero while retaining separate currencies. The impact on prices, theoretically founded in the Law of One Price, appears to be visible in a reduced volatility of relative prices across borders, as border effects are reduced to 20 per cent of their previous levels. However, geographical distance still matters for price formation. Evidence of financial market integration is found in small interest rate differentials.

Part II focuses on past convergence within the European Union. It begins with Chapter 3 by Maria Antoinette Dimitz and Doris Ritzberger-Grünwald, Economist and Deputy Head of Division, respectively, of the OeNB's Foreign Research Division, and Jesús Crespo-Cuaresma from the University of Vienna. Their study examines the impact of European integration on the long-term growth of the current EU member states by means of panel data methods. The authors find a significant positive effect of the length of EU membership on long-term economic growth and establish that the positive effect is higher for countries with an income level that is below an estimated threshold. This asymmetric growth bonus can thus be interpreted as a convergence-stimulating effect of EU membership on long-term growth. The authors suggest that technology spillovers are an important underlying factor of this growth bonus. The fact that the income levels of all EU candidate countries currently lie below the estimated threshold may suggest that these countries would profit disproportionately from EU membership.

Contributing to the objective of finding the determinants for successful regional developments in catching-up countries is Chapter 4, 'Regional convergence in Spain, 1965–95', by Angel de la Fuente, Professor at the Instituto de Análisis Económico (Barcelona). This chapter investigates the sources of productivity convergence, using panel data for the Spanish regions. The results indicate that technological catching up, the equalization of educational levels and the redistribution of employment across regions account for most of the observed reduction of regional disparities.

Under the heading of 'Restructuring of industrial areas: lessons in support of regional convergence in an enlarging Europe', Michael Steiner, Professor at Karl-Franzens-Universität Graz and Director of Joanneum

Research, compares industrial regions in the CEECs to the old industrial areas in Austria 15 or 20 years ago, using the example of Styria, which had been a stronghold of Austria's nationalized manufacturing industries and was hit seriously by the decline of certain sectors. By way of conclusion, he states that first, the evolution of regions was not an automatic process and that successful economic adjustment called for new policy strategies and instruments (described with the key words 'clustering' and 'networking'); and second, the process of convergence was similar in some regions of the CEECs to the process in Styria in that certain institutional preconditions were required.

Karl-Heinz Paqué, Professor of International Economics at Otto-von-Guericke University Magdeburg, contributes a chapter on the state of the east German economy 11 years after German reunification. His chapter is entitled 'German reunification: a special case with general lessons?' Paqué points out that since 1996, eastern German labour productivity has stagnated at only two-thirds of the level of western Germany. In his view, eastern German manufacturing is still too small, too little export-oriented and too little geared toward producing highly innovative product ranges ('innovation gap'). This gap may be closed by 'knowledge import', that is by attracting direct investment from western Germany, and 'knowledge creation', that is by developing an endogenous innovative industrial base and thereby reducing the very high mobility of skilled labour. For developing innovative capacities, tax incentives and subsidies should be focused on commercial research and development activities, and fiscal support should promote universities and public research institutions. Karl-Heinz Paqué stresses that among the general lessons that could be drawn from the German post-reunification experience, proximity to Western industrial centres would not only have advantages, but also disadvantages such as high inter-regional labour mobility which, in turn, could lead to a brain drain.

Chapter 7 gives the conference keynote speech by Xavier Sala-i-Martin, Professor of Economics at Columbia University, on the topic of 'Convergence and divergence: theoretical underpinnings'. The chapter aims at giving three reasons why convergence is of interest and reformulates the main definitions involved. First, convergence serves to test the new endogenous growth theory against the old neoclassical model, since the old growth theory, unlike the new one, predicted convergence across countries. The result is that β-convergence, that is a negative relationship between the level of income and the rate of income growth, does hold, but only if variables which characterize the steady state of the economy (for instance, the savings rate) are controlled for conditional β-convergence. The second reason for the renewed interest in convergence is the evaluation of government policies.

The third reason is related to globalization and so-called anti-globalization criticism. The degree of income-per-capita dispersion is shown to have increased over the last decades at a global level of aggregation when countries are taken as units of analysis. But when considering people as units of analysis, σ-convergence, that is, the reduction of income-per-capita dispersion, occurred, mainly owing to rapid real growth in India and China.

Part III focuses on the Central and Eastern European EU candidate countries' achievements in real convergence since the beginning of transition. In his chapter on 'Structural change and catching up' János Gács, Project Leader at the International Institute for Applied Systems Analysis (IIASA), analyses major macro-level changes on the production and utilization sides of GDP as well as structural changes in the industrial sector. The most important development on the production side of GDP was the substantial reduction of previously overdeveloped industrial activities on the one hand and the emancipation of service activities on the other. Even if a large share of 'screwdriver operations' in multinational networks may distort the picture of manufacturing structures, the countries that attracted the lion's share of foreign direct investment either managed to achieve strong structural shifts in their industries or to develop subsectors with potentially high unit values, or both. János Gács notes that substantial fluctuations took place on the utilization side of GDP. However, domestic savings support the evolving real convergence process only in a few countries. This development emphasizes the importance of utilizing foreign savings, particularly in the form of direct investment.

Chapter 9 by Jozef Konings, Professor at the Catholic University of Leuven and Director of LICOS, the Centre of Transition Economics at the Catholic University of Leuven presents an analysis of the restructuring of industrial firms in Poland and Romania based on firm-level data. He draws a distinction between defensive restructuring (proxied by labour shedding) and strategic restructuring (measured by investment). He shows that both defensive and strategic reorganization take place even within narrowly defined sectors. The focus on strategic restructuring was stronger in Poland than in Romania. Other important findings may be summarized as follows: (1) large firms are more likely to engage in defensive restructuring and less likely to engage in strategic restructuring; (2) firms operating in export-oriented sectors engage less in defensive restructuring and tend to favour strategic restructuring; (3) import penetration and concentration levels have no effect on restructuring; (4) private firms engage in more defensive and more strategic restructuring, with foreign-owned firms achieving a higher extent of restructuring than domestic-owned companies.

Roman Römisch, Research Economist at the Vienna Institute for International Economic Studies (WIIW), analyses the development of regional disparities within the accession countries in Chapter 10. He shows that there were large disparities between the regions around capital cities and other regions in the respective countries. Moreover, he shows that regional divergence has, in recent years, increased in accession countries, which is mainly attributable to a boom in the various capitals. The most important factor in determining the economic performance of a region was its economic structure, which was, in most cases, inherited from the past communist era. Another decisive factor was the distance to Western borders. Moreover, agglomeration effects exerted significant and positive influences on regional GDP and unemployment levels, as these regions were able to exploit economies of scale and economies of scope, networking externalities as well as increasing forward and backward linkages in production.

Jarko Fidrmuc, Economist at the OeNB's Foreign Research Division, and Iikka Korhonen, Economist at the Bank of Finland Institute for Transition Economies (BOFIT), co-authored Chapter 11, on the correlation of supply and demand shocks between the euro area and EU accession countries during the 1990s as well as on the corresponding correlations for most present EU countries. According to the authors, in the case of the accession countries, the correlation of supply shocks differs greatly from country to country. Some countries are at least as well correlated with euro area shocks as many current EMU members are. The three countries with the highest correlation of demand and supply shocks are Estonia, Hungary and Poland. This may be explained by the fact that these countries received the highest level of foreign direct investment on a per capita basis among the accession countries and that they have very extensive trade relations with the euro area countries (and the EU in general).

Part IV is devoted to the issue of how to balance real and nominal convergence in EU accession countries in general, focusing in particular on examining the challenges for monetary and exchange rate policies in the convergence process. Chapters by the heads of research of six accession countries' central banks include active and original contributions by representatives from the CEECs.

In his introductory chapter, Peter Mooslechner, Director of Economic Analysis and Research at the OeNB, sketches some of the interrelations between real and nominal convergence, highlighting, *inter alia*, that risks for real growth (temporarily) may well result from premature efforts to achieving full nominal convergence very quickly. In addition, the process of real convergence will probably be accompanied by further strong capital inflows. Under a currency board arrangement, such capital inflows may lead to inflationary pressures via additional money supply growth, while under a floating exchange rate regime they may introduce significant exchange rate movements. When assessing the degree to which the countries represented in the session already fulfil the optimum currency area (OCA) criteria, Peter Mooslechner raises the question of whether the actual entry into the European Union's internal market would constitute a significant asymmetric shock despite the existence of free trade provisions under the Europe Agreements.

Aleš Čapek, Executive Director of the Monetary Department of the Czech National Bank, points out in Chapter 13 that real convergence is a long-term process. This implies a trend of real appreciation, which is an equilibrium process and may amount to 2 to 3 per cent per annum. Under a fixed exchange rate, this real appreciation will show up as higher inflation. Under a floating rate regime, it may also materialize as nominal appreciation. In the runup to E(M)U participation, the Czech Republic, following an inflation targeting strategy, intends to combine a modest nominal trend appreciation with a small inflation differential to the euro area. After accession to the euro area, fiscal policy will be the only macroeconomic policy tool for aggregate demand management. It is thus of paramount importance to increase the room for manoeuvre of fiscal policy.

In Chapter 14, Tina Žumer, Economist at the Bank of Slovenia, and Uroš Čufer, Director of the Analysis and Research Department of the Bank of Slovenia, stress that Slovenia has already fulfilled the standard real convergence benchmarks for participation in a monetary union. However, further progress in this area would still be highly welcome. From their point of view, there is no long-term conflict between nominal and real convergence, as the long-run Philips curve is vertical. The central bank can foster convergence by aiming for price stability, strengthening banking supervision and avoiding major and/or lasting macroeconomic disequilibria.

Paweł Durjasz, Director of the Research Department of the National Bank of Poland, and Jakub Borowski, Economist at the National Bank of Poland, state in Chapter 15 that the real convergence challenge for Poland is bigger than for other advanced accession countries, as the GDP-per-capita ratio is still relatively low, while Poland is more advanced on the way toward nominal convergence than the Southern European EU countries were at the beginning of the 1990s. In their view, Poland has no alternative to direct inflation targeting at the current stage. Owing to fiscal and labour market rigidities, the recent disinflation leap has been rather costly, but it helped to reduce the current account deficit to sustainable levels. The main challenges for the years to come are dealing with the Balassa-Samuelson effect (which should, however, not exceed 2 per cent per annum and should thus not pose an insurmountable problem to meeting the inflation criterion) and the convergence play (the risks of which can be minimized by a gradual lowering of inflation earlier).

István Hamecz, Managing Director of the Economics Department of the National Bank of Hungary, and Ágnes Horváth, Senior Economist at the National Bank of Hungary, argue in Chapter 16 that participation in the euro area is a positive net present value project for Hungary and that the country therefore plans to join economic and monetary union as early as possible (that is around 2006). Hungary will grow faster as a member of EMU (by around 0.5 percentage point per annum) than outside EMU, while the costs and risks are limited (and have to be compared to the costs and risks of joining later, for example on the exchange rate front). The Balassa-Samuelson effect and the inflation it entails will not constitute a major problem for Hungary, as this effect will presumably be relatively limited in size. Hungary is currently more advanced in fulfilling the OCA criteria than the countries of Southern Europe were five years before joining the euro area. The same is true, state Hamecz and Horváth, of Hungary's advances toward nominal convergence.

Marián Nemec, Director of the Institute of Monetary and Financial Studies of the National Bank of Slovakia, sketches the current state of his country on the way to convergence with the European Union in Chapter 17. He reports progress in recent years, while also pointing out still remaining weaknesses, in particular in several areas of structural reforms and, relatedly, in the country's fiscal position. Given the uncertainties involved along the remaining path toward convergence, a flexible monetary framework is most appropriate and implicit inflation targeting, the strategy currently followed by the National Bank of Slovakia, appears to be suitable to support further convergence while leaving open the possibility to react to unforeseen developments.

In Chapter 18, Märten Ross, Vice-Governor of the Bank of Estonia, points at the successful functioning of the currency board in Estonia since 1992 and argues that this arrangement is a good option to foster convergence. He maintains that nominal exchange rate stability has not affected competitiveness negatively and has therefore not hampered real convergence, either. Estonia will probably have a trend growth of 3 percentage points above EU levels, which will translate into an inflation differential of about 2 percentage points. Convergence, he states, needs a careful handling of public spending. Furthermore, a long-term strategy is key to coping with the fact that convergence is not a stable process.

Leszek Balcerowicz, President of the National Bank of Poland, held the gala dinner speech. He focused on long-term real convergence processes and factors underpinning successes and failures in this area. Taking a global view, Leszek Balcerowicz said that catching-up failures had emerged in most of the non-Western world, in all of Latin America until 1990, in all communist and in many post-communist countries. Among catching-up successes one can name Chile, China, some post-communist countries and some Asian 'tigers'. Public failures seem to be the root causes of a lack of convergence: on the one hand, overblown state interventionism, consisting of protectionism, monopolism, high tax levels and high redistribution, and on the other hand, lack of authority where the state is necessary. Fundamentally, the question is, not that of state or market, the question is what kind of state is appropriate? The most successful type of state would obviously appear to be a rational, limited state that focuses on law and order, the efficient supply of public goods, macrostability and the protection of capital owners.

Part V deals with the question of the financial sector's contribution to real growth.

Joseph Bisignano, Senior Adviser of the Bank for International Settlements, chose the title 'Searching for Schumpeter: the financial sector and economic growth in industrial countries' for his chapter on the importance of the financial sector for real sector developments in developed industrial countries. According to Bisignano, the Austrian economist Joseph Schumpeter can be associated with endogenous growth theory ('creative destruction') and with the finance and growth school, which picks up his argument that financial intermediation not only helps encourage savings, but also assists with efficiently allocating financial capital. He stresses that the elimination of factors leading to 'financial repression' is by itself unlikely to contribute much to growth without attention to reform in legal, informational and corporate governance infrastructures. While there is evidence that financial development contributes to growth, growth also encourages financial development. In conclusion, the search for Schumpeter and the so-called Solow residual requires a close look at the institutional infrastructure, in particular the judicial system, and at regulations which may constrain the adaptability of markets and intermediaries.

Andy Mullineux, Professor at the Birmingham Business School, University of Birmingham, and his colleague Victor Murinde co-authored Chapter 20 on 'Financial sector convergence in Europe'. They begin with a brief snapshot of the current situation in the financial sector of the CEECs. They anticipate that the ongoing consolidation process of the financial sector in the CEECs will probably end with a European-style *bancassurance* system coupled with an increased reliance on capital markets, while domestic stock exchanges will soon have outlived their usefulness in Europe. While the final results of the econometric tests they are currently applying to determine whether a shift toward convergence in the banking systems of the accession countries had taken place were not available yet, they present the results of a previous paper that applied a similar approach to a group of transition economies. Accordingly, the banking systems of the transition economies seem to have converged on the EU model only in certain key aspects of intermediation, while the mobilization of time and savings deposits is lagging behind particularly strongly.

Franz Schardax, Economist at the OeNB's Foreign Research Division, with his colleagues Thomas Reininger and Martin Summer, gives an overview of the state of the financial sector in three advanced transition economies (the Czech Republic, Hungary and Poland) in Chapter 21. In the corporate sector's funding structure, domestic bank loans represent the most important source of external funding in these countries, with foreign loans increasingly gaining importance, while the capital markets' contribution is negligible. In contrast, for the public sector, capital markets are the most important source of funding, with domestic non-banks and foreign investors playing an important and increasing role in the demand for government debt securities. Reininger et al. conclude that based on the ratio between total external corporate funding and gross fixed capital investment, the domestic and foreign financial sector is likely to have contributed to growth in Hungary.

Part VI deals with the issue 'Is There Somebody Left Out in the Cold? Prospects of CEE Countries Other than Current Accession Countries'. The chairman of this session, Michael Landesmann, Professor and Director of the Vienna Institute for International Economic Studies (WIIW), briefly underlined that disparities in income-per-capita levels between advanced accession countries and other transition countries, including the CIS countries, had increased significantly during the 1990s.

In Chapter 22, Vladimir Gligorov, Professor and Senior Economist at the Vienna Institute for International Economic Studies (WIIW), focuses on the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Macedonia and the Federal Republic of Yugoslavia) and the wider area of South-Eastern Europe (including Bulgaria and Romania). Many countries in this region are burdened by poverty and unemployment, macroeconomic disequilibria, slow structural adjustment, limited competitiveness, weak institutions and an insufficient rule of law. Notwithstanding, economic and financial links to the EU are strong. But their economic integration is hardly ever accompanied by an integration of values and politics, revealing an inconsistency in public preferences. In his view, the EU has not yet been able to influence this inconsistency in any decisive manner. With the prospect of possible future EU accession far off, vested domestic interests and corruption may repeatedly maintain the upper hand in struggles to shape economic policy.

Hermann Clement, Deputy Director of the Osteuropa-Institut in Munich, bases his chapter on the development of Russia and Ukraine and their relations with the EU. Following a long transition crisis, both countries boasted remarkable economic growth rates of 5 to 10 per cent annually over the two most recent years. Considering the extreme contraction of investment and slow structural changes, sustaining the current level of growth will be a major challenge. The two countries cannot expect a significant increase in foreign direct investment inflows without accelerating reforms. The EU supports transition in both countries via the Tacis programme, the Partnership and Cooperation Agreements and the Common Strategies. The EU's share in these countries' total foreign trade is far below its corresponding shares in the foreign trade of the accession countries. With enlargement, the EU's share in the overall trade of Ukraine and Russia will rise by about 8 percentage points, while the energy component of trade will augment further. Hermann Clement judges calculations of potential Ukrainian and Russian losses through EU enlargement to be exaggerated. Both countries should gain from EU enlargement, particularly in the long term.

Part VII deals with 'Policy Challenges Within the (Enlarged) EU: How to Foster Economic Convergence?'

Val Koromzay, Director of the OECD's Country Studies Branch, presented empirical evidence on cyclical convergence in the euro area during the 1990s. Based on a set of indicators, he compared the classical catching-up countries (Finland, Greece, Ireland, Spain, the Netherlands and Portugal) with the remaining euro area member states, denoted as the core group. High differences in the national inflation rates, which are partly attributable to the Balassa-Samuelson effect, make an appropriate monetary policy more difficult. Euro area-wide co-ordinated discretionary fiscal policy may have the power to influence the business cycle. National fiscal policy, on the other hand, is not a very powerful tool for dealing with cyclical divergence, as the automatic stabilizers, although working in the right direction, have a very limited impact and leakages through imports by these small and open economies are sizeable. According to Val Koromzay, the most effective tools are measures to promote labour market flexibility and to foster intra-euro area trade, structural policy and an effective income policy.

In Chapter 24, Vasco Cal, General Co-ordinator of the Cohesion Report of the European Commission, summarizes the main aspects of the second Report on Economic and Social Cohesion, which was adopted by the European Commission in January 2001. In this report the Commission analyses the regional disparities in a European Union of 27 member states and the contribution of Community policies to cohesion. Compared with the present situation, regional disparities would more than double in an enlarged EU. While there is no doubt as to the continued need to provide assistance to the less-developed regions, the financial aspects and the focus on national or regional development will still have to be discussed in due time before the expiration of the EU's current medium-term financial outlook that covers the period until 2006. The report points out the disadvantages of the present type of zoning and opens up the possibility of indirect zoning to be determined by the individual member states or of selecting priority topics instead of specific recipient areas.

Judy Batt, Professor at the University of Birmingham, argues in Chapter 25 that the implementation of the Schengen border and visa regime would run counter to fostering economic convergence between regions on both sides of the eastern border of an enlarged European Union. Border trade and temporary work spells on the western side of the border would be hampered, and the economic well-being of many people in the countries east of the EU's new eastern border would suffer. In the worst case, Schengen might spur migration and also foster anti-Western attitudes. All this could destabilize the situation in the regions beyond the EU's eastern border, which would, in turn, have a negative impact on the EU's new eastern border regions. Judy Batt calls on the EU to rethink its neighbourhood policies and to set up a special task force to promote those Euroregions which encompass the eastern regions of accession countries that are likely to join the EU in a first wave, and the western regions of other Eastern European countries, such as Romania and Ukraine.

Stanisław Gomulka, Professor at the London School of Economics, starts Chapter 26 from the proposition that the process of EU and EMU accession carries high risks and challenges for the accession countries, while holding only small risks and challenges for EU incumbents. Moreover, while risks are prevalent in the period up to EU and EMU integration, large benefits will mainly materialize after countries join the euro area. Given their low current saving rates, accession countries will have to tap external savings if they want to grow quickly, or to raise domestic savings substantially, which would, however, hamper growth. A high-growth strategy would entail the risk of a boom–bust cycle. For the current members, in turn, EU enlargement would not be very costly, given the small size of accession countries in GDP terms.

Chapter 27 by Klaus Liebscher, Governor of the Oesterreichische Nationalbank, stresses the importance of the euro area as an anchor of stability in Europe and in the world. Given the current weakening of global growth, EMU contributes to avoiding possible exchange rate or financial tensions in Europe. Convergence is pivotal to the historical integration process in Europe. Transition and the preparation for EU accession ultimately aim at convergence. While institution building and human capital formation are making progress in these countries, per capita incomes remain much lower than in the present-day European Union and inflation continues to be somewhat higher on average. In his view, the pace of further disinflation in accession countries should be determined in line with the overall economic situation, in particular with the need of countries to increase real convergence. The Maastricht inflation criterion should not be seen as an immediate requirement, but rather as an objective of central banks during the period of ERM II.

The conference on which this volume is based was rounded off with a note by Gertrude Tumpel-Gugerell. In her concluding remarks, she stressed that economic convergence was not simply an automatic process and that there was a risk of long-term divergence. To avoid the latter, first, there is a need for an appropriate institutional development, in particular of the legal and administrative systems. In the case of the accession countries, these should be strengthened in the ongoing preparations for EU membership. Moreover, a well-functioning financial sector is a precondition for dynamic economic growth. Thus, structural changes in the financial sector should promote the financial intermediation of saving to real investment. Finally, Gertrude Tumpel-Gugerell expressed her conviction that the discussions had deepened the understanding of convergence processes in the European Union as well as of the strategic and fundamental challenges that accession and other transition countries are confronted with in their efforts to catch up with the European Union.