

Executive summary

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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 Zemplerová, 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 impor-

tant 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.

