

**SOUTHEAST EUROPE AND THE WORLD WE LIVE IN**

**DANIEL DAIANU**

**SOUTHEAST EUROPE  
AND THE WORLD WE LIVE IN**



**EDITURA ACADEMIEI ROMÂNE  
BUCUREȘTI, 2008**

Copyright © The Romanian Diplomatic Institute, 2008.  
All rights reserved.

**Descrierea CIP a Bibliotecii Naționale a României**

**DĂIANU, DANIEL**

**Southeast Europe and the world we live in /Daniel**

Dăianu. – București: Editura Academiei Române, 2008

ISBN 978-973-27-1628-1

821.135.1-92=111

070(73) Southeast EuropeTimes (0:82-92) “2002/2007”

Editor: Rodica FLORESCU  
Computer Operator: Luiza DOBRIN  
Cover: Nicoleta NEGRUȚ

---

Final proof: 28.01.2008. Format: 16/54 × 84  
D.L.C. for large libraries: 330.191.6(4)(081)  
D.L.C. for small libraries: 33

---

## CONTENTS

<i>Foreword</i> by Armando Marques Guedes .....	7
<i>Preface</i> by Franz Lothar Altmann .....	9
<b>Introduction</b> .....	13
<b>Part I: The world we live in</b> .....	17
Events spur re-examination of business ethics, social responsibility .....	19
Which globalization is the way? .....	22
Is “unconventional economics” staging a comeback? .....	26
Will developmental economics stage a comeback? .....	30
Economic policy: the end of ideology? .....	33
Who fears outsourcing and off-shoring? .....	37
Oil prices, emerging economies reshape global picture .....	41
The race for competitiveness .....	44
Why fast economic growth isn’t enough .....	48
The soul of capitalism .....	51
<b>Part II: Which way goes the European Union</b> .....	57
The EU’s biggest challenge: managing rising complexity .....	59
Is the European model sustainable .....	62
Agriculture and the Doha trade round .....	65
States must balance tax competition in Europe .....	69
Maintaining low inflation in transition economies .....	72
EU referenda complicate accession prospects .....	75
Cooperation, compromise are backbone of EU enlargement .....	79
Lessons of EU accession .....	82
“Economic patriotism” in the EU .....	86
Labor markets and effects of migration .....	90
<b>Part III: Romania’s journey to the EU</b> .....	95
Economic policy focus: tax revenues in Romania .....	97

Romania, the IMF and an expected decision.....	100
Rushing into the capital accounts is risky.....	103
Does Romania have a functioning market economy?.....	107
EU accession roadmaps could cause some bumps .....	110
Romania's economic policy challenges in 2004.....	114
For Romania and Bulgaria absorption capacity is essential.....	117
Revenues and the flat tax in light of Romania's EU accession.....	120
Romania and the Lisbon Agenda.....	124
The Romanian economy: what to watch for in 2006.....	128
News mostly good for the Romanian economy.....	131
Euro adoption is to be approached carefully .....	135
<b>Part IV: The Balkans and the EU .....</b>	<b>139</b>
Economic reconstruction: the role of European Aid.....	141
Unemployment in the Balkans: how much of a concern? ....	144
Will economic recovery last in the Balkans?.....	146
Infrastructure is key to economic development and cooperation .....	148
The Latin American crisis: lessons for the Balkans.....	151
Tax policy in Southeast Europe: some issues.....	154
Absorption capacity of EU funds plays critical role for membership seeking countries .....	158
Conflicting perceptions and economic challenges.....	160
Positive signs of cooperation.....	164
EU constitutional disputes and Southeast Europe .....	166
EU enlargement and the Western Balkans .....	169
World Bank forum targets growth in Southeast Europe ..	172
NATO membership: what it means for economic development .....	174
Fighting corruption in SEE countries: the EU factor.....	177
EU Presidency holder Austria has close ties to SEE countries.....	181
Which way ahead for the Western Balkans? .....	184
Economic, political, and institutional adjustments needed for countries joining the EU .....	188
References .....	193

## **FOREWORD**

*It is rare that the scope of books written by economists ranges beyond the technicalities of their often very specialized subject-matter. In this one, however, it certainly does and in a manner which is most welcome. It fills a gap. Professor Daniel Daianu is not only a researcher internationally recognized for his academic excellence; he is also, as a former Minister of Finance and a high level advisor, a seasoned practitioner. In this collection of newspaper articles published in the Southeast European Times – a collection now for the first time aggregated in one volume – Dr. Daianu manages with ease, depth, readability, and intellectual panache to go well beyond the usual limits which afflict specialists. Here is a set of papers that throw a bright light both on the political background and consequences of a thickening mesh of economic and political interdependence in a Southeastern Europe which was for far too long led astray from the central role that it can – and should and surely will – fulfill in the process of regional cohesion, an unfolding project that simultaneously marches toward global integration, and does so while guaranteeing a careful balance between human dignity and rising standards of life. Professor Daianu is the paladin of an erudite version of that project. Carrying it out will not be an easy task in an Eastern Mediterranean that has been in a less complex neighborhood. Mapping issues, and touching upon the ongoing successful experiences of Romania and Bulgaria, Daniel Daianu craftily designs paths to guide his part of our common world, in a manner which is both democratically and economically enriching, towards an achievement of these results. This is economics – that is, choice – at its best.*

*Armando Marques Guedes*  
Professor, Faculty of Law of the *Universidade Nova de Lisboa*, Portugal  
President of the Portuguese *Instituto Diplomático*

## PREFACE

Which world do we live in? This is an appropriate question heading the first part of a collection of articles Daniel Daianu had written and published over the past extremely exciting years that have changed Southeast Europe and the World immensely. Not everything developed as rapidly positive as expected or hoped, and many appearances call in fact for interpretation and/or justification. How do we see for example globalisation and neo-liberalism in the context of the transformation efforts of the countries in Central East and Southeast Europe? Is free trade equally beneficial for all economies regardless of their level of development and competitiveness? Often we feel as if certain issues do have more than two sides of a coin, and this is what Daianu is trying to make us aware of. The world we live in is changing every day, and so do economies as well as politics, becoming more complex and also much more detailed at the same time. It is not surprising that socio-economic theories have problems to follow and explain the trends and new phenomena. Daianu calls it the search for the ultimate piece of wisdom, the “ideal” type of economic policy whereby ideology is not dead as he describes it convincingly in his piece “Economic Policy: The End of Ideology?” No, on the contrary, we discuss Keynesianism and monetarism, neo-liberalism and laissez-faire, globalization versus global capitalism, free trade versus fair trade, welfare economics versus deregulation, flat tax versus socially adjusted tax rates and so forth.

In fact, we live in a world of increasing varieties and challenges where answers to many of the worrying questions are often difficult to formulate since economic theory and social approaches may collide with reality in politics and economics. As an example financial liberalisation may serve which started in the late sixties and early seventies becoming one of the most important processes in the world economy over the last two decades of the twentieth century. It influenced positively the level of interest rates and indirectly the structure of capital costs, the marginal efficiency of investment and the levels of aggregate savings. But it is rather puzzling that over the last two decades of the twentieth century four out of ten fastest growing economies were largely or partly financially repressed: South Korea, Taiwan, Sri Lanka and in particular China.

Reading Daianu's articles we find this variety of issues and questions addressed, and to a great extent also answered respectively explained from a viewpoint that is European and Southeast European at the same time. The challenges are not always of global nature, many are special for Europe and even more special for Southeast Europe. Which way goes the European Union is he asking, and the answer is definitely not given. A success story as it undoubtedly is, the EU today is torn between deepening and enlargement facing growing scepticism if not even disaffirmation regarding the latter in the core (old) member states. The constitution issue depicts most visibly the different views whereby some of the "New Europe" countries from the 2004 enlargement seem to fall after their accession into political populism and disarray and a kind of national thinking and economic patriotism which irritates "Old Europe" To be fair, also in the latter we observe an apparent resurgence of protectionism. Daianu explains this by arguing that liberalism (or globalisation), by its very nature, brings about such reactions throughout the world, in rich economies as well as in poor ones.

But apart from economics, do we see progress in developing other areas of cooperation, like *e.g.*, in Common Foreign and Security Policy? We should not be too quick in answering NO, because there are many areas where the EU member countries have been able to find the necessary compromises and willingness to cooperate. But even if CSFP is still more a project than reality, it cannot be neglected that the EU has become an important international player, more often as a mediator than as actor, but nevertheless respected as a growing soft power with balanced interests and approaches in international conflict resolutions.

The European Community did not have aspirations for a common foreign policy before the wars in the Balkans erupted in the early nineties. The need to speak with one voice became obvious after the shaming disunity over whether and how to intervene in order to stop killing and looting. Since the mid nineties the European Union (EU) became more and more engaged in Southeast European issues after having been on the military level only junior partner of the USA in the early years of the Balkan conflicts. However, starting in the late nineties the European Union is increasingly taking over also commitments in the military sector and in particular in the larger security sector areas. However, for the sustainable stabilization and development of the Balkans the offer of the European Union of a membership perspective for the Western Balkans, given at the Thessalonica summit in 2003, is much more important. But it is not only for the sake of the Balkans that the EU perspective is kept alive, also for the EU itself the white spot which the Western Balkan countries now represent by being completely surrounded by EU member countries shows how incomplete the European reunification still is. The world we live in needs a strong and stable Europe, and Europe will not be stable and free from internal disruptions, clashes and conflicts as long as parts of Southeast Europe are separated from the process of European integration.

The collection of articles presented in the book at hand does not only induct the reader into the most relevant and topical issues of contemporary importance if one deals with Southeast European affairs, but in addition offers many inspiring reflections and approaches which go beyond the ordinary and traditional way of arguing. It mirrors in an impressive manner the rather rare combination of academic analytical (economic) thinking and practical political reviewing and evaluation which is needed to understand the complexity of the difficult situation of disrupted Southeast Europe. Daianu as an economist by profession and an internationally well reputed former finance minister proves this ability convincingly.

*Dr. Franz-Lothar Altmann*  
Associate Professor, German Institute  
for International and Security Affairs (SWP), Berlin

## INTRODUCTION

Southeast Europe, when seen as a cluster of countries, has gone a long way toward establishing the institutional underpinnings of market economy while political pluralism has become an entrenched fact of life. Bulgaria and Romania have joined the European Union at the start of 2007, which should provide more ground for optimism regarding the region as a whole. Economic recovery has been a constant feature in recent years, inflation is quite low region-wide, and financial systems are much more solid than a decade ago. Nonetheless, major economic problems (such as huge unemployment, extensive underground economies and aid addiction) persist and institutional weaknesses are highly visible.

A big question is what type(s) of capitalism(s) will evolve in the Region. Institutional fragility – as experience elsewhere in the world amply shows – is not easy to deal with, the functioning of state bodies is fraught with conflicts of interest against the backdrop of widespread corruption, income inequality has been rising sharply, and citizens' bitterness shows up at the polls, sometimes, in a disturbing manner. In addition “the political geography” of the Region is still blurred the status of Kosovo being the most glaring case. These circumstances indicate that, though progress has been considerable according to a democratic agenda during the past 15 years, still much lies ahead so that the citizens of Southeast Europe feel the benefits of economic reforms and political liberties comfortably and securely.

I have been a regular contributor to *Southeast European Times* (formerly *Balkan Times*) for several years now. In my articles I have tried to present views on various policy issues, which have come out from my experience as a Romanian policy-maker and as a concerned observer of the economic and politics of this region. This volume brings these articles together. I have tried to look at problems afflicting the Region from a wider, European, perspective, which itself is embedded into a global framework – that regards demographic dynamics, institutional vibrancy but also fatigue, trade frictions, and not least, the economic rise of Asia.

The first part takes a look at a series of global issues which have a bearing on Southeast European countries as well. The second part examines how the European Union has been evolving in the past decade, the challenge of managing its growing complexity and dealing with unfavorable demographics, the impact of the global race for competitiveness. Part three refers to Romania's journey to the European Union and part four looks at the Balkans' quest to join the European Union. At the end of the volume there are references to authors whose work is mentioned in the articles.

A silver-line of my articles is that the whole of Southeast Europe should join the European Union; the sooner the better.

*Daniel Daianu*

**Acknowledgements.** I should start with what lies at the very origin of this collection of articles. After my stint as a high public servant in the Romanian Government (1997-1998) I was invited to teach in the USA, first at Berkeley, and next, at the UCLA. While being there I was asked by

Dr. Marta Muco, whom I had known for years as a keen observer of economic developments in the Balkans, whether I would like to write for *Balkan Times* (currently *Southeast European Times/SETIMES*). I accepted and this decision was the start of five years of collaboration. I used this opportunity to write monthly columns in SETIMES where I shared thoughts on various economic and political issues that concern Southeast Europe and, in a wider context, Europe as a whole. Over time I realized that the range of topics I have dealt with provides the skeleton and the flesh for a structured way of looking at Southeast Europe, for examining the broader picture. When the Romanian Diplomatic Institute (RDI) invited me to come up with a personal contribution to a new series of publications I seized the chance to bring all these pieces together. Professor Vlad Nistor, the General Director of the Institute, and Dr. Radu Dudau, the Director of Research of the RDI, have made it possible and I am grateful to them for their encouragement and support. I also thank Ms. Alina Bacanu for the kind assistance in preparing the manuscript for publication. SETIMES is thanked for the permission to reproduce the articles which I wrote during 2002-2007. The name of this volume might strike a resemblance note with Will Hutton's "The World We'Re In"; this was not intended.

PART I  
**THE WORLD WE LIVE IN**

## **EVENTS SPUR RE-EXAMINATION OF BUSINESS ETHICS, SOCIAL RESPONSIBILITY**

Adam Smith is regarded as the father of economics, mainly for his book *The Wealth of Nations*. But he also wrote *The Theory of Moral Sentiments*, which underlines the moral underpinnings of a vibrant and socially cohesive capitalism. Smith's vision, in turn, can be linked to Max Weber's famous work, *Protestant Ethics and Capitalism*, which further explores the tie between values, institutions and economic performance. Francis Fukuyama, in "The End of History" was right in a fundamental sense – the demise of totalitarian communism closed a chapter of history. But many of his hopes have been clouded by events during the last decade.

Lately, issues of business ethics and social responsibility among firms and individuals have been at the forefront of public debate. Widespread corruption and unethical behavior are primarily seen as features of institutional fragility and a lack of democratic credentials, found in the developing world in particular. But the recent spate of corporate scandals across the Atlantic and in Europe illustrate a more complex reality. A similar wave of scandals gripped the United States in the 1980s. Is there a cyclical pattern in advanced economies, linked with unavoidable behavioural excesses during periods of exuberance, which then subside over time following policy and institutional adjustments? Or, can one establish institutional circumstances and peculiar policies which enhance unethical

behavior, and which do not trigger adequate responses automatically? Can one link the social and economic dynamics of capitalism to apparent shifts in the values that drive entrepreneurs' behaviour? Is the profit motive equivalent to greed – or, to quote Alan Greenspan, "irrational exuberance"? What is the role of norms (formal and informal) in constraining socially irresponsible behavior?

The post-communist transition is replete with cases of corruption and unethical behaviour. The simple explanation points to the institutional weakness of post-communist societies, a precarious functioning of checks and balances and a corrupted judiciary together with a feeble law enforcement capacity. In an optimistic vein, the same reasoning would highlight the advance of structural and institutional reforms, which allow these societies to reduce maligned and unethical behaviour over time. Joining the EU can be viewed according to this upbeat logic. A more broadly defined answer, however, would look at the issue of governance in both the public and the private spheres and scrutinise lessons worldwide, both in rich and poor countries. Alternatively, a pessimistic answer would talk about a "path dependency" and note the persistence of widespread corruption, precarious institutions and malfunctioning markets in large parts of the world. In Southeast Europe, the weak state syndrome and the fragility of institutions, as well as the widespread criminalisation of economic life, should be causes for deep concern.

In transition societies, the prospects of joining the EU have operated as a catalyst for reform and a strong support for dealing with the pains and frustrations of social change. But more than a few citizens are disappointed by the results of reforms, while widespread corruption and unethical behaviour anger much of the population. Some citizens relate these phenomena to market reforms, and this perception is

reflected in the polls. Once the first wave of accession takes place, benefits would accrue to many citizens, but disappointments, too, are likely to become more intense. Such likely outcomes call for a candid discussion about the linkage between values, morality and the dynamic of capitalism, and about what is needed to make it more fulfilling for most of the population. This is why the public debate on effective regulations, enforcement and institutions – which should strengthen the ability of markets to deliver consumer satisfaction and prevent massive social exclusion – has not lost any relevance. The scope of the state in providing public goods should be judged in the same vein, although this role should be judged in conjunction with the need for a streamlined and more efficient public sector, which should not undermine the proficiency of the private sector.

The public debate on ethics and the economy acquires new overtones when looking at the world in light of globalisation. Aside from transnational terrorism, one can point to the dark side of globalisation: inability to cope with global and environmental issues, massive illegal immigration, increasing poverty in many areas of the world and poor functioning of international financial markets. In this context, issues of governance acquire more salience. And governance cannot be dissociated from the values and mindsets of those who make decisions.

The years following the Great Depression brought about new regulations, aimed at restraining excesses and unethical behaviour. An example was the Glass-Steagall Act in the United States, which separated investment banking from commercial banking. Recent scandals in the corporate world call into question the wisdom of the wide deregulation that occurred in the banking industry and in energy markets in the late 90s. Institutional adjustments followed the end of

the Second World War as well. History seems to indicate a cycle of policies and institutional adjustments following large economic dynamics. It may be that after the "deregulation euphoria" which featured so highly on the agenda of governments, a new phase is about to set in. This phase would underline the need for effective market regulations and a more enlightened co-operation between the public and the private sphere.

This logic would have to apply to the international economy as well, which needs public goods and demands reshaped international institutions capable of ensuring global governance. These challenges cannot be dealt with unless economic rationality blends with social and moral values. The lessons are particularly valid in transition societies, where the issues of governance and social responsibility – in both the public and private spheres – are very acute.

.Setimes 23.12.2002

## WHICH GLOBALISATION IS THE WAY?

There can hardly be a concept in international life that has triggered more controversy in recent years than globalisation. Some, particularly in the rich countries, see it as a *deus ex machina* for doing away with misery and conflict in the world. Others, especially in the poor countries, see it at the roots of mounting tensions in the world. Why is it so? What lies behind this stark cognitive dissonance? There are two ways of looking at the dispute: one is to scrutinise facts which, directly or indirectly, rightly or wrongly, are related to *globalisation*; another is to examine the concept itself, its very content.

Facts give highly conflicting signals. Technological change has reduced transportation and transaction (information) costs and speeded up the transfer of know-how, albeit in a highly skewed manner, among regions of the world; the internet connects hundreds of millions of people instantaneously; world trade has expanded tremendously and broadened the scope of choice for individuals throughout the world. The collapse of communism has expanded the work of market forces and democracy in a large area of the world. And the very dynamic of the EU can be seen as an alter ego of globalisation on a regional scale. At the same time, the distribution of wealth in the world seems to be more unequal nowadays than 20 years ago; the myth of the "new economy" has dissipated and corporate scandals in the affluent world show that cronyism and bad governance are a more complex phenomenon than is usually assumed and ascribed geographically; financial and currency crises have been recurrent in emerging markets and have produced economic and social havoc in not a few countries; trade liberalisation has primarily favoured rich countries, which preach what they do not practice; social fragmentation and exclusion have been rising both in rich and in poor countries; there is a sense of disorder and a rising tide of discontent and frustration in many parts of the world; nonconventional threats, the use of mass destruction in particular, are looming menacingly.

Arguably, to make sense of the facts is to look at the conceptual underpinnings of globalisation. And here there is an interpretation of globalisation which is pretty much overloaded ideologically. Let's be more explicit. The last couple of decades have clearly been dominated by a paradigm, one which has extolled the virtues of unbridled markets, privatisation and extreme downsizing of the public sector (state intervention in the economy); this philosophy has widened to international markets – finance and trade –

and the IFIs have often championed it. The way the IMF pushed emerging countries into opening their capital accounts during the 90s is a glamorous illustration of this approach. Another example is the way energy markets were "liberalised" in emerging economies without proper regulations, which should protect consumers. This paradigm has retreated somewhat in recent years, following disappointing economic performances around the world and the nefarious functioning of financial markets. But its resilience is powerful and visible even in how it shapes the language used by the media.

Globalisation can be understood in a different vein, which looks at the functioning of real markets - with their pros and cons – and which takes into account insights of advanced economic theory such as informational asymmetries, increasing returns (while technological progress is intense), agglomeration effects (clusters), multiple (bad) equilibria, the role of economic geography, and so on. The salient lessons are obvious: the need for effective regulation of markets; the role of the state in providing public goods; the role of institutions (structures of governance); the need of public goods and good governance in the world economy; the importance of *variety* and policy ownership in policy-making. To some, this interpretation may sow seeds of confusion. But, in this way, one can dispel a biased interpretation of globalisation. Moreover, globalisation would no longer be assigned an ideological mantra and one-sided policy implications. Instead, it becomes an open-ended concept, which purports to define the mutual "opening" of societies, under the impetus of technological change and the manifold quest for economic progress. Moreover, it rids itself of a perceived West-centered origin. Such an unconstrained interpretation of globalisation would have major repercussions for national public policies and international politics.

Thus, national public policies could be fairly pragmatic and varied (not succumbing to fundamentalism) and geared towards the traditional goals of economic growth, price stability and social justice. Markets would have to be properly regulated and the state would have to provide essential public goods, which crowd in private output. As the rigged financial and energy markets in the United States have shown, these concerns are valid for rich and poor countries alike. Dani Rodrik, the well-known Harvard University academic, aptly observed that there is no modern economy that does not blend the public and the private spheres. An inference would be that going to the extreme with privatisation could be more than deleterious, which is particularly valid in the case of public utilities.

The international economy is replete with problems that need adequate answers. Financial markets – under the pressure of volatile capital flows – function precariously, and the system needs revision. It appears that one of Keynes' intellectual legacies, enshrined in the Bretton Woods arrangements (namely, that highly volatile capital flows are inimical to trade and prosperity), has not lost relevance. Those who say that it is hard to fetter capital movements in our times make a strong point, but do not solve the issue. The volatility of financial flows imparts a deflationary bias to policies worldwide, enhances trade protectionism and competitive exchange rate devaluations. Ultimately, the international financial system would have to undergo substantive changes in order to avert lethal crises.

*Free trade* cannot benefit poor countries when rich economies heavily subsidise agriculture and use trade barriers whenever they feel "injured"; double talk and hypocrisy make a mockery of the virtues of free trade and give moral ammunition to advocates of *fair trade*. Likewise, diminishing aid to very poor countries is hard to justify when

acknowledging the huge asymmetries in the world. A keen sense of urgency and pragmatic vision would demand a different policy in order to deal with the threats of spreading epidemics, massive illegal migration, abject poverty and environmental disasters – not to mention the scourge of international terrorism. All these challenges make up an agenda which can be assumed by an enlightened interpretation of globalisation.

It was refreshing to listen to Tony Blair's expose in front of the British ambassadors recently. It was heartening to see that a leading Western statesman understands there is a need to *listen* to the rest of the world, to the voices of the disenfranchised; that unilateralism and narrowly defined interests cannot work in a "global society"; that the values of liberty, decency and morality cannot be divorced from a sense of trying to achieve more justice worldwide. To sum up: the war against terror needs a much broader agenda and an enlightened interpretation of globalisation would help to this end.

Setimes 17.02.2003

## IS "UNCONVENTIONAL" ECONOMICS STAGING A COMEBACK?

For a keen observer of macroeconomic policy dynamics worldwide, a sequence of developments provides much room for reflection. Let's consider facts. Interest rates in the United States have reached the lowest level in almost 40 years, with the federal rate reaching 1.25 per cent lately. The justification for this sharp decline (from the level of a couple of years ago) is the need to avoid a prolonged

recession after the burst of the stock market "bubble" and the demise of the so-called "new economy". Otherwise said, monetary policy is seen as a weapon for preventing aggregate demand from falling too much. Moreover, a member of the Federal Reserve System board, Ben Bernanke, made a stunning statement a while ago: against the narrowing down room of maneuver, following the very low level of interest rates, the Federal Reserve System would be ready to intervene to buy US Treasuries as a means of injecting liquidity into the economy. In IMF terminology this would be money printing – strongly discouraged by IFIs throughout the world – in order to combat inflation.

In Japan, where deflation has gripped the economy and interest rates have decreased to practically zero for years now, some reason along similar lines. They envisage defeating what Keynes, probably the most influential economist of the 20th century, called the *liquidity trap*; they contemplate the Bank of Japan resorting to inflation-creation via money printing – by buying government bonds – as a means of reviving consumption and thereby steering the economy out of its long stagnation. The European Central Bank, too, seems to be giving up its ultra-orthodox stance and cautiousness regarding the persistent sluggishness of the European economy. Recently, the ECB cut its key rate to 2.5 per cent; other cuts are expected this year.

The rate cut of the ECB has occurred at a time when the strictures of the Financial Stability Pact are taking a severe toll on some of the largest European economies, which can hardly cope with the 3 per cent budget deficit limit. Consequently, there is some talk of reviewing and possibly adapting the Pact to the reality of slow economic motion in the EU. One can detect here the attempt to combine a more relaxed monetary policy with a budget stimulus for the sake of stimulating economic activity. This, basically, is the logic of Keynesian economics, which says

that governments have a role to play in macro-economic management through policy tools: monetary exchange rate and budget policy.

Meanwhile, the Bush Administration has announced a budget for this year and estimates for 2004. These are reminiscent of the Reagan years, a time when budget deficits ballooned. As a matter of fact, a heavy dose of Keynesian economics can be seen in this budget, although one can harbor serious qualms about its fine print and sustainability. The IMF has backed down from its push for capital account opening worldwide, in the aftermath of financial and currency crises. Exchange rate competitive devaluations are also being attempted around the world, and trade disputes are coming increasingly into the limelight. Interestingly, bailouts have taken place in some industries (both in the United States and in EU member countries) when national security considerations seem to have gotten the upper hand.

There are several ways to interpret the policy developments mentioned above, which are quite surprising in view of the dominant paradigm of the last two decades. This (neo-liberal) paradigm extolled the virtues of low budget deficits (balanced budgets), low inflation, no interference of government in managing the economy, full privatisation and so on. I would note, first, that inflation is at a very low level in both the United States and in Europe, a fact that annuls much of the fear of using inappropriate monetary policy counter-cyclically. Secondly, balanced budgets should be examined over the cycle, which may give governments some leeway in tolerating temporary higher deficits. It is true, however, that the sustainability of budget deficits should be of concern; it is good that debate is taking place in both the United States and in EU member countries. Last but not least, paradigmatic fundamentalism seems to be on the retreat; people, both in policy-making circles and in academia, realise that intellectual bigotry is not of much help

in the real world, that market economies need effective regulations (a fact which was amply proved by financial, energy markets and corporate scandals), that governments have a role to play in economic life when it comes to providing public goods – including effective regulations. This would be the rationale for the comeback of policy measures which some would view as "unconventional". These measures, on the one hand, do not mean giving up the ABC of sound economics; on the other hand, they connote the need for policy to vary, according to circumstances.

How should this return of "unconventional" economics be interpreted in transition economies? Clearly, where inflation is still high, implementing lax monetary policy would be counterproductive; inflation would creep up again and bring about instability. Likewise, where quasi-fiscal deficits are high and financial discipline is low, higher budget deficits would strain credit markets and maintain high interest rates, crippling firms. Exchange rate depreciation would also stimulate inflation wherever macroeconomic stability is fragile and inflationary expectations are not favorable. The bottom line is: transition economies need solid institutions and a good economic performance track record in order to experiment, relatively safely, with "unconventional" policy measures. But some flexibility and autonomy of macroeconomic policy is quite useful in order to deal with powerful adverse shocks. If macroeconomic conditions do not provide much room for macroeconomic policy variation, other instruments can be used more flexibly. I am referring to trade policy, which needs to be more in tune with the reality of asymmetries in the world economy. Frequently, what is preached by powerful economies is not practiced; the opening of the capital account should be undertaken with prudence, and only when institutions are solid and the economy is more or less stable; privatisation should go hand in hand with effective measures of enforcing

competition. In case public utilities are privatised (whether totally or partially), these operations should not be done blindly, without regard to the prices end users would have to pay, for governments have a moral and fiduciary obligation to preserve wide access to public goods for their citizens.

Setimes 7.04.2003

### **WILL DEVELOPMENTAL ECONOMICS STAGE A COMEBACK?**

The basic rules of the economic game which underlie the sound functioning of economies can hardly be questioned. Free prices and competition are essential for proper resource allocation; there is a need for clearly defined and protected property rights in order to foster entrepreneurship and commercial transactions; hard budget constraints need to operate ubiquitously in order to have financial stability; over the longer term low budget deficits are better than large ones; money printing is bad for monetary stability. At the same time, however, intellectual bigotry and doctrinal fundamentalism are detrimental to good policymaking, which needs to be pragmatic and not skewed towards vested interests.

With a new millenium now under way, the jury is still out on several central issues which have divided economists over the decades. This ambiguity should trigger a more candid debate among policymakers and government advisers. Let me single out some of the central issues which concern the situation of the developing world, in particular:

Although free trade is deemed desirable by most economists, the existence of large asymmetries and dynamic

effects provide a rationale for developing countries to seek some protection; some distinguish between free and fair trade. As Dani Rodrik put it, free trade is not always conducive to economic growth. The failure of the recent trade talks in Cancun is a stark reminder of this reality, which relates to the discrepancy between what rich countries preach and what they practice (the case of agriculture subsidies is notorious).

Free capital flows have been revealed to be quite threatening for emerging markets. The IMF no longer recommends the opening of the capital account, as it used to a decade ago, unless proper regulatory and institutional prerequisites exist.

There is renewed interest in market co-ordination failures and an acknowledgment that a rationale exists for public intervention in the economy in this respect. The proliferation of financial and currency crises, as well as gross irregularities in the functioning of other markets (energy trading, for example), make a compelling case for strengthening regulatory frameworks and law enforcement by the state (some would say that a "market-oriented regulatory state" gets an increasing profile).

The role of government in providing public goods is undeniable. In addition, some would argue that fostering industrial and technological development is also part of the government's role. The EU's Eureka programme, as well as a series of defence programmes in the United States, can be described as examples of industrial policy.

Fiscal neutralism, if taken to the extreme, can be deceptive in a world of large asymmetries. There are numerous examples of advanced and emerging economies which use fiscal devices cleverly, in order to promote national economic goals; such devices can be used in order to foster domestic savings.

Who is accountable for the provision of public goods in the world economy? Do major economies have a moral and operational responsibility in this respect, including the co-ordination of various policies in order to avert bad equilibria in the world economy?

While underscoring the pre-eminence of markets in resource allocation and rewarding of entrepreneurship, economists continue to debate the economic role of governments. This debate has been fueled by theoretical insights brought about by the "New Theories" (as Robert Gilpin refers to them): the theory of multiple equilibria, which posits the possibility of persistent bad equilibria; the theory of *endogenous growth*, which undermines some of the basic constructs of neoclassical economics (such as "the law of diminishing returns"); the thesis of "path dependency" (the role of history), the importance of geography; the role of information costs and asymmetries; and the role of *clusters* in achieving competitive advantages (Michael Porter's use of clusters in explaining competitive advantages reminds Gunnar Myrdal's concept of cumulative causation), etc.

The New Theories rely on, and bring back to the limelight, theses of the old development economics. Albert Hirschman, Paul Rosenstein Rodan, Ragnar Nurkse, Gunnar Myrdal, Harvey Leibenstein, and others highlighted the role of institutions and structural features of poor countries, which keep them hostage to various types of traps. That suggests a need for development assistance – or what Rodan termed as the "Big Push" in a famous article written in 1943.

To sum up, the current debate on development economics has rediscovered several of its old issues. In this context, it re-emphasises the existence of externalities, multiple equilibria, bad path-dependencies, vicious circles and "underdevelopment traps", all of which pose numerous challenges to public policy. It is increasingly obvious that

public policy (at the national and the international level), while it has a role to play in order to address government failures, also needs to address market co-ordination failures. In this context, one needs to underline the importance of good institutions and proper structures for public and corporate governance, which condition the overall performance of the economy. The wide variety of economic performance in transition (post-communist) countries must be related to the different functioning of institutional set-ups and policy diversity.

It may be that we are on the verge of a new age of development economics, seen against the backdrop of the very disappointing record of economic advancement in most of the developing world (excluding China and parts of India), transition failures in many post-communist countries, and the backlash against "unmanaged" globalisation. Olivier Blanchard, Paul Krugman, Dani Rodrik, Joseph Stiglitz, and others form a remarkable platoon of brilliant economists, capable of injecting more realism and creativity into development policymaking.

Setimes 20.10.2003

## **ECONOMIC POLICY: THE END OF IDEOLOGY?**

The past decade has been suffused with claims that economic policy, in the advanced countries, is being driven by an emerging new consensus on principles and practice. In the UK, the reinvented Labour Party has adopted Anthony Giddens' "Third Way" as its mantra. During the 1990s,

highly glamorous seminars featuring Bill Clinton, Tony Blair, Gerhard Schroeder, Lionel Jospin and others attempted to explore the terrain between traditional social democracy and unrestrained liberalism. George W. Bush's presidential bid may have been helped by his choice of "compassionate conservatism" as a campaign slogan. It has appeared as though Social Democrats (in Europe), Democrats (in the United States), center right parties (in Europe) and Republicans (in the United States) were coming closer, both in principles and in economic policy.

What are the sources of this apparent new consensus? Arguably, there are several. Broadly speaking, it can be traced to our ongoing desire to gain control over our environment, particularly through greater efficiency. During the first quarter of the past century, Max Weber's "rationalisation of life" meant rational accounting, rational law, and rational technology; the same principle can be extrapolated to "rational economics" as a form of hard science. In the 1970s, another famous sociologist, Daniel Bell, upheld the primacy of knowledge and theory-related activities in ordering our life and fostering man's technological and economic ascendancy – implying that economic wizards could secure a foolproof policy.

Even the clash between Keynesianism and monetarism, as the two main competing macroeconomic paradigms, could be seen in the light of searching for the ultimate piece of wisdom. Another origin of policy amalgamation is the death of communism. Francis Fukuyama's "End of History" was presumably seen by many as an embodiment of the single ideology (liberal democracy), which was meant to rule the world. Last, but not least, globalisation – as an incarnation of unfettered markets and the downsizing of government, operating worldwide – also provided an impetus to the vision of an "ideal" type of economic policy.

At the start of the new century, facts are disavowing oversimplifications. There are numerous examples which demonstrate that conflicting ideas matter a lot, that reality cannot be encapsulated into a procrustean ideological bed; and that economics continues to be softer than some of us try to make people believe. Let's be more specific. Policy-wise, it is increasingly clear that trimming the welfare state and the public sector is not sufficient to achieve the expected efficiency gains; this endeavour needs to be accompanied by effective regulations of various markets (financial and energy, in particular), which otherwise can easily be rigged. The "new economy" paradigm (which claimed to combine high growth rates with very low unemployment) proved to be, simply put, a mirage of the 1990s. The developments of the last couple of years in the United States and elsewhere offer ample proofs in this regard, motivating public authorities to initiate the Sarbanes-Oxley Act. Likewise, contrary to the prevailing tenets of not many years ago, economic policy, as it is currently undertaken in the United States and Europe, does not preclude running larger budget deficits during a downswing of the cycle. This is the explanation behind the return of some basic Keynesian recipes to the limelight. It should be said, nonetheless, that while Keynesian macroeconomics seems to be enjoying a higher profile nowadays, the EU member countries are simultaneously trying to make their markets (labour, products, services, financial) more flexible.

How does globalisation fit into this picture? The pressure of more intense competition forces governments to streamline their public sectors, which frustrates trade unions and many citizens at large. But rich countries, in the West, remain welfare states *par excellence*, albeit in an evolving manner. One can detect here a rising or returning Keynesianism in macroeconomic policy-making, combined

with a retreat when it comes to social policy; the result is an apparent policy contradiction. Another consequence of globalisation is the creation of an international policy agenda. By omission and commission, some of the wealthy countries' less-inspired policies have given a renewed high profile to issues such as fair versus free trade; dealing with abject poverty in the world; protecting the environment as a public good for mankind; the code of conduct for international corporations, managing contagion effects in the world economy; and policy co-ordination among the leading economies of the world.

In fact, the traditional ongoing battle between left and right – within the framework of democratic politics – is being shifted partially onto the international arena. The debate on global governance (that is, on institutions and policies) reflects a growing awareness that there are issues that need to be addressed internationally, in a multilateral context and using collaborative approaches. Arguably, the choice between globalisation and "managed globalisation" is between accepting the effects of completely free markets – with total policy disregard for market failures and their social consequences – and trying to construct an international policy, which should address or prevent massive coordination failures. The debate over the most desirable form of capitalism, and the most effective type of state intervention in the economy, partially turns into a debate over contrasting forms of "global capitalism".

The second policy route makes sense in a global economy, in which there is acceptance of the need for international public goods. Otherwise, under increasing pressure from foreign markets and other threats (including terrorism, illegal immigration and spreading diseases), governments would resort to national means of protection – such as trade protectionism, trade clashes and competitive devaluations.

Ideology is not dead. It shapes social and economic policies – although in subtler forms and following cyclical patterns. It may be less often felt nationally to the extent that the battlefield of ideas expands increasingly beyond national borders. In any case, globalisation is likely to reflect more and more the battle of ideas, with traditional politics delving increasingly into the international domain. How policymakers address the hot issues in the international economy will provide clues regarding its dynamics.

Setimes -27.10.2003

## **WHO FEARS OUTSOURCING AND OFF-SHORING?**

The pros and cons of outsourcing and offshoring have become the subject of vigorous debate in many countries. Many economists believe a combination of factors – including high educational levels, low local wages and good governance – are necessary for countries to capitalise fully on the advantages of a global economy. Southeast European countries are well-positioned in terms of skills and wages, but will need wise public policies in order to reap the benefits of outsourcing within Europe.

Recent years have witnessed a rising choir of disquiet in advanced countries as to the impact of global trade on their economies. In the United States, leading politicians from both major parties have objected to what they perceive as multiplying runaway jobs due to outsourcing and offshoring. The concerns are even more acute in Western Europe; several French and German ministers have made

public their worries about industrial relocation. Former French Finance Minister Nicolas Sarkozy and German Economy Minister Wolfgang Clement have been especially vocal. They have not hesitated to blame new EU member states for allegedly practicing unfair competition via lower taxes. How has it come about that advanced economies, which have traditionally been staunch supporters of free trade, seem to be having second thoughts?

Traditionally, the less benign side of global free trade has been ascribed to its effects on countries that either cannot make the best use of their comparative advantages, or that face stiff protectionism from wealthy economies in certain domains – for example, farm products. In general, such economies are to be found in the developing world, where poor governance and the inability to absorb new technologies are widespread. This state of affairs led Harvard economist Dani Rodrik to remark that free trade is not necessarily welfare-enhancing for poor economies.

There are both theoretical and realistic reasons for this apparent partial turnaround in the public rhetoric coming from affluent countries. In terms of economics, the arguments that stress the virtues of free trade form the basis for rationalising commercial exchanges among countries; nonetheless, these arguments lose some of their power and appeal when the distribution of gains is largely asymmetrical and dynamic competitive advantages dominate. Years ago, Paul Krugman and Elhanan Helpman wrote seminal pieces on what they called "strategic trade". One can posit that the economic rise of Asian economies (and most impressively that of China over the last couple of decades) is to be judged through such policy lenses – namely, through strategic trade policy, which was embedded into a sort of development-focused industrial policy by using market forces in a smart way.

Nowadays, the new information and communication technologies (ICT) bring about great opportunities for developing economies, to the benefit especially of well-educated people. Again, Asian countries fare quite well in this respect. The "India unbound" of the last decade is the outcome of market-oriented reforms, taking place amid a vast pool of English-speaking engineers and computer/software specialists. At the same time, only some parts of India have been touched by rapid economic progress, and much of the country is still mired in abject poverty.

What matters in the global economic game is the existence of substantial wage differentials among countries and regions. It is this factor which drives industrial relocation, as globally-oriented companies shift operations to areas which combine cheap labour with adequate technologies. The intensity of this process depends both on the wage differentials and the quality of other production factors. Leading mainstream trade economists, such as Jagdish Bhagwati, argue that advanced economies have little to fear, since they specialise increasingly in higher value-added products and services; all countries, therefore, will be better off in the end. This argument, however, has been disputed recently by Paul Samuelson of MIT; writing in the *Journal of Economic Perspectives*, he suggests that "sometimes a productivity gain in one country can benefit that country alone, while permanently hurting the other country by reducing the gains from trade that are possible between the two countries". Samuelson goes on to argue that "post-2000 outsourcing is just what ought to have been predictable as far back as 1950", since it is the result of other economies around the world assimilating advanced technologies and catching up with the United States.

Against a backdrop of new ICTs and global wage differentials, major shifts in the distribution of industrial and

service activities are probably unavoidable. Moreover, some leading industrial economies do not appear to be keeping pace sufficiently with this process as far as restructuring is concerned; the lag harms some of their labour segments, and puts pressure on real wages. As a result, anxiety about outsourcing and offshoring develops. It is easy to understand why such anxiety exists in Western Europe, where wages are a large multiple of what well-educated Eastern and Central European workers earn. Although framed in global rather than continental terms, the Lisbon Agenda was a product of this fear. The big EU member countries primarily worry about Asia and the US economy, and regard the Lisbon Agenda as a competitiveness policy response.

The fear of outsourcing and offshoring can be seen as analogous to the deep transformation depression of the last decade in post-communist economies. These went through a dramatic fall of output because resource reallocation – at the new market clearing prices – could not happen rapidly enough. Similar pains can be detected nowadays among some groups of workers in rich economies, who cannot compete in the new global economy, while policymakers react one way or another. Protectionist measures in various countries complicate the situation further.

The bottom line is that countries with a highly-educated population, a substantial level of investment in education and forward-looking public policies are the most likely to enjoy the fruits of technology dissemination on a global scale. Because Central and Eastern European countries have comparatively well-educated populations and low local wages, they stand to benefit greatly from outsourcing within Europe. But they will need intelligent public policies in order to make the most of this opportunity.

**Setimes 31.01.2005**

## **OIL PRICES, EMERGING ECONOMIES RESHAPE GLOBAL PICTURE**

Economists differ when it comes to interpreting the significance of rising oil prices, which in real terms are approaching those which triggered the stagflation of the 1970s. Optimists suggest that market balance will be restored once supply side problems – including bottlenecks in refining capacity – are resolved. Others, factoring in the economic ascendancy of China and India, increased competition for resources and the threat of global warming, see a more complicated picture. In the past, the more pessimistic scenarios have been partly invalidated by technological advances and the operation of market forces. Will that be the case again? A collision of issues – economic, political, strategic, and ecological – suggests that policymakers should not be complacent.

When the oil price went above \$50 per barrel, the world started to worry. When it reached \$70 per barrel in September – subsequently slipping down to between \$60 and \$65 – analysts began looking carefully at the next threshold.

The reason is clear: in real terms. \$80 per barrel is equivalent to the price level which triggered stagflation in the Western economies several decades ago. At that time, Arab oil-producing countries used this strategic commodity as an economic and political weapon; in several rounds, the oil price escalated to over \$40 per barrel. The price meant a drastic and considerable change of the terms of trade between the oil exporting and importing countries.

Wealthy, industrialised countries absorbed the oil price shock through economic slowdown (even recession) and heavy monetisation of their surging budget deficits. Over time, the rise in the price of industrial products compensated

for the new price of oil. The combination of recession and high inflation – close to 20 per cent just before the advent of Paul Volcker at the helm of the Federal Reserve – confounded not a few macroeconomists; they had a hard time in accepting that massive under utilisation of resources can cohabit with a much quicker pace of inflation. Consequently, the conventional paradigm had to be extended to take into account the scenario in which a powerful supply-side shock overpowers the ability of the economy to undergo a smooth and fast reallocation of resources, as a means to absorb that shock. In this case, recession combined with higher inflation becomes inevitable.

Arguably, the Western economies experienced a shock which, decades later, was to be felt on a much grander scale by post-communist economies. Whereas the West had to deal with a brutal change in the terms of trade for a strategic commodity, post-communist economies had to deal with the wide-ranging institutional reforms and resource reallocation following the collapse of the Soviet trade bloc. Indeed, Soviet bloc countries were partially insulated at the time of the oil price shock, for they benefited from cheap oil from the former USSR. Poor oil-importing economies were the hardest hit, suffering a double blow: a much higher price of oil, plus gradually rising prices of industrial products.

Today's higher oil prices thus raise a simple question: is the current situation similar to that of several decades ago? On the one hand, refining capacity bottlenecks indicate that there is a supply side problem, which was amplified by the consequences of natural disasters, such as the Katrina and Rita hurricanes. Likewise, oil exploration has not been expanded sufficiently in recent years. The policy implication is that market balance could be restored were these supply constraints eliminated. However, there is one major novelty in the picture: the economic ascendancy of Asia – and

particularly of China and India – creates an additional, growing pressure on the oil and gas market.

The big question, then, is this: What is the potential impact of this new global economic picture on the price dynamic of basic commodities, on which the functioning of modern economies relies?

In a Malthusian, pessimistic scenario, further sharp price rises can be envisaged, with a struggle for the control of key resources. Let us recall the intellectual and policy-related debates after the publication of the Meadows report "The Limits to Growth" – which was commissioned by the Club of Rome more than three decades ago. Likewise the modeling of global dynamics (the Forrester Model, developed by the MIT professor Jay Forrester) was stimulated in order to investigate what was likely to happen in the wake of severe change of circumstances on commodity markets. The Malthusian view was partially invalidated by technological advances and by the operation of market forces, which made the use of alternative energy sources profitable at the new prices. Could we bet again on technology and be complacent? Perhaps, but the answer has to take China and India into account.

The demand side shock is likely to continue, with Asian economies exerting pressure on the oil and gas market in the years to come. Arguably, this alone posts that the price of oil will not be returning to below \$40 a barrel any time soon. Furthermore, although the price hike has been comparatively gradual, it is nevertheless forcing adjustments in consumption and production. Once again, the most severely hit are poor countries, especially those that import energy.

Several implications can be drawn. The competition for the control of oil and gas fields will intensify in the years to come, impacting geopolitical and security related concerns; a

frantic search for new fields will be ushered in; oil and gas will be seen even more as highly strategic commodities and major economies will define external policies accordingly. It is highly probable that the needs of industries to be more competitive will collide with ecological concerns at a time when the effects of global warming are ever more visible and worrying.

Higher oil and gas prices slow down growth and lead to higher core inflation. Hence, major trade-offs for both firms and governments emerge, requiring policy clarity and thorough calculations of costs and benefits. A new thrust for energy conservation is to be expected under the new circumstances. Private and public budgets will be increasingly strained unless measures are enacted soon and implemented consistently over time.

Setimes 3.01.2006

## **THE RACE FOR COMPETITIVENESS**

At a time when US leaders are expressing concerns about staying competitive, data shows that the EU is lagging behind the United States. On the whole, the bloc has not invested adequate amounts in research and development, while productivity growth has been sluggish. Despite the ambitious goals of the Lisbon Agenda, specific steps at implementation have been mired in debate, and much remains in the hands of European national governments. Both the United States and the EU, meanwhile, face a growing challenge from Asian economies; if the prospects are enough to worry US President George W. Bush, then it is surely time for a "wake-up call" in Brussels.

In his most recent State of the Union address, US President George W. Bush touched on competitiveness challenges, voicing concern that the United States risks falling behind in science and technology. For citizens in the EU, this "wake-up call" may have seemed surprising: from a European perspective, the United States appears to be ahead. A 2005 report from Conference Board, a high-profile business organisation, showed that productivity growth in the 15 "old EU" member states was 0.5 per cent, as against 1.8 per cent in the United States (and 1.9 per cent in Japan). For the period 1995-2005, annual growth in national output for every hour worked in the EU-15 averaged 1.4 per cent, compared with 2.4 per cent in the United States.

Likewise, data compiled by the European Commission (EC) in Brussels also suggest the EU lags behind the United States in key areas. Research and Development (R&D), for instance, represented only 1.93 per cent of the bloc's GDP in 2003, as opposed to 2.58 per cent in the United States and 3.15 per cent in Japan. True, there is a broad variety in performance across the EU, with the Nordic countries overtaking the United States in terms of amounts invested in R&D. For Sweden, Finland and Denmark these figures are above 3 per cent. However, the stark truth is that the heavyweights of the EU do not spend nearly as much in this area as the EC thinks would be adequate – namely, 3 per cent of GDP.

The ambitious EC blueprint known as the Lisbon Agenda was formulated with an eye to the performance of US companies and the excellence of the American way of blending academic research with high-tech and industrial pursuits. For instance, the EC proposed setting up a European Institute of Technology, modeled after MIT. The idea was criticised as being a "top-down" approach, sucking money and resources from the alternative option of

supporting high level research through a European Research Council. Indeed, controversies have often arisen over specific measures aimed at implementing the Agenda, and much remains in the hands of European national governments. However, it is clear that the United States represents a kind of benchmark for policymakers, and it is also clear that the EU has been sluggish in achieving its goals in terms of competitiveness. The bottom line is that the bloc faces a growing challenge.

The success of the EU's Nordic fringe has been due not only to major R&D efforts undertaken both by governments and private companies, but also results from flexible product and labour market, as well as a clever overhaul of welfare networks. The newer EU member countries seem to fare comparatively well in terms of productivity growth; the 2005 report of the Conference Board indicates an increase of over 6 per cent in these economies, which have capitalized on their catching up potential. Arguably, however, just catching up isn't enough. Over the longer run, demographics and an expected sharp rise in wages (according to the Balassa-Samuelson effect) will diminish the growth differential sharply, unless appropriate policies are put into effect.

If we are comparing the EU and the United States, then, Bush's concerns might strike some as unjustified. However, there is another factor to be considered: Asia. China, India and other Asian economies are increasingly a source of competitive pressures in the global economy. These economies are absorbing advanced technologies at a rapid pace and excel in innovation – India's remarkable engineering institutes, like those in Bangalore, can match the best in the Western world. Scientists from Asian nations are becoming an ever more noticeable presence in top scientific journals, illustrating the region's potential to shape the research agenda of the future.

When we introduce Asia into the picture, we can see that the United States and the EU both face competitiveness challenges, although the nature of those challenges is somewhat different. For the United States, they appear to be mainly related to global strategic interests, which in turn are affected by the emergence of new global powers. For the EU, they involve worsening demographics and the crises of the welfare state, together with insufficient resources devoted to R&D and the difficulties in managing complexity. There is a common denominator, however: both the United States and the EU will face increasingly stiff competition from Asian economies.

A couple decades ago, global competition was defined in a triangular formation: US-EU-Japan. The picture today cannot be seen so simply. The evolving global economy brings with it new major competitors and a change of competitive hierarchies. Unless governments and companies are clairvoyant and adjust to trends by investing more in R&D and education, painful corrections will be likely in store.

Those who believe that only non-zero games prevail in the world economy do need a "wake up call" to reality. The dramatic changes under way open up the possibility for cooperative relationships, but also for emerging tensions. Consider, for instance, the growing need for energy and basic commodities in Asia, with China and India as the prime consumers, the unsolved geopolitical crises in various parts of the world (in the Middle East in particular), nuclear proliferation, and the visible and hidden aspects of the struggle against terrorism. An array of developing trends points the way to a highly uncertain world ahead.

**Setimes 3.04.2006**

## WHY FAST ECONOMIC GROWTH ISN'T ENOUGH

Conventional wisdom assumes that growth goes hand in hand with political stability. That's not necessarily so.

Recent political developments in Hungary, Slovakia, the Czech Republic and Poland have raised eyebrows among observers worldwide. How can it be that after EU accession domestic politics in these countries has stumbled in such an alarming manner? Instead of a consolidation of democratic politics, the post-accession period has seen fragmented, stalemated governments, coalitions formed by mismatched parties with incompatible philosophies, and in Hungary's case an eruption of political tensions into public anger. The trend is puzzling to many.

It pays to remember, however, that these economies are part of the dynamic area of Europe, with annual economic growth rates that have been many times higher than those in the core of the EU (5-6% vs 1-2%). Conventional wisdom, blending politics and economics, says that wherever economic growth is high, social stability and sound politics have a better chance of prevailing. In the case of Central Europe, a logical inference would be that, owing to significant economic growth in this decade, a large part of the population would enjoy tangible economic fruits and, therefore, support the ruling coalitions.

EU accession was expected to buoy the foundations of these young liberal democracies. And there is another factor to consider. Unlike citizens in most of the EU-15 (Portugal and Spain are exceptions), people in the post-communist countries have lived through the command system. One would expect them to be better able to detect fake democrats and cheap populism, be it on the right or the left. Orderly

democratic life would seem to be more alertly guarded in countries that endured so long without it.

In fact, there is an ongoing debate among economists about the fundamentals of economic growth, and about the relationship between democracy and prosperity. Some argue that growth matters first and foremost, even when it incurs substantial inequities among social partners. Another line of reasoning, however, argues that sustainable economic growth should not impair social cohesion, and that it has to be accompanied by adequate production of public goods. Good practices in both the public and the private sectors, as well as an effective fight against corruption, are key.

The experience of post-communist *Mitteleuropa* suggests that high growth rates, in and of themselves, are not enough to secure a sound social and political life. Arguably, wherever in Central and Eastern Europe numerous citizens have lost out in the economic race or have found themselves marginalised (excluded from the fruits of economic growth), their frustration is likely to be captured by extremist parties and centrist parties lose political ground.

As for the buoying power of EU membership, this was in a sense more effective when the countries involved were hoping to get into the bloc. That hope enabled politicians with differing ideological stances to rally citizens behind the banner of a "return to Europe". More than a few of these citizens saw this "return" as an initiation into a Nirvana-like society, with immense economic benefits. Now people have seen that nothing changed dramatically for the better after May 2004. On the contrary, some additional pains have been brought about by the rigours of complying with the EU regulations.

A wake-up call was unavoidable. It has been amplified by the revival of "economic patriotism" in the major EU member states, a force which seems to contradict the very

principles with the bloc has been so earnest about imposing on would-be members. In order to join the EU, Eastern European countries diligently observed the intellectual and operational matrix of the Union – for instance, the total opening of markets, including those for financial services and public utilities. In these sectors, Eastern Europeans have in fact been much more liberal than their western counterparts. It is easy to comprehend the frustration in some political circles in central Europe when EU heavyweights preach what they do not practice.

Economic nationalism in the West thus spurs economic nationalism in the East. Other issues add fuel to the fire – for example, Poland's fear of Germany and Russia, both of which are working together in the very sensitive field of energy procurement.

The memory of the past is not necessarily an effective antidote to antiliberal sentiments. People enjoy their political liberties and like to voice their satisfactions and frustrations, but it is all too easy to forget how things were when such liberties were non-existent and how that affected their lives. Younger people who have no personal experience with communism do not know what it is like. Their reference points are different. In way that is not too dissimilar, some in the West are oblivious to the second world war and its atrocities, including the Holocaust.

Actual democracy and textbook democracy are two different things. In practice, democracy means the functioning, for better or worse, of checks and balances. The actual state of democracy hinges greatly on the morality and sense of accountability of political leaders, which can be dismaying under certain conditions. It is for this reason that some talk about a democracy deficit in EU member countries and a shortage of responsible politicians, of true statesmanship. More than a few myths and clichés are fading

away in the "New Europe", and individual and group psychologies react one way or another.

Eastern European societies are much less prosperous than their western EU partners. At the same time they are facing similar structural challenges: aging, the crisis of the welfare system, identity-related confusion, and a rising pressure of immigration. High economic growth is not a panacea. It will not forestall a political reaction if governments prove incapable of dealing with the social challenges that accompany modernisation, against the background of globalisation. There are no easy solutions, and national politicians will be severely tested in this respect in the years to come. What they do will influence domestic politics and their countries' economies greatly.

Moreover, what is happening in Central Europe should sound warning bells when it comes to the Balkans. SEE countries are also making the transition from communism, with all of the hopes and disappointments this entails. Economic woes, including unemployment, are substantial. "Enlargement fatigue" and other barriers have made the prospect of EU entry remote for some countries in the region. They face the same pressures that have fostered instability in Central Europe, but with less of an anchor to keep them on a steady course.

Setimes 6.11.2006

## THE SOUL OF CAPITALISM

The free market system, driven as it is by the profit motive, is sometimes portrayed as being intrinsically valueless and amoral. Yet there is a strong tradition that links

capitalism to ethical behavior, seeing the latter both as a check on excesses and as necessity for achieving success in the marketplace. It is sometimes forgotten that Adam Smith, widely regarded as the father of economics, also authored "The Theory of Moral Sentiments", and that Max Weber, the famous sociologist, connected hard work and moral values with the advance of capitalism in the western world.

In the wake of the Enron, Worldcom, Parmalat and other scandals, renewed attention was paid to the ethical underpinnings of a sound market economy. In Romania, too, a series of business scandals – linked with privatization deals and the regulation of markets – have captured the attention of the Romanian public. Evidence of shady dealing and other malfeasance has angered many people, leading some to suggest that Romanians as a whole are hesitant about embracing capitalism. This line of reasoning, however, is one-sided, over-simplistic and misleading. It is one thing to suggest that people crave a more decent form of capitalism, and quite another to say they disdain capitalism altogether.

Capitalism's undeniable virtues enabled it to win the ideological battle with communism and the command system. In terms of resource allocation, market-set prices and the ability to calculate costs and benefits transparently, a market economy has clearcut advantages. But there is more to the story. Capitalism cultivates a particular virtue: entrepreneurship. As industrious as managers and policymakers may be, it is often a different figure – the entrepreneur – who is best able to identify major new opportunities and capitalise on them.

Hayek, Kirszner, Rothbard, Schumpeter and the Austrian School in general have made an essential contribution to explaining the role of entrepreneurship in economic development. Without entrepreneurs and their blend of visionary and practical thinking, progress would be

much slower. Consider what Bill Gates has meant in the history of Microsoft Corporation and even the IT industry as a whole, or the way a team of gifted managers at Nokia have turned the Finnish firm into a star of the world telecommunications industry.

However, such figures share the marketplace with far less honourable sorts. And capitalism itself comes in a variety of forms, not all exemplary. In many Latin American countries, for instance, it has been accompanied by oligarchs, extreme income polarisation, civil unrest and occasional outright warfare, as well as frequent breaches of civil liberties. In Asia, a statist form of capitalism puts its imprint on domestic politics, which typically has an authoritarian bent. When people idealize capitalism, they usually do so with reference to the "liberal democracies" – the United States, the EU, Canada, Australia, New Zealand. But even the liberal democracies are not monolithic. Some have made a plausible distinction between the so-called Anglo-Saxon model and a "continental" model. The former is more liberal in the European sense, while the latter is more attentive to social issues.

Moreover, capitalism evolves. More precisely, individual and group rationality – which refers to *capacity to learn* – affects behavior, organisational life and policy. For instance, some now criticise the harshness of the Sarbanes-Oxley legislation – the Public Company Accounting Reform and Investor Protection Act of 2002 – because of what it may entail for competing in the global economy. On the other hand, such legislation was demanded by an outraged American public, in response to the inadequate functioning of financial and energy markets, not to mention numerous conflicts of interest and abuses of power. The Great Depression, too, necessitated the introduction of strict measures in order to rescue capitalism from its own perils.

Unbridled market forces can bring about havoc and misery to too many people and public policy has a role to play to avert it.

A simple dichotomy between capitalism and communism may have made sense in 1989, but is far from meaningful now. Rather, the significant question today concerns what forms of capitalism are evolving in Central and Eastern Europe, and in other areas of the world. EU entry does not give a clearly defined answer to this question. The degree to which laws are observed and markets function in EU member states is of continuing relevance. The business world has rules of decent conduct. Without such rules business would turn into a jungle. When rent-seeking and corruption are ubiquitous, when politicians and judges can be easily bought, economy and domestic politics become rotten. This is not the type of capitalism that can make the majority of citizens happy and dignified. I prefer the capitalism of Bill Gates to that of Michael Milken and Ivan Boesky.

The need in the EU to cope with the pressures of globalisation and demographics is not a reason to dismiss morality and the need for mutual respect. In an enlarged Europe we need a capitalism that performs economically and socially. For this to happen, the liberty of markets has to be accompanied by the rule of law, which should punish those who are careless about and disrespectful of public interest.

An overbloated and corrupt public sector must be combated fiercely, and there is still much to do in the new EU member countries to this end. At the same time, one should not close their eyes to wrongdoing in the private sector as well. In order to be embraced wholeheartedly by citizens, a market economy requires a moral compass. Profit seeking is the essence of a market economy, and without efficiency progress is unimaginable. But when values and a

sense of direction are lost, social cohesion melts and the system breaks down. It is the responsibility of public policy to try and correct malignities that affect the functioning of markets and to deal with the social fallout of greed, lack of honesty and cynicism. A decent capitalism requires such policymaking, just as it requires the virtues found in individual beings as they strive in pursuit of happiness and material rewards.

**Setimes 2.01.2007**

PART II  
**WHICH WAY GOES  
THE EUROPEAN UNION**

## **THE EU'S BIGGEST CHALLENGE: MANAGING RISING COMPLEXITY**

The recent EU summit in Thessaloniki reaffirmed the Union's decision to admit ten new members next year, and sent an additional signal to countries in the Western Balkans that they eventually would join as well. The summit was also important because of its attempt to define more clearly a common stance in the areas of defence and security, at a time when the relationship with the United States needs to be strengthened to meet the threats of the 21st century effectively. Geopolitical and security concerns have been very much at the forefront of the Union's agenda in recent years, and the next wave of enlargement is being viewed in this context. It would be a mistake, however, to overlook the most serious challenge facing the Union: how to manage its increasing complexity.

There are several ways of defining rising complexity. One way is in terms of the Union's geographic expansion – not a trivial development when it involves added arrears, which evince specific institutional traits and large gaps in economic development. During its next wave of enlargement, the Union – in a sort of big bang approach – will take in a cluster of nations which have, on average, per capita incomes that are significantly lower than the EU average. An analogy with the accession of Portugal and Spain decades ago is instructive, but of limited value. Both of those countries benefited from a large array of lasting derogations from EU rules, allowing them to catch up

economically, and their accession occurred in a period of increasing well-being for the EU member economies. But derogations are restricted now, and the economic state of the EU is under considerable strain. Moreover, "reverse derogations" are being put in place, such as restrictions on labour movements from new to old EU member states.

For this reason, EU expansion raises a series of questions related to the Common Agricultural Policy (CAP) and to structural and cohesion funds. It is true that CAP reform appears to be on the brink of a breakthrough – in the sense of delinking production of subsidies – but much still has to be done.

The wider economic disparities in the enlarged Union give a higher profile to the challenge of convergence, both real and nominal. It is not clear that structural and cohesion funds alone are capable of reducing these disparities, so that common policies can be effective. There are two salient aspects to the question. One has to do with the impact of large discrepancies on the functioning of the Union, when some markets – labour markets, for example – show significant rigidities. Another issue is that of dissimilar economic conditions among EU member countries, which may require differentiated policy responses. These, however, are much less feasible because of the single currency and common monetary policy. The current pains several large economies are experiencing in meeting the Financial Stability and Growth Pact are quite telling. Arguably, such difficulties are not simply rooted in the effects of the business cycle, and may not be alleviated by fiscal harmonisation.

The aspirant countries need to grow economically in order to meet the demands of their populations and to help the Union function smoothly. Most of them, in fact, do have important assets, such as a vast pool of highly skilled and comparatively inexpensive labour, relatively good educational systems and geographic proximity to their main

markets. These assets provide cause for optimism. But the strictures of the Maastricht criteria (which concern the level of inflation and interest rates, the size of budget deficits and overall public debt) may be too constraining when it comes to achieving higher growth rates as the means to catch up economically; too low targeted inflation rates would likely impair growth in economies where significant productivity gains in the tradeable sectors would push up the prices of non-tradeable goods too far. One can hypothesise differently and argue that sound macroeconomics and markets which are more flexible than those in the "old" part of the EU might provide a competitive edge to the new members, allowing them to cope with the inflationary pressure entailed by the advance of prices in the non-tradeable sector. But is it a sure bet?

The EU needs substantially more convergence, nominal and real, so that its "heightened variety" following enlargement does not diminish its overall economic and related political performance. Rising complexity does not necessarily involve less homogeneity and convergence. But as things stand currently, this is an open question which needs to be addressed by policy and institutional reforms. These reforms bear not only on the economic prospects of the current members of the Union but also on those of aspirant countries. For instance, Bulgaria and Romania have their own very complicated and demanding reform agendas, both institutional and economic. And they have to move forward with these reforms resolutely so that their prospects for joining the EU are not harmed. At the same time, the way the Union manages its rising complexity is likely to play an increasing role in the years to come, in terms of enhancing or hindering the accession chances of the two countries.

Political and geopolitical concerns appear to have driven enlargement more than economic ones have. Undoubtedly, enlargement brings about its own economic

benefits. But unless properly managed and bolstered by internal EU reforms (CAP, competition policy, the pension systems, etc.), enlargement could fuel tensions among member countries and decrease the likelihood of admitting other aspirant countries. There are so many stakes involved in adequately managing the Union's rising complexity that failure to do so would prove a terrible blow to all European countries, whether "in" or "out" of the club. But it must also be acknowledged that such management is a very tall order.

Setimes 4.08.2003

### **IS THE EUROPEAN MODEL SUSTAINABLE?**

Recently, I sat on a panel that discussed whether or not the "European Model" is sustainable. The debate was not a pure intellectual exercise, since this model – assuming it can be said to exist – influences policymaking both within and outside the EU. The entire project of the EU, according to politicians, is aimed at giving a special economic and social meaning to European societies, one that goes beyond the quest for international competitiveness.

While the claim in favour of the existence of such a model has its merits, it is not indisputable. On the one hand, one can find features of capitalism in Europe that are distinctly different from what is generally called the Anglo-Saxon variant, as well as from the type encountered in Asian affluent societies. On the other hand, the welfare state, although in a varied form, is a ubiquitous trait of advanced capitalism worldwide. Moreover, some convergence among the patterns of functioning of capitalism has taken place in the last couple of decades under the spell of globalisation.

Significant social and economic variety exists inside Europe. People differentiate between a Scandinavian model (with its emphasis on social redistribution), the British model (which is closer to the American model), and a Mediterranean model, which seems to be of a more "disorderly" sort – although the bulging budget deficits in Germany and France have cast some doubt on this assessment. Some analysts point at the EU aspirant countries from Central and Eastern Europe as examples of a more liberal (in the European sense) form of capitalism. So where does that leave us with regard to the European model?

To answer the question posed above, I would argue, one should not underestimate the influence of EU construction as a process of depth and large scope. The EU project can be considered along at least two lines. One line is rooted in the construction itself, which aims at spreading common standards throughout the Union and imposing common rules of policymaking and institutional set-ups. I would mention here the Social Charta, which is an attempt to make the social dimension of the Union more uniform.

At the same time, the EU project – mired in the throes and policy dilemmas and trade-offs of enlargement and deepening – faces the challenge of managing increasing complexity. The Union increasingly assumes a common denominator in various social and economic areas. But it is strained by a highly visible contradiction between its well-entrenched social model and the need to make markets more flexible. This contradiction would not be so acutely felt in the absence of tremendous pressures exerted by globalisation and by the competition from low-wage economies (including Eastern European neighbouring countries).

Globalisation, and particularly the liberalisation of finance and trade, undermines the lavish welfare state in Western Europe. Social assistance is trimmed down by

necessity and pension systems are being overhauled. This painful and politically very sensitive undertaking is taking place against the background of population ageing, which is an underlying demographic dynamic in Europe and elsewhere.

In general, European citizens are being asked by their governments to rely more on themselves and to ask less from the state. Although globalisation has a non-trivial ideological component, the forces at work have acquired a powerful momentum of their own, which is driven by technological change and intensified competition. The latter can be restrained by bouts of protectionism (in trade and competitive devaluations) and security concerns, but its power currently seems to be unassailed. What lies in the more remote future depends on many social, economic and political variables, and history has some relevance in this regard. It is instructive to recall what followed the Victorian period of the 19th century, which is considered by many historians as epitomising liberalisation at the high end, including the free flow of labour.

Arguably, globalisation increasingly shifts the ideological confrontation between left and right in democratic societies into the international arena. This can be seen in such phenomena as the anti-globalisation backlash in rich countries, the stalled trade talks, and the enhanced international competition between social democratic and centre-right parties. The soul-searching process addressing global poverty, and exemplified by the work of International Financial Organisations, can be attributed to the same development.

How the European model evolves in the future hinges on several factors. One is linked with the management of increased complexity. For the sake of economic and social functionality, the EU will have to find more appropriate

institutional and policy constructs. The clash of paradigms and ideas will shape things as well. For instance, the large-scale failures in financial and energy markets have ushered in a new period of market regulation, which reshapes public policy accordingly (The Sarbanes-Oxley Act in the United States is a clear example).

Policy pragmatism is in much higher demand than policy fundamentalism, though hard-nosed ideologies are present in the corridors of power. Public policy has been forced to reconsider the theses of older times, such as the need for the state to provide public goods, in order to regain moral ground lost to corporate scandals. That issue relates to domestic as well as international politics. For the latter, issues such as environmental protection, containing and combating diseases in the poor world, securing drinkable water and fighting poverty make up an urgent agenda, one which would help deal with international terrorism too. In all these areas, the European Model has something relevant to say and do. But if it is to succeed, it has to make a significant contribution to how the world evolves in the years and decades to come, economically, socially and politically.

**Setimes 8.12.2003**

## **AGRICULTURE AND THE DOHA TRADE ROUND**

Events have kept much of the world's attention focused on Iraq and the Middle East. Geopolitical concerns and the threat of terrorist acts are shaping the agendas of many governments. These concerns, however, cannot obscure the deteriorating economic situation in many parts of the globe,

which face low or slowing GDP growth rates, high or rising unemployment, trade clashes, spreading social destitution, inability to respond to natural disasters, and other problems. Since the United States is the engine of the world economy, some hopes are tied to signs of a US economic recovery, but ongoing stagnation and even recession in Western Europe dims the broad perspective.

In such an environment, developing countries fare worse – socially, economically and politically. Economic distress in most of Africa, as well as in parts of Latin America and Asia, is accompanied by faltering institutional structures, by social fragmentation and disintegration, and by interethnic conflicts and violence. Multiplying cases of failed states compound an increasingly worrisome dynamic.

These trends provide an important context for the WTO meeting in Cancun. When the Doha trade round was initiated, many hailed it as a means not only to arrest rising protectionist tendencies, but also to redress a major imbalance in world trade. Within the context of the recurring debate over free versus fair trade, the Doha round is supposed to tackle what are probably the most inequitable aspects of world trade: a highly restricted access, for developing countries' farm products, to rich countries' markets, and the heavy subsidisation of agricultural production in rich economies, undermining farm production in developing countries.

Farm products are the main export item of many developing countries. In poorer countries, meanwhile, food expenditure accounts for a large share of people's overall spending. The United States and the EU spend about 280 billion euros annually on farm subsidies, but their aid for development amounts to only around 50 billion euros. The heavy subsidies maintain excessive levels of output in rich countries and allow their farmers to compete unfairly against poor countries' farmers.

One should not underestimate the serious obstacles in the way of meeting poor countries' legitimate demands. Farmers comprise important, politically influential lobbies in rich countries, making reforms difficult to implement. Security considerations also enter the picture, particularly in a period when non-conventional threats and the need to avoid excessive dependency on foreign sources of procurement are receiving an ever higher profile. Nevertheless, it is hard to dispute the major flaw in the current arrangements, which penalise poor countries' peasants and harm development prospects. For years now, the World Bank has underlined this inimical state of affairs, and top US and EU officials have acknowledged the stark facts. But narrowly-defined national interests have dented meaningful reform progress.

Recently, the US and the EU reached an agreement on farm trade, which should enhance the talks in Cancun. As analysts have aptly observed, however, the deal does not offer any concrete figures for tariff and subsidy cuts, not to mention non-tariff barriers. As a result, the deal looks more like a letter of intent, devoid of numerical significance. The Cancun meeting could be further weakened if progress in trade (especially in farm trade) is linked with demands on non-trade rules. The EU seems adamant about undertaking joint negotiations on investment rules, competition policy and other non-trade regulations. These rules – the so-called "Singapore issues" – are important, but not so critical at this stage of the overall debate. Unless wisely formulated and implemented, non-trade rules may not advance the economic development of poor countries. As things stand now, the non-trade issues would arguably overload the Doha agenda and diminish the Cancun meeting's chances of success.

The countries of Southeast Europe have large agricultural sectors. Agriculture provides, in general, between 8 and 20 per cent of GDP; in Albania's case, the

figure is nearly 50 per cent. Large segments of the population live in rural areas. At the same time, productivity is low, and public budgets cannot help much. Unless farming gets a technology/productivity boost and market access improves in the EU, the lot of farmers in Southeast Europe is bound to worsen. Together with high unemployment in the region, this would strain local economies more and aggravate social frictions.

The less developed countries of Europe need easier access for their farm products on EU markets, a fact which provides a strong argument for reform of the Common Agricultural Policy (CAP). On the other hand, those of Europe's poorer countries which have a good chance of joining the EU are interested, for social reasons and because of their large rural populations, in the maintenance of substantial farm subsidies. For them, subsidies would offer a safety net at a time of deep retrenchment of public budgets. Among the countries which are to join the EU in 2004, Poland and Hungary face this predicament. It is even more serious for Romania and Bulgaria, which have larger rural populations. The Western Balkans would experience the same dilemma: a need for better market access, combined with the aspiration to join the EU and get farm subsidies.

One sees, therefore, that the CAP, which is perceived as a major nuisance for world trade, can induce ambivalent policy attitudes among EU accession countries. Most of the latter wish to join a rich club; however, their economies are not sufficiently competitive. Social destitution in rural areas could get out of hand unless non-farm job creation is intense, effective social safety nets are put in place, and outward labor movement takes place with few restrictions.

At the same time, the Doha trade round remains vital for the development of poor countries, and EU accession countries need to look at the broad picture. For Balkan

countries which have remote prospects of joining the EU (and, consequently, are less interested in farm subsidies), a successful Doha trade round would imply better protection of their domestic production and easier export access for their farm products. But for the Doha trade round to be completed successfully, visionary statesmanship among the leaders of the developed countries, deep concern for the poor of the world, and related adequate policies have to get the upper hand.

Setimes 22.09.2003

## **STATES MUST BALANCE TAX COMPETITION IN EUROPE**

Fiscal policy in reform-minded transition countries has been shaped by three key priorities: simplifying the fiscal system, establishing transparency and clear procedures, and ensuring that legislation is applied fairly. Over time, it has also become increasingly clear that tax hikes for the sake of increasing budget revenues can be self-defeating, and that public authorities should limit contributions to social security funds in order to stimulate job creation and the development of small- and medium-sized enterprises. These lessons can be seen within the context of government efforts to streamline expenditures in order to keep budget and current account deficits under control.

At the same time, more than a few transition countries have grasped fiscal policy as a potent tool for attracting Foreign Direct Investment. During the 1990s, Central European countries used tax holidays and other fiscal stimuli for this purpose. The resulting impact on the volume and

amount of capital inflows helped turn these economies around and improved their competitiveness. While red tape and corruption are most often cited by investors as obstacles to business expansion, fiscal policy matters also.

How meaningful fiscal policy and tax competition can be is illustrated by Slovakia's success in inducing Hyundai to invest in a major automotive project. The country competed fiercely with its neighbours, combining wage comparative advantages with impressive financial resources. This example can be viewed from two perspectives. One is with regard to the entry of ten new countries – including eight formerly communist countries – into the EU. It appears that joining the Union compels member states to seek legislative uniformity. Even so, there are areas in which national prerogatives remain significant, resulting in visible differences even when the general policy principles are the same. Tax legislation is one such area.

A second perspective relates to the ability of governments to use fiscal policy in order to foster more business. Some new entrants into the EU are lowering taxes to such a degree that old members are talking about "unfair competition". Slovakia has introduced a single income tax quota (19 per cent), emulating the model Baltic countries have experimented with for years.

Corporate taxes have also been recently lowered in Poland and Hungary. The policies of these Central European countries have prompted varying reactions among the older EU member states. Austria, for instance, has determined that it must come up with similar policies in order to stem a possible capital flight. Germany and France are arguing that tax competition is reminiscent of competitive devaluations, in which exchange rates are used to enhance export competitiveness. The result, they warn, will be losses for everyone. The French and Germans also insist that it is not

appropriate for countries benefiting from EU structural and cohesion funds to practice tax competition against the donors.

Although national fiscal policies present a wide range of variation within the EU, the reaction from some of the more established member states should not be underestimated. Strained welfare systems and high wages are speeding up outsourcing, offshoring and job losses. At the same time, the EU's lack of success in implementing the goals of the Lisbon Agenda – which aims to make the Union the most competitive area worldwide in terms of a knowledge-based economy – reinforces these fears. It may be only a matter of time before the European Commission in Brussels sets about defining "rules" intended to govern tax competition inside the Union.

Meanwhile, candidates and would-be candidates for EU membership are caught up in conflicting policy thrusts. It is clear to Bulgaria, Romania and Croatia that they cannot simply overlook what their neighbours are doing, and that they must simplify and optimise their tax systems. Romania, for instance, must reduce its social security contributions to a much lower level. At the same time, these countries have to find ways to keep their budget deficits under control, while locating additional revenues necessary for funding development projects.

Tax competition presents both opportunities and perils. Lower taxes can stimulate business and, under the right conditions, increase budget revenues. Pushed too low, however, they can be inimical to budget revenues and endanger public goods such as infrastructure, education and healthcare.

In relatively poor countries, including many in Southeast Europe, it would be wishful thinking to expect such goods to be provided solely by the private sector. True,

more and more discussion is taking place about the role of public-private partnerships in developing infrastructure in the Balkans. But when per capita income is low, and much of the population has a difficult time making ends meet, such partnerships will not be able to provide all the answers. The state necessarily remains a major provider of public goods, and international financial institutions play an important role in assisting local governments to this end. Governments have to find the right balance. They must seek to improve efficiency and keep their fiscal systems competitive, while not going too far with taxation experiments.

**Setimes 12.07.2004**

### **MAINTAINING LOW INFLATION IN TRANSITION ECONOMIES**

One-digit inflation rates have become a general feature of European transition economies. This is good in itself, and also an advantage for the transition countries which have joined, or wish to join the EU. An important question, however, is whether low inflation rates will be maintained over the longer run, in view of EU requirements.

According to one line of reasoning, a trade-off exists between growth and inflation in transition economies because of the so called Balassa-Samuelson effect. Within this context, it is worth examining a relatively new monetary policy regime known as "inflation targeting" (IT). The countries that have pioneered this system include New Zealand, Canada, Chile, Israel, the United Kingdom, Australia and Sweden. During the late 1990s, it was adopted officially by the Czech Republic, Poland and Hungary.

Under IT, the central bank manages monetary policy instruments with the direct goal of containing inflation over the medium term. Inflation becomes the overriding goal of monetary policy. All the other indicators (output gap, money stock growth, the exchange rate) become auxiliary variables; the central bank takes them into account only if this information helps improve its inflation forecast. These forecasts are contingent upon the central bank's view of the transmission mechanism, the current state of the economy and a planned path for the instrument. Complex econometric modeling and statistical inference-building based on high-quality data and economic information is needed in order to produce reliable forecasts. A subjective assessment of the inflation path may be included also.

From the implementation point of view, a basic prerequisite for inflation targeting is the central bank's full autonomy. The relevant price index must be defined; in general, it is a traditional consumer price index. Countries adopting IT must then choose the target and range, and the bank must decide which instruments it wants to utilise. In recent years, central banks all over the world have chosen to have a say regarding short-term interest rates, mainly through reverse-repo operations carried out in the money market.

Many influential economists argue that inflation targeting rules out an inflation bias because the central bank has a single goal under this regime: price stability. Thus, there can be no conflicts of interest between multiple objectives, such as the standard conflict between inflation and economic activity. The policymaker's accountability should be quite high under IT since performance can be directly measured, for instance by the deviation between actual inflation and the target.

However, the benefits theoretically arising from IT may not be so easy to achieve, particularly within the context of less-developed transition economies. The European Central Bank (ECB) has decided not to adopt monetary targeting, since in a new economic environment – one characterised by a wide heterogeneity among member countries, with new monetary institutions and a money market in ongoing development – it is impossible to infer, from scarce data, a reliable money demand function. Like the United States, the European Monetary Union aims to address a variety of threats to price stability, including exceptional events such as deflation, war, terrorist attacks, import price shocks or stock market crises.

In developed countries, adoption of IT implies that the central bank has the technical ability to make a reliable conditional forecast of inflation, and can adapt its instruments in order to bring the forecast close to the target. All the benefits which derive from IT in terms of accountability and credibility stem from these conditions. However, obtaining a reliable conditional forecast is a very difficult challenge, one which the ECB itself has not undertaken. What if the forecast is wrong? The relationship between the instruments is generally assumed to be known; but is this relationship carved in stone for a developing economy with significant structural fragility?

The overall performance of the IT group of countries is not very conclusive. A series of studies indicate that inflation targeting has, on the whole, proved to be a successful policy. It appears that IT reinforces accountability, credibility and resilience to external shocks, and helps high-inflation countries reduce inflation to normal levels. At the same time, these studies demonstrate that inflation in IT countries is not lower than in non-IT countries. In transition economies the experience is mixed. Central banks in these countries have

often missed inflation targets by a large margin. In the Czech Republic, Hungary and Poland, progress with disinflation has been good, but the persistence of a relatively high level of uncertainty makes it difficult to predict inflation over the medium term, as required by the IT approach. This is not a minor shortcoming. It provides a lesson for other transition economies which are thinking about adopting IT.

For IT to prove beneficial, the proper conditions must be fulfilled, or the central bank risks losing credibility. There is a significant possibility of making the wrong forecasts and missing inflation targets. Thus, it is not advisable to adopt a rigid framework for monetary policy management if the criteria for smooth functioning of the system are not being met.

Furthermore, as recent data show, inflation in almost all the Central and Eastern European countries has been following a downward trend, irrespective of the choice of monetary arrangements and regimes the central banks of these countries have employed. If sensible domestic fiscal and monetary policies are being pursued, there are no reasons to think disinflation should not continue in the absence of a genuine IT regime.

**Setimes 6.09.2004**

## **EU REFERENDA COMPLICATE ACCESSION PROSPECTS**

The results of the referendums in France and Holland have demonstrated the depth of socioeconomic and political currents which have been present in a number of EU countries for years now. Many citizens are frustrated about

the way the Union's enlargement has been unfolding. Flaws in the institutional set-up, which triggered the working out of the Treaty, combine with the erosion of the welfare state and the effects of globalisation to produce a volatile political dynamic. The talk about a democratic deficit in the EU is not without substance; rather, it reflects a schism between political elites and the population at large.

There is a considerable variety of economic performance within the Union, with Scandinavian countries well ahead of Mediterranean ones in terms of GDP growth rates, employment, budgets and other factors. At the same time, a sense of stagnation among the older EU members is easy to discern. By and large, the Treaty of Rome signatory states are in the grip of economic fatigue.

The relative merits and disadvantages of the Anglo-Saxon and Continental models are a source of ongoing debate. There are countries (Denmark, Finland, Sweden) that have not dismantled the welfare state and have achieved good economic performance while also scoring at the upper end of the EU spectrum in terms of fulfilling the targets of the Lisbon Agenda (which aims to boost competitiveness throughout the EU area). National experiences indicate, therefore, that actual economic performance depends on concrete institutional set-ups, which may or may not help cope with economic and technological change.

Western European economies are confronted with social challenges which are rooted in the ageing populations, falling birthrates, a certain institutional sclerosis (which recalls economists Douglas North's and Mancur Olson's writings about the hijacking of public policy in market economies by vested interests), immigration and the competitive pressures generated by the new information and communication technologies and globalisation. More than a few EU member states have witnessed an increasing divide

between, on the one hand, those who are capable of weathering the shocks produced by globalisation and new technology and, on the other, those who succumb to pressure and enroll among the ranks of the marginalised and disgruntled. EU member countries face increasingly intense competition from low wage countries, in the form of what is often called outsourcing or offshoring. This has become a major political theme in Western Europe as well as in the United States.

How public policy can respond adequately to social and economic challenges is not easy to work out. The problems are quite clear, but policy answers involve complex trade-offs and painful adjustments. Frequently, co-ordination failures plague policy. Situations differ widely among various countries, although many have at least one thing in common: public budgets that are increasingly under strain. For instance, German companies excel at raising productivity and competing on foreign markets, but unemployment remains high at home and the public budget is well above 3 per cent of GDP. By contrast, in Italy competitiveness both at home and abroad is a source of worry for political and business elites, while the public budget appears to be spinning out of control.

It is increasingly clear that finding a way out of the whole requires reform of the welfare state, in combination with public policies designed to stimulate R&D for the sake of enhancing competitiveness. Otherwise, gradual decline is almost inevitable. The achievement of Scandinavian countries in the past decade suggests a policy venue which could be replicated, more or less. Germany seems to have embarked on this road, although it faces heavy social opposition to painful measures. One way or another, the social contract between citizens and states has to be rewritten, preserving the basic ingredients of the welfare

system while giving economies more flexibility and capacity to face global competition. Arguably, this presents the biggest challenge for the old EU member countries in the years to come. That this endeavour is inescapable is amply indicated by the response of people in the Western European countries to the recent round of enlargement. By bringing into the Union a number of low-wage economies, the eastward expansion amplified fears, among the existing member states, of runaway jobs, declining wages and other globalisation-era pressures.

EU enlargement can be looked upon as a facet of globalisation, which frequently attracts blame for economic woes. Indeed, the rise of China and "India Unbound" has the potential to shake up what had previously seemed to be well-entrenched hierarchies. But it pays to ask ourselves whether the relapse into protectionism is the proper solution to the intensity of competition in the world economy. It is one thing to accuse low-wage countries of using unfair means (such as the exploitation of children), and another to blame them for capitalising on low wages to boost their exports. Low wages, by themselves, are not an unfair competitive tool. Is there any moral basis for asking lower-wage countries to slow their progress because of the damage this might inflict on stagnant economies in Western Europe?

EU member states cannot avoid the need to stay competitive, which in turn requires revamping welfare systems and achieving technological change. But these objectives are time consuming and not easy to undertake socially. Politicians have to be more candid and persuasive in what they say and do. They have to form coalitions of interests in society that can support reforms effectively.

The EU is going through hard times, a fact which complicates Bulgaria and Romania's scheduled accession in 2007. Under the current circumstances, the possibility of a

one-year delay is high. More MPs in the West are talking about halting, or indefinitely postponing, the enlargement process. This is not good news for the rest of Europe, in particular the Western Balkans, which has come to rely on the EU anchor as a powerful motivating force for political and economic progress. It remains to be seen whether the French and Dutch votes amount to a brief spate of turbulence, or a major sea change with a potentially deep impact on the region's prospects.

Setimes 4.07.2005

### **COOPERATION, COMPROMISE ARE BACKBONE OF EU ENLARGEMENT**

An international rescue effort recently brought to the surface a seven-man crew of a Russian submarine trapped under 600 feet of water. A British Royal Navy underwater robot, the Scorpio Craft, proved essential to untangling a web of fishing nets and a misplaced antenna. The endeavour's success was in stark contrast with the Kursk submarine disaster five years previously, in which all crewmembers perished amid what many perceived as the Russian government's reluctance to seek outside help. There are lessons in this story – among other things, lessons about the importance of co-operation and solidarity.

Britain is also playing a central role in a crisis of a different sort – the turmoil that has come over the EU following French and Dutch voters' rejection of the Constitutional Treaty and the subsequent failure, at the June European Council summit, to agree on a budget for 2007-2013. These setbacks appeared to expose lingering

weaknesses and divisions within the Union. As the current holder of the EU's presidency, Britain has taken on the challenging task of helping to steer the Union through a period of turbulence and self-questioning.

The budget fiasco is a bitter pill for the EU's new member countries (NMC). Whereas long-standing members derive only fractions of their national revenues from the EU's budget, the situation is much different for the NMCs, whose per capital incomes range between 35 per cent and 70 per cent of the EU average. EU structural and cohesion funds can reach up to 4 per cent of their GDP. Some NMCs have been ready to accept smaller net disbursements of EU funds in order to lower the Union's budget to 1 per cent of the EU GDP, rather than the 1.16 percent proposed by European Council President Jean-Claude Juncker, to no avail. Neither France nor the UK, the two heavyweights involved in this "battle", have demurred.

Since Britain is a main contender in the budgetary debate, perhaps an analogy with the Russian submarine rescue can provide some inspiration. At a time when the Union is facing peril, compromise and co-operation will be vital to mountain a successful "rescue effort".

Unfortunately, the draft EU budget was submitted for approval before the parties reached agreement on how to distribute the funds between so called "forward-looking" support for research and development, structural reforms and "backward looking" agricultural and regional policy activities. Further worsening the negotiating climate, the summit also combined a debate over the Union's Common Agricultural Policy (CAP) with debate over Britain's rebate.

It is hard to dispute that the CAP needs further reform, considering the failure of the Doha Trade Negotiations and the plight of the many poor countries that rely on the export of farm products. On the other hand, it would be unwise to

make EU farm policy dependent on national prerogatives. EU member countries could end up fighting each other with subsidies, in spite of competition policy rules, thus further crippling developing countries' interests. Arguably, the solution is to scale down subsidies to farmers, but in a socially acceptable way and timeframe and by framing CAP within overall economic policy. At any rate, a consensus should not have been out of reach during the Summit, and the need for CAP reform – though real – hardly constitutes a valid reason for derailing the 2007-2013 budget.

The British rebate is a more complex issue. British pundits and politicians, Tony Blair included, frequently extol their country's economic success, demonstrated by higher growth and lower unemployment than in most of the core of the old EU. They may be overshooting, however, when they point the finger at an underlying economic model that should be propagated throughout the Union. After all, the best economic performance in the EU is on the Scandinavian fringe, which suggests that the "European social model" can work when labour market reform and proper research and development are undertaken properly. And French and German industrial prowess should not be underestimated.

Certainly, however, the British have a point when they insist on more workfare – as opposed to welfare – and on greater market flexibility. Their success over a period of two decades, however, undermines the logic of the Rebate, which was meant to reconcile the low UK per capita income decades ago with the implications of a weak farm sector. The UK now has a considerably higher income per capita – a fact which clearly points to a need to reconsider the Rebate.

Finally, what some say about regional policy being a waste of resources is wrong, both conceptually and politically. There certainly has been some waste of resources. But it is hard to deny that the economic development of

Spain, Portugal, Greece and Ireland is to some extent also due to the inflow of EU funds. This flow will be even more important for most of the NMCs, certainly for Bulgaria and Romania and eventually for the Western Balkans, which are less affluent societies with comparatively undeveloped infrastructure. Politically, it would be more than myopic to practice arm-twisting within the Union for the sake of pleasing home constituencies.

The British presidency should convene an extraordinary meeting of the EU council for the sake of mending fences and reaching a compromise on the budget. Politicians now have a chance to show that they can match the valor of the Royal Navy. For this to happen, however, there is need to prepare the ground better technically and show statesmanship at a time of international tension.

Setimes 22.08.2005

## LESSONS OF EU ACCESSION

"Enlargement fatigue" in the EU has been a topic of discussion for some time, even before the proposed constitutional treaty went down in a stunning defeat in France and The Netherlands. Some argue that the last wave of expansion, with ten new members joining overnight, has already stretched the bloc almost as far as it can currently go – the malaise in some of the bloc's older members, they argue, signals a need for consolidation. But while a malaise undoubtedly exists, it could be argued that the fundamental problems have little to do with enlargement, and to speak of enlargement fatigue is to misrepresent the basic issue.

There are deep currents of change in the world economy, driven by technological advances and the economic rise of Asia. These currents have major implications in areas that resist transformation. Some European heavyweights show signs of institutional sclerosis. They are unable or unwilling to make needed adjustments even as the global economy signals again and again the urgent need to do so. Thus, feelings of despondency, political impotence and a growing inclination to blame outsiders arise.

Despite the widespread concern that "something is rotten in Denmark" – in other words, that a need exists for major structural reforms, as set out by the updated Lisbon Agenda – things are not equally bleak across the Union. In fact, the record is multicoloured. Some of the northern countries boast good economic and social performance, providing policy inspiration for others, while some southern countries are faring considerably worse. Most of the new member countries (NMCs) have shown remarkable economic growth rates in the last few years, an average of over 5 per cent yearly, more than doubling the average in the old 15 member countries. The Institute for Comparative Economic Studies of Vienna has projected some degree of economic slowdown in several NMCs for this year, but the growth differential between East and West remains large. There is substantial potential for catching up in the years to come.

In terms of economic growth rates, the Union can be portrayed by two axes: one that separates the better performing north from the underperforming south; and another dividing the stagnating west and the vigorous east. The latter split has implications for Southeast Europe. The Union will eventually include the countries located in part of the continent, and it pays to consider what their forerunners have witnessed on their way to and after accession.

Joining the EU has proved an extraordinary anchor for change, for institutional and structural reform. It has rallied wide popular support for measures which, otherwise, might have been very hard to implement. In this respect, we must not underestimate the importance of keeping hopes alive during times of economic and social duress affecting more than a few citizens. Moreover, hope must be sustained after accession as well, when citizens may become increasingly disgruntled if growth rates, as translated into personal incomes, are low. And herein lies a major difference in the collective psychologies of Eastern Europe compared to parts of the West. Economic vigour fuels hope in countries aiming for major improvements, while stagnation breeds frustration.

The growth differential between east and west is especially significant because post-communist economies are still plagued by institutional fragility. As economic theory stipulates, what matters for long-term growth is the quality of the institutional set-up. On this hinge capital formation, technological progress, and the building up of human capital on an adequate scale. Arguably, the efficiency reserves in transition economies and their capacity to restructure and absorb new technologies, in spite of inherent institutional fragility, has defied more sceptical views. This observation, it goes without saying, is applicable to Southeast European economies, which benefit from relatively well-qualified labour and low wages, and whose proximity to western economies favours substantial industrial relocation.

Two inferences can be drawn. Firstly, economic growth rates of above 5 per cent annually can be sustained in the region, aiding the process of catching up. Such rates would help deal with massive unemployment and its nefarious economic and social effects. But for such rates to consolidate, there is a need for intense absorption of new technologies, for innovation on a broad scale. Such

innovation is badly needed so that these economies will not become over-dependent on low value-added manufacturing and services.

Related to growth and its prospects is policy consistency. In spite of vacillations and setbacks, accession countries have achieved remarkable progress in their institutional set-ups and the restructuring of their economies. Arguably, they evince more flexibility in certain respects than some of their western counterparts. And I am not referring here to labour markets only. Low inflation is now ubiquitous, budget consolidation has been advancing steadily (though the "budgetary shock" of accession is quite significant, for it demands several percentages of GDP for the EU budget fee and co-financing of EU funds), and market regulations have been improving markedly. It is an open secret that policy consistency is critical for sustainable growth.

Also important are business-friendly fiscal policies which stimulate investment and job creation. The development of small- and medium-sized firms relies on a congenial fiscal environment as well. There is increasing fiscal competition in the EU, and no country's policies can afford to be insensitive to it. For the NMCs, the current candidates for accession, and Balkan countries looking for eventual membership, the artistry in fiscal policy lies in reconciling the need to be more business-friendly with the needs of raising the resources of public budgets. Higher budget revenues are called for in order to cope with functioning inside the EU.

A further factor is one that is too often overlooked in economic discussions. Recent years have demonstrated the impact of climate change, with huge floods and dramatic fluctuations of temperature producing havoc in several central and eastern European countries in recent years,

jolting public budgets. I submit that such occurrences are likely to be repeated, and clairvoyant policymakers have to make adequate room for contingencies when they allocate state revenues. This is a challenge for the years to come, in the sense of not allowing budget deficits to get out of control. Regional co-operation must also be increased, since natural disasters do not acknowledge borders. Solidarity is a sign of policy wisdom and statesmanship.

Last, but not least, the SEE countries need to wage a more effective fight against corruption, criminality and the hijacking of the state by vested interests. For sustained growth to benefit most of the population, as well as for a strengthened rule of law and a surer democratic transformation, this demarche is a must.

Setimes 26.09.2005

## **"ECONOMIC PATRIOTISM" IN THE EU**

Well-entrenched cliches are often brought into play when the EU is being described: single markets, the free flow of capital and labour, increasingly more uniform pieces of national legislation, strict anti-trust laws, devolution of public policy prerogatives to supranational bodies, and so on. These cliches project the image of a Union in which corporate identity becomes ever more detached from member countries, according to the logic of economic liberalisation. To paraphrase one of Kinichi Ohmae's well known books, a "Union without borders" epitomises, on a smaller scale, the borderless world envisaged by advocates of globalisation.

One can draw, from the logic of liberalisation inside the Union, the rhetoric that extols the virtues of "European champions" – companies which operate across European borders and are capable of being key global competitors. European Commissioner for Competition Neelie Kroes does it frequently in the more or less fractious debates she has with the governments of individual EU member states.

"The borders are gone. It is all about European champions, and global champions," Kroes said in March. "When we took the decision to come together in the EU, when we took the decision to create one internal market, the national champion [became] outdated."

According to one line of thought in Brussels, the so-called European Champions should underpin the EU's ambition to become the leading economic player in the world economy – the paramount mission set forth in the Lisbon Agenda. For several decades now, leading EU member states have tried to match the prowess of American and Japanese firms, and the Union's further development has been seen in this framework. Within the last decade, this rivalry has acquired an additional dimension owing to the economic rise of China, India, and other Asian nations.

However, there have been series of recent developments in the EU which do not fit into the conceptual framework described above; rather, they clash with the logic of single markets. For example, the Union's heavyweights have used a variety of means to maintain the primacy of domestic capital in banking, public utilities and other sectors that are judged to have national strategic importance. Thus, when the Italian group Enel announced its plans to acquire a majority stake in Gaz de France, the French government responded swiftly: a merger between Gaz de France (where the state has a controlling stake) and the private group Suez was announced.

In his turn, Romano Prodi retorted that were the Left to win the national elections in Italy, it would block attempts by French firms to take over Italian companies. This is the same Prodi who formerly occupied the post of European Commission president. The Spanish government, too, has reacted negatively to the plan of the German group Eon to take over Endesa, a leading Spanish public utility.

The list of defensive moves goes on. For instance, several high profile European politicians voiced concern about Mittal's attempt to acquire a controlling stake in Arcelor, in the steel industry. Incidentally, Mittal is owned by a family of Indian origin, though the firm is headquartered in Europe. Or consider the pharmaceutical industry, where the French government has backed top national companies in order to maintain a national flavour. In Germany, government officials as well as heads of companies are concocting schemes and "poison pills" for the sake of fending off hostile takeovers.

What lies behind this apparent resurgence of protectionism when it comes to leading national companies in various fields? One explanation would be that liberalisation (or globalisation), by its very nature, brings about such reactions throughout the world, in rich economies as well as poor ones. In addition, the EU is going through a difficult period, manifested by demographic issues, the crisis of welfare states, productivity slowdown, and other factors. In such a climate, "economic patriotism" is a predictable policy offspring.

The implacable development of single markets entails defensive reactions one way or another, some would argue. Because competition produces winners and losers, there may be an inherent temptation on the part of EU member governments to support their leading firms.

However, there is another way of framing our analysis. We could also say that the vision of a Union made up of equal partners (in terms of bargaining power and the ability to shape formal and informal networks of interaction among governments and private companies) is far from corresponding to reality. The "heavyweights" have sought and will continue to seek ways to uphold their vectors of economic power and obtain preferential treatment – remember, for instance, how Berlin and Paris got away with a serious breach of the Financial and Stability Pact rule on budget deficits. As fondly as we may wish to talk of a European playing field, the idea of "Europe" remains something of an abstraction. Given this underlying nebulosity, it is not surprising that the bloc's leading players try to keep decision-making centres at home.

One can go further with this logic of power distribution in the Union. As long as a common foreign and security policy remains a distant goal, and as long as military (nuclear) arsenals are not under common (EU/supranational) control, it is unrealistic to expect that large countries will nonchalantly allow the takeover (sometimes hostile) of their top firms by foreign companies, or let major companies go down the tube – we may recall here the controversy around Alstom and the dim view Paris took of a possible Siemens-led rescue operation. Moreover, the fight against terrorism increases the propensity of national governments to reinforce their local means of response, which involves locally-controlled industrial firms.

Another factor relates to a scenario which is seldom discussed publicly, but is surely on the radar screens of strategic planners and thinkers. Let's assume that the economic and political project of the Union, for various reasons, gets bogged down over time, or becomes increasingly diluted. In such a case, governments will want

to have vectors of economic power under domestic control. What Commissioner Kroes calls "European champions" would be an object of competition among major EU member countries when it comes to controlling stakes and who should host the headquarters. In brief, the turn towards protectionism suggests that countries are hedging their bets when it comes to the long-term prospects for the bloc.

The irony is that protectionist strategies increase the chances for the Union to see its deepening stalled; it favours centrifugal forces and the likelihood of sharpened divisions over all kind of basic policy issues. Such a dynamic does not bode well for future European enlargement.

Setimes 29.05.2006

## **LABOR MARKETS AND EFFECTS OF MIGRATION**

Labour markets in the new EU member countries can puzzle an outsider. Whether the unemployment rate is low (around 5.5%, as in Romania), or high (above 15%, as in Poland), sectoral labour shortages are being felt throughout the economy. And consequences can be quite severe.

How is it that shortages can coexist with surpluses – unemployment – so visibly in market economies? A historical look at the economic policies of transition economies might help untangle this paradox.

For many years, the rise of wages in transition economies was influenced by a key provision in the agreements signed by governments with the IMF. Specifically, public sector wages were not supposed to grow by more than a certain rate annually. The rate determined

how many people had to be laid off in order to raise salaries for public sector employees. Clearly, a trade-off was at work here.

The provision operated also as a benchmark for collective bargaining sessions between firm owners and workers in the private sector. The root issues were fear of large budget deficits and the need to combat inflation and unsustainable external deficits. In recent years, however, the situation has evolved markedly.

In Romania, two major features of the economy explain wage dynamics. One is the share of the private sector in GDP formation, amounting to over two-thirds. This presumably diminishes the leverage that public sector pay has on the functioning of the overall labour market. Now that Romania has joined the EU, it may be that the dominant social model in the bloc – where trade unions are more powerful than, say, in the United States – will have a strong influence.

A second feature is massive migration. According to some estimates, more than two million Romanians work abroad, mostly in EU member countries. This migration explains why the unemployment rate is so low in Romania, even though industrial restructuring is taking its toll. There are cities and areas in Romania where unemployment is almost nil, and employers have a very hard time filling available positions.

Upward pressure on wages is an unavoidable effect of the steadily falling unemployment rate. Labour shortages are intense in certain sectors such as construction. Bechtel, a leading American firm and a major contractor in Romania, recently complained about such shortages. And this case is not unique.

The fact that migration reduces the overall unemployment rate and puts upward pressure on the average wage level is not surprising. But there's more to the story. In

transition economies, a phenomenon tends to occur which is, ironically enough, reminiscent of the command system: simultaneous shortages and surpluses. A leading Hungarian economist, János Kornai, wrote a groundbreaking book explaining how the command system is inherently prone to this problem, because of its inability to allocate resources efficiently or achieve price equilibrium in market economies the coexistence of large shortages and surpluses should not be the rule of the game; rather, it indicates market rigidity due to various factor.

One cause, much debated in the literature and verified in practice, is the capture of jobs by insiders. This causes some people – as the French call them, "les exclus" – to remain outside the labour market circuit. Higher unemployment can also arise because of powerful shocks, such as sharp rises in the price of energy. The oil crisis of the 1970s, for instance, engendered "stagflation" in western economies.

It is noteworthy that surpluses and shortages can co-exist at largely different rates of unemployment. Unlike Romania, Poland has a high unemployment rate. Yet construction companies in Poland, as in Romania, complain about the lack of skilled workers. For the period 2007-2013, the Polish transportation ministry has allocated around \$38 billion in the sector. But many worry that the lack of manpower could severely delay this ambitious construction programme. This, in turn, would slow down the pace of modernizing hard infrastructure.

An uninformed observer might see no cause for worry. In the long run, after all, aren't markets supposed to allocate resources where they are mostly needed? In fact, the reality is more complicated. People do not acquire new skills easily or readily. Even when the market demands such skills, there can be a lag time before the labour force is able to provide

them. The difficulty of adjustment is a common denominator in many transition economies.

Western countries have their own forms of inertia. In old EU member countries, for instance, the opposition between insiders and outsiders has prompted an intense debate. "The global middle asks for reassurance," writes Harvard economist and former US Treasury Secretary Larry Summers. He was referring to the anguish experienced by wage earners in affluent economies under the pressure of Asian competition. The inference is pretty clear: those who have jobs will do whatever they can in order to keep them, even if it impedes the smooth functioning of markets.

In Eastern Europe, upward pressure on wages will likely continue in the years to come. Indeed, wages may well grow more rapidly than forecast because of the impact of intense migration. The rise in wages would be felt in both the private and public sector too. Should that happen, unintended negative effects could emerge. Rising wages, if unaccompanied by adequate productivity gains, will cause inflation to creep up again and lead to larger, menacing, external deficits.

Meanwhile, for the first time, Eastern European labour markets are beginning to exert pressure to admit immigrant workers. Rising labour scarcity is being seen in various fields, in conjunction with considerably superior GDP growth rates (as compared to Old Europe). It is perhaps not coincidental, then, that Poland and the Baltic countries have opened their markets to Bulgarian and Romanian workers, without any restrictions.

19. [www.setimes.com](http://www.setimes.com)-22.01.2007

PART III  
**ROMANIA'S JOURNEY TO THE EU**

## **ECONOMIC POLICY FOCUS: TAX REVENUES IN ROMANIA**

Romania's economic growth in 2001 was at its highest level in five years – gross domestic product (GDP) jumped by 5.3 per cent and exports continued to surge. Nevertheless, imports grew even more rapidly, bringing the current account deficit to 6 per cent of the GDP. The increase in debt has been a significant part of the economic picture, forcing policymakers to turn their attention to financial discipline and tax collection.

Tax collection has continued to be a challenge to budget execution, which led to a "sequestration" of capital expenditure late in the year, in order to meet the budget deficit target of 3.5 per cent. At a time of swift economic recovery, fiscal revenues dropped as a share of the GDP, which is quite unusual. The smaller tax intake can be explained by the evolution of overall debt, which grew by almost 5 per cent of the GDP during the same interval.

It also can be attributed to fiscal facilities granted to small and medium-sized enterprises and state-owned companies, some of which were privatised last year. There should, however, have been some offsetting positive influence of privatisation revenues that, presumably at least, had entered the public purse. Another factor could have been the practice of tax deferral for many state-owned and some private companies.

The bottom line, however, is that tax collection was below expectations last year, which has prompted Bucharest to seek additional ways to raise fiscal revenues in 2002 to try to keep close to the programmed budget deficit of 3 per cent.

There has been talk, therefore, about increasing excises for gasoline, alcohol and tobacco, and about eliminating the VAT exemption for house construction and other endeavors. One can debate the merits of such proposals – for instance, the adverse effects of raising tobacco excises – but the focus should be on the big question: why did fiscal revenues go down?

Imagine how much revenue the 19 per cent VAT could generate against the backdrop of a GDP of about \$40 billion, even after the share for household economy is deducted. There is a need to mount a joint effort to improve tax collection, as an optimal means for running a more effective budget policy.

It is important to better examine the roots of this situation and determine the best way to tackle it – not simply to apply quick-fixes, which are ineffective over the longer run. Prime Minister Adrian Nastase's declared intention to overhaul tax policy and its implementation is a welcomed effort.

Because of a strained budget, the government is discussing with the IMF an upwards revision of the budget deficit for 2002 – to 3.2 per cent. A 3 per cent budget deficit and a higher quasi-fiscal deficit may be worse on the whole than a 3.2 per cent budget deficit and a decline in the quasi-fiscal deficit. Care must be taken to avoid unproductive rigidity in setting policy parameters.

The issue of tax collection is closely linked with the financial health of major public utilities. The utilities have a long history of being unable to make good on their financial claims as a result of fluctuating energy prices, obsolete

technology, the impoverishment of a growing part of the population and a lack of financial discipline. A rise in the relative price of electricity and heating is not unsubstantiated economically in view of the procurement cost of raw energy from abroad.

It is good news to see that the government envisions a mechanism for distributing the new financial burden over a longer period of time. Substantial energy savings can also be achieved by both individual households and industry through proper measurement of consumption. The longer-term solution to the public utilities' woes lies in heavy investment in energy infrastructure, which requires capital and, in this context, privatisation.

The IMF has said that the privatisation process proceeded too slowly in Romania in 2001. But privatisation alone is not the answer: proper structures of corporate governance matter tremendously, and competition policy and regulation are essential to achieving good economic performance. Privatisation in the energy sector needs to be buttressed by well-balanced contracts.

As the current financial plight of Argentina indicates, extremely high price of utility services provided, together with the overvaluation of the local currency, contribute significantly to the declining loss of competitiveness. In Hungary, the question of the price of public utility services has inflamed the relationship between foreign investors and the government. The pitfalls of deregulation in the energy markets can suggest how best to proceed with privatisation in this field.

The Romanian government must impose hard budget constraints and must foster privatisation to bring in capital. At the same time, privatisation must be accompanied by a good regulatory framework in order to adequately deal with

monopoly behaviour, to secure fair prices for consumers and to avoid external over-indebtedness.

Setimes 22.03.2002

### **ROMANIA, THE IMF AND AN EXPECTED DECISION**

I can hardly recall a release of IMF installments to Romania – in the framework of a stand-by agreement – that has stirred less public comment. As a matter of fact, a favorable IMF decision was widely expected this time, in spite of protracted discussions and some acrimonious remarks made, especially, by the Romania side. As currency market operators would say, the decision was already "priced in".

Although one can have qualms about using a two-year-old structure of household expenditures for measuring inflation, it is a considerable decline from January to August 2002. In 2002, inflation may even drop a bit below 20 per cent. Economic recovery has continued and the expected rise in the GDP is 4.5 per cent for this year. The latter number hinges, however, on an anticipated favorable impact on agricultural output after this summer's heavy rainfall. The budget deficit has been kept under control – for the first seven months it has been 1.4 per cent of the GDP, while the target is 3 per cent for the entire year – and the current account deficit stays within the territory of safe external finance.

Clearly, the improvement in the value of the euro has helped improve the trade imbalance since Romania exports more than 65 per cent to the EU markets – while only 50 per

cent of all imports come from those markets. Likewise, the big increase of private transfers from abroad – as Romania has exported labor massively in recent years – has played a major role in the easy financing of the trade deficit. And last but not least, the reserves of the National Bank have continued to rise. Including gold, they are currently above \$6.5 billion, which accounts for about five months of imports.

The improving macroeconomic picture has triggered a positive response from the rating agencies, which has preceded the IMF Board's decision. Thus, Romania got a B+ from Fitch, and similar grades were given by other major agencies. These ratings would lower spreads for Romanian bonds on international capital markets and ease external financing of current account deficits. With consistent policies put in place and further structural reforms Romania could achieve an investment grade (namely, cross the BBB threshold) by the end of 2003 or early 2004 and attract more direct foreign investment.

However, some of the major weaknesses of the Romanian economy should keep us pretty alert in the period to come. The most glaring of these weaknesses is a lack of financial discipline, which is illustrated by the dynamic of arrears. Some numbers would suggest that arrears have grown during 2001 and, in this year, too – having gone above 45 per cent of the GDP. When disinflation is intense the rise of arrears indicates the diminishing ability of inefficient companies to use inflation as a way to reduce their payment obligations in real terms. Should it be the case for a big number of firms, this could backfire in the not too distant future.

It may be that the declining interest rates may help highly indebted enterprises to roll over their obligations at more favorable payment terms, but the issue remains a serious one. The situation of public utilities is highly relevant

in this respect. The balance sheet of energy providers appears to have been worsening in the last couple of years as they, unintentionally, took over the role of former state owned banks in providing "soft" credits to companies. But "soft" credits are a misnomer, since non-payments are involved. Burgeoning claims by public utilities on various state companies, which cannot, or do not pay, produce quasi-fiscal deficits which, in the end, would burden the public budget unless dealt with in due course. Unless the issue of the financial situation of public utilities – and of financial indiscipline– is tackled in a determined way it could stifle future economic growth.

It is fair to say that the rise in efficiency and the corresponding reduction of costs in the energy sector depend, frequently, on big investments, and the latter does require the involvement of foreign capital. But privatisations in this field should happen against the backdrop of an effective regulatory framework – which should control monopolistic abuses, protect consumers and avoid excessive external indebtedness of the country.

For the sake of macroeconomic balance, the Ministry of Finance has to improve its tax-collection practices, because raising tax rates (as it did with excises lately) is not the way to go. Cutting programmed expenditure is not either. Better tax collection would also help the government in creating resources for financing the social program, which was devised to assist low income families following the dramatic rise in the price of energy; better tax collection has to go hand in hand with fiscal reform measures.

The government needs also to control better wages in the public utilities. In general, wage dynamics have to be linked with productivity gains.

As to monetary and exchange rate policy, the National Bank would be well advised not to let the Romanian Lei appreciate too much in real terms unless productivity gains

are substantial; the Euro's real appreciation vis-à-vis the US dollar cannot go on indefinitely and speculative capital inflows should be discouraged. The National Bank should also monitor closely the short term borrowing of commercial banks from abroad.

Caution, prudence and consistent policies are demanded from the government and the National Bank in view of the increasingly complicated and uncertain international environment, and persistent economic gloom in the EU and the US. The goals of economic policy for 2003 should consider these circumstances as well and prepare contingency measures.

**Setimes 14.10.2002**

## **RUSHING INTO THE CAPITAL ACCOUNTS IS RISKY**

The EU requires all candidates to open their capital accounts (KAL) by the time of accession, but makes no specific demands on speed or procedures to pursue. In 2001, Romania unilaterally committed itself to liberalising movements of capital by 2004 – well in advance of its prospective date of accession. There are only two exceptions: one regarding specific money market instruments and another concerning inward land purchasing by foreigners. While the effort to catch up with other candidate countries is quite laudable, the KAL decision calls for serious examination in view of its possible, less benign consequences.

Following the series of wild financial and currency crises worldwide during the last decade, a wide consensus has developed among economists that full opening of the

capital account should not be hastened prematurely in emerging economies. Basic prerequisites for full liberalisation of capital transactions are the existence of a solid growth-supporting macroeconomic framework, the elimination of major structural imbalances and a healthy and well-tested operational and regulatory framework for the financial system.

Romania has improved its economic performance considerably in the last couple of years and a series of indicators look quite good. The overall public debt is fairly low (under 30 per cent of GDP); the domestic public debt is only 8 per cent of GDP and its financing is accomplished increasingly with longer maturities and at lower interest rates. The external indebtedness of the country is low (below 30 per cent of GDP); the reserves of the Central Bank (NBR) amount to circa 5 months of imports. The share of external short term finance of public external debt is low. On these grounds, one might try to justify the decision to open the capital account at a swift pace.

But Romania still has important vulnerabilities, a fact which should make public authorities more cautious and lead them to re-examine the current sequencing of KAL. Inflation is still high; there is a very low level of monetisation and financial intermediation, which makes wide swings of capital flows highly disturbing and sterilisation operations (by the NBR) costly; there is insufficient restructuring in the real sector and poor governance at the enterprise level, creating inflationary pressures and straining the public budget. Law enforcement in the financial sector remains weak and the new prudential rules are still to be tested; bank profitability and efficiency are low. Therefore, one can imagine a scenario of rises in the prices of domestic assets, following substantial speculative capital inflows (stimulated by the Leu's real appreciation), which may create instability. Reckless internal and external over-indebtedness of local

firms and municipalities may also ensue, which would be quite threatening in view of the still soft budget constraints operating in Romania; the trade deficit may grow again sharply, abetted also by the real appreciation of the Leu, while it is not solidly proven that private transfers from abroad would not stop growing, or even decline, as a consequence of possible international adverse events.

There is another issue that should concern policymakers. Full KAL cripples the ability of public authorities to conduct an autonomous monetary policy while they try to achieve some stability of the exchange rate. In the latter case, the burden of macroeconomic adjustment falls overwhelmingly on budget policy, and a deflationary bias may very likely be imparted to its stance.

What is happening currently in the EU – with several of the leading countries being at great pains in meeting the demands of the Stability Pact (in terms of budget deficits) – should be a stern warning in this regard. In order to restore some autonomy to monetary policy, a free floating of the exchange rate would have to be practised, but this in itself could be highly destabilising and require an extremely restrictive monetary policy (following sharp depreciation of the exchange rate).

Is the Romanian economy ready to accept the consequences of full KAL from this perspective, one involving a much diminished room of maneuver for macroeconomic policy? This question gains an even higher profile by judging the likely time of Romania's accession into the EU. This is why the "look good" indicators and the confidence some entrust in the ability of Romania to rely increasingly on remittances from abroad and revenues from tourism do not warrant complacency; the latter is equally hindered by the 2007 time target for EU accession. One should also keep in mind the balance of payments crisis the

Czech Republic went into after opening the capital account, or the mounting fiscal difficulties it is currently experiencing along with Hungary and Poland.

Arguably, policy-makers would be well advised to re-examine, in practical terms, the current KAL program by considering the need to make an effective preference for long term flows against short term flows (the liberalisation of short term flows should be accompanied by adequate prudential measures); the need to make an effective preference for capital inflows against capital outflows; and the need to avoid an undifferentiated and complete liberalisation of capital inflows. Likewise, more attention should be given to the principle of contingency: actual liberalisation should proceed only when only well-defined macroeconomic and structural conditions and criteria are fulfilled.

There are number of concrete measures to "shape" the composition of flows which policy-makers might consider. Unremunerated reserve requirements could be imposed for short term investment or credit taken in foreign currency. The NBR could practice a system of discriminatory reserve requirements on foreign exchange deposits of banks. Restrictions could be placed on corporate and public sector short term credits from abroad. Banks could be prohibited from using short term debt instruments as collateral for borrowing in foreign exchange abroad. Support could be given to the creation of an independent rating agency for Romanian corporate and municipalities' debt instruments. Purchase abroad of bonds, shares and other securities could remain subject to authorisation by the competent supervisory body.

Since the EU does not impose a timetable on Romania for full opening of the capital account, a readjustment of the programme can be made. It would also be wise for the government and the NBR to consult with experts from IFIs,

such as the IMF and the World Bank, for this is a matter of utmost importance for the economy.

Setimes 3.03.2003

## **DOES ROMANIA HAVE A FUNCTIONING MARKET ECONOMY?**

The European Commission (EC) asks countries aspiring to EU accession to comply with two fundamental requirements: to have a "functioning market economy" and to withstand competitive pressures in the Union. The second demand recognises the dramatic reduction in scope of national economic policy in an area which practices a common monetary policy, and in which intra-trade barriers no longer exist. Twelve EU member countries share a single currency; in a softer form, the ERM2 constrains exchange rate policy in the remaining states. Both demands are seen as essential for enhancing nominal and real convergence, without which the Union would be undermined from within.

The transition countries which are to be admitted in 2004 were granted functioning market economy status a while ago. Bulgaria, too, received it last year. The neighbouring country's economic upgrade, along with the debate over Turkey and other would-be accession countries, has raised the stakes for Romania, in a race which has become increasingly challenging in view of the economic and geopolitical circumstances which accompany enlargement.

Do basic market institutions exist in Romania, and do free prices, for the most part, allocate resources? Clearly, they do; Romania has a functioning market economy. But major weaknesses are present, including lack of financial

discipline, insufficient enforcement of market regulations, low transparency and stability of the regulatory framework, inefficient public administration, an unsatisfactory judiciary, and so on. Thus Romania still has quite a way to go in order to become a highly performing market economy. Could the status of the country's economy be changed by the end of this year?

Some economic evidence suggests that it could. Recovery continues; the GDP grew by 5.7 per cent and 4.9 per cent in 2001 and 2002, respectively. It will probably slow down to about 4 per cent this year, primarily because of economic stagnation in the West and a bad domestic harvest. Inflation, the scourge of the past decade, is coming down decisively. From 30.3 per cent in 2001, it decreased to 17.8 per cent in 2002 and will most likely fall to around 13 per cent this year. The banking system is much sounder now, following a massive clean-up operation, and its reserves have jumped remarkably in recent years. Overall public indebtedness is below 30 per cent of GDP, out of which the external public (and publicly guaranteed) debt is about 75 per cent, while short term indebtedness is relatively low. Budget deficits have been kept under 3 per cent in the last couple of years and current account deficits have been, on average, around 5 per cent.

This state of affairs has not gone unnoticed by the major rating agencies, which increased Romania's standing from B- to BB-. This is still below investment grade, but prospects for further positive revisions are deemed fairly high. The improved economic picture has emboldened top Romanian officials, who expect a positive judgment from the Commission in next November's report.

Other arguments can be used in Romania's favour as well. Some countries have registered sharply deteriorating economic indicators (budget and current account deficits) well ahead of their accession in 2004, while Romania's

economic performance during the same period has improved quite visibly. Furthermore, when long-standing members of the EU have had a difficult time meeting some of the Maastricht criteria, does it make sense to be overly strict with Romania? Of course, one can reverse the logic of that question: if well-functioning market economies can have such a hard time inside the Union, how would less well-functioning ones fare after joining the Club? The answer depends on examining other basic issues such as ability to give up the autonomy of policymaking (as a shock-absorber device) to the degree implied by accession. Are the Maastricht criteria in need of amendment, so that policy responses can be enhanced in times of duress? These issues concern the EU members and aspirant countries equally.

There are also factors which weaken Romania's credentials for receiving an upgrade. Hard budget constraints do not yet operate ubiquitously, and large loss-making companies produce sizeable quasi-fiscal deficits, especially in the energy sector. There is a deepening crisis in the pension system; domestic investment is too low to support long-term growth; the agricultural dossier is burdensome and worries our EU partners; and public administration is in need of major reform. Most of these problems cannot be dealt with rapidly, since they have a structural nature. Some of them, however, do not pertain to Romania only; they have a high profile in other accession countries as well. Moreover, the crisis of pension systems has been a problem for the existing EU members as well.

The bottom line is that a change in status makes sense if double standards are to be avoided and genuine economic progress acknowledged. At the same time, the Commission should also reiterate that Romania's economy has major specific weaknesses; that 2007 represents a timetable for admission and not a firm decision of the EU; that the period prior to admission allows Romanian authorities leeway for

effective autonomous economic policy-making, which should be used (and not abused!) in order to combat the country's economic vulnerabilities; and that populism should not lead economic policy astray during the upcoming election year. Brussels has powerful incentives in its dialogue with the Romanian government. For instance, Romania can benefit on financial assistance amounting to circa 1 billion euros per year, provided economic and institutional progress continues at a steady pace.

It would be highly disappointing for most Romanian constituencies if the EC were to decide to wait for further signs of economic and institutional improvement in order to upgrade the country's status. Nevertheless, we should remember that we institute reforms primarily for ourselves, and that whatever decision is made in November, no solid guarantee exists that Romania will join the EU in 2007 unless structural weaknesses are addressed with a strong commitment and results of improvement (which involve the assimilation of the *acquis*) multiply in a convincing manner. Romania needs a considerably better-functioning market economy in order to join the EU successfully.

Setimes 25.08.2003

### **EU ACCESSION ROADMAPS COULD CAUSE SOME BUMPS**

At the last EU summit in Copenhagen, Bulgaria and Romania received roadmaps which act as yardsticks of reforms needed for EU accession. Although the roadmaps are fairly eloquent, they leave a number of questions unanswered.

The adoption of the *acquis communautaire* (the set of EU norms and regulations) is only partially a technical operation of transposing the EU rules into national legislation. In a deeper sense, the assimilation of the *acquis* concerns the actual functioning of local institutions as a precondition of economic and social performance. For this reason, the European Commission has underscored the need for reform of public administration and justice and for continuing the fight against entrenched corruption.

Arguably, the reforms that are being requested by the EU are more demanding than the creation of a "conventional" market economy together with a liberal democracy. This is because the EU is the fruit of organic development and also of meticulously engineered institutional construction. The latter, in particular, is meant to bring national contexts – of relatively close economic development levels – nearer institutionally and functionally. Accession demands a series of institutional adaptations, which otherwise would not be asked for.

In spite of lingering economic discrepancies, the EU is made up of prosperous economies and societies. Therefore, Bulgaria and Romania are confronted with a major developmental handicap, which cannot be done away with quickly. The income per capita in Bulgaria and Romania is below 28 per cent of the average in the EU in Purchasing Power Parity terms.

At the same time, the Maastricht criteria, which concern the level of inflation, interest rate differentials, budget deficit limits, and limits of variation of the exchange rate, are not easy to fulfil and may constrain economic growth. The autonomy of economic policy would be severely constrained even during the pre-accession period and may reduce considerably the capacity to deal with adverse shocks.

The "political economy" of enlargement is also an issue to consider. The first wave of enlargement in 2004 can be taken for granted; further accession waves are far from being a certainty. Future enlargement depends on the internal metabolism of the EU, which could be severely tested by rising divergence of economic performance, due to mounting economic difficulties all over the EU in recent years, and by the formation of various "coalitions", with different views on the nature of deepening and the management of EU internal issues as well as the formulation of a common security and foreign policy.

A main inference is that the assimilation of the *acquis* implies both benefits and costs, and the latter are not to be underestimated. Moreover, costs are not easy to illustrate and measure, and that could create a credibility problem for public authorities should these costs be revealed as substantially higher than anticipated.

Admittedly, benefits would go far beyond costs. The accession negotiations would discipline policy making; EU accession related reforms would become more consistent and steady. Against the background of assimilating the *acquis*, the link with the EU looks far richer than that with the international financial institutions. The EU could provide a push in order to overcome a developmental and modernisation challenge. Aside from the benefits brought about by institutional reforms, financial assistance can make a huge difference, if it is used wisely. The EU can also provide an economic "shelter" at a time when uncertainties and vagaries multiply in the world.

But there is a series of aspects that the roadmap leaves open:

There are policy issues which do not have clear-cut solutions and multiple policy options are available; choices should try to optimise according to domestic circumstances and most likely external conditions.

Policy needs to observe the ABCs of sound economics (achieving low inflation, keeping fiscal balance over the business cycle, making hard budget constraints operate ubiquitously, etc.) but be pragmatic at the same time; it is inimical to succumb to theoretical fundamentalism when it comes to real life. For example, markets should be regulated effectively.

Policy needs to avoid hasty decisions, which may score "prestige points" but are likely to be quite costly unless addressed properly. One example would be a hasty full liberalisation of the capital account.

The fate of national industry depends on how domestic sectors enter main European industrial networks. Public authorities can play a role by using various policy tools (including tax incentives and a better business milieu for inward investment in industry). This assertion does not imply continuing to subsidise heavy loss makers and denting the profitability of successful companies.

Infrastructure needs a lot of improvement. To this end, funds from the EU and from other specialised institutions – the European Investment Bank, in particular – have a key role to play. The experience of Portugal, Spain and Greece shows what tremendous progress can be made by making good use of EU structural funds.

More resources have to be assigned, via the public budget, to education and health care services. This issue will be increasingly challenging in the years ahead. As in the case of infrastructure, a better performing economy and better tax collection would allow significant improvements.

Agriculture will, very likely, be a major stumbling block in accession negotiations, for it holds a relatively large share of the GDP and keeps much of the active population busy. One should also consider the heavy subsidisation of this sector in the EU.

The purely economic problem could be compounded by farm land consolidation, which would likely force younger people to try to find jobs in the urban areas. This might recreate the old "rural overpopulation problem" if other sectors do not provide a sufficient number of jobs. In view of the demographic ageing in Europe and the increasing propensity (because of wage differentials) of Bulgarians and Romanians to work abroad, the export of labor may offer a venue for alleviating or averting a major social crisis. Both countries need to avoid a Latin American-type evolution in this regard, and proper agreements with the EU would be a means of tackling the issue. In fact, a "Grand Bargain" may be in the offing. Transition economies would supply labor to the EU, making it possible for citizens who work abroad to send substantial amounts of money back home; and these private transfers would make up a *sui generis* safety net.

Setimes 21.04.2003

## **ROMANIA'S ECONOMIC POLICY CHALLENGES IN 2004**

Romania finished 2003 with a positive, but not unblemished, macroeconomic record. The country saw economic growth of around 4.7 per cent. Inflation is down to 14.1 per cent. The budget execution seems to have ended with a deficit of 2.3 per cent, and Central Bank reserves have grown marginally to just below 8 billion euros. Inward Foreign Direct Investment (FDI) also has risen to more than 1 billion euros, though not in a spectacular fashion. These results were accompanied by upgrades from the main rating agencies, although Romania still is several notches below investment grade.

Spoiling the picture, however, is the surge in the current account deficit, estimated to have reached about 6.5 per cent of the GDP – which is about 3 per cent more than in the previous year. In addition, tensions related to insufficient industrial restructuring have continued, and may have contributed to the rise of the trade deficit. An illustration of these tensions is the persistence of large arrears in the economy.

The economic year 2004 is important in and of itself, and also in terms of the direction the Romanian economy is taking with the aim of joining the EU in 2007. Disinflation is getting to a critical stage; further advances hinge essentially on fiscal and financial discipline, which in turn depend on the restructuring of several key industrial sectors such as energy generation and distribution.

What are the driving factors behind the rise of the current account deficit in 2003? A macroeconomic explanation would focus on last year's economic growth. Unlike previous years, growth during 2003 was fuelled by internal demand rather than exports. Other causes can be found in the financial lack of discipline and inefficiency in the economy, heavy dependency of exports on intermediate imports and the worsening terms of trade for the Romanian economy. Oil has been more expensive. The severe drought entailed additional imports of grains and foodstuffs. Other factors include a low ability to produce domestic products; the real exchange rate appreciation of the domestic currency; and the euro's appreciation against the US dollar – which has made imports from the dollar zone extremely attractive. At the same time, the general subsidy given to exporters in 2000 has undergone diminution. Consumer credit, too, has played a role.

The government's assumed main policy targets for 2004 include bringing inflation down to 9 per cent; a 5.5 per cent GDP growth rate; and a reduction of the current account

deficit to 5.8 per cent of GDP – although that figure is still being discussed with IMF experts. The possibility of achieving these targets has to be evaluated in relation to election year pressures, the rise in the current account deficit and structural constraints. Prominent among the latter are quasi-fiscal deficits, which can burden the budget severely unless dealt with in due course. On the other hand, the goal of concluding negotiations with the EU this year could provide a strong policy anchor.

Two aspects of the policy targets stand out. One is the highly ambitious disinflation rate – from 14.1 per cent to 9 per cent. The second is a looming conflict between the economic growth target and the need to control the current account deficit.

The challenge of bringing down inflation to a single-digit level should be examined in the context of an insufficient restructuring of the economy and the existence of arrears. Hard budget constraints do not operate ubiquitously, and loss-making companies produce sizeable arrears and quasi-fiscal deficits. High inflation has been used by many companies as a means to stabilise arrears in real terms and thereby survive. Current disinflation strains loss-making firms. Unless restructuring makes considerable headway, persistent large quasi-fiscal deficits will clobber the budget and the economy in the future. Disinflation will stalemate at some point unless hard budget constraints operate unabatedly.

It could also be argued that the projected pace of disinflation clashes with the economic growth objective, given the surge in the current account deficit. One can imagine a scenario in which the growth target would be least impaired by trying to stick to this year's current account deficit, in the hope that larger inward FDI and portfolio inflows would make financing relatively easy. The desire to maintain the economic growth objective of 5.5 per cent looks

quite attractive in relation to expected pressures during an election year. But this policy mix would jeopardise the macroeconomic balance by betting on highly variable factors.

Bringing inflation down to a single-digit level and reducing the current account deficit by a substantial margin – 0.7 per cent to 0.8 per cent of GDP – requires containing domestic demand firmly. If other conditions remain unchanged, that would unavoidably bear on the GDP dynamic. Certainly, one needs to factor in the effects of the electoral year, which may cause policy slippages.

There are premises for limiting collateral damage resulting from populist measures, owing to the EU anchor – Romania wishes to conclude as many negotiating chapters as possible this year. If policy slippages stay small, a single-digit inflation rate could be achieved with a current account deficit below 6 per cent of GDP. By contrast, a primary focus on growth would harm the other goals. A policy mix, which aims at optimising under constraints, would have to include prudent liberalisation of the capital account.

**Setimes 16.02.2004**

### **FOR ROMANIA AND BULGARIA, ABSORPTION CAPACITY IS ESSENTIAL**

A recent budget decision may prove to be a basis for the European Commission (EC) to develop common EU positions this spring so negotiations can proceed on the chapters in the accession talks that have financial implications. The decision was accepted by the EU on 22 March – and if Bulgaria and Romania join the Union in 2007

– the two countries will receive almost 15 billion euros for effective spending between 2007 and 2009.

The decision was welcomed in Sofia and Bucharest, since it is regarded as a signal that the two countries are next in line for accession following this year's EU enlargement. The move indicates that budgeting is being done in light of a strategic decision and a corresponding timetable.

The budget proposal, however, comes at a complicated and momentous time in the history of the Union. Many wonder how enlargement can be combined with a genuine deepening. Managing the increasing complexity of the enlarged Union is perceived as a formidable challenge for the years to come. There is rising concern about the EU's apparent lag behind the United States and some Asian economies in terms of competitiveness and the use of information and communication technologies.

Some, particularly in the donor countries, thus argue that the EC is doing things backwards. The budget, they say, should place more emphasis on funding research and development activities, which would underpin knowledge-based sectors and bolster the Union's ability to compete in world markets.

Barring increases in the Union's budget, the debate inevitably pits donor countries against recipient countries. The outcome of the debate has special significance for the new member countries, which would become the largest recipient areas for financial assistance. For some of these countries – Poland and Romania, for example – large-sized rural sectors complicate matters even further, due to the challenge of reforming the Common Agricultural Policy.

Enlargement fatigue along with constitutional disputes institutionally bogged-down reforms and economic pains within the Union and have raised the stakes for Bulgaria's and Romania's accession in 2007. The issue of how these

two countries use EU funding is receiving considerably more attention than in the case of the countries which are joining the Union this year.

EU funding is already available to candidate countries. How this funding is used – before and after accession – is of enormous significance. EU financial assistance can supplement national budgets during periods of severe retrenchment, and when the output of public goods – health care, education, repair and construction of infrastructure – is under pressure. Moreover, EU assistance can target the development of local institutions, which underpin economic performance.

The way a candidate country uses financial assistance is indicative of its ability to develop economically and to catch up with the EU member countries. Bulgaria and Romania's relatively low absorption capacity shows that both countries are attracting considerably less Foreign Direct Investment than they need.

Another way of looking at absorption capacity, which relates it to how EU members view a candidate country, is that low absorption capacity can dent a country's credentials for membership if some inside the Union see it as a reflection of inadequate economic and institutional prerequisites for accession. For this reason, using financial assistance as efficiently as possible has additional importance and should be a top policy priority in a candidate country.

However, the ability to use financial assistance is no less important following accession. New member countries must contribute significant amounts to the EU budget. Romania, for instance, would have to pay an annual amount of about 800m euros upon accession. Complying with the requirements of the *acquis communautaire* will be quite costly, as would be observing EU regulations in the area of environmental protection.

A low absorption capacity could, paradoxically, turn a new member country into a *de facto* net donor. Policymakers in the new member countries, and in Bulgaria and Romania, need to think seriously about how to increase the capacity to absorb financial assistance. Such absorption must be judged not only in pure technical terms – as an absorption coefficient, which should be as high as possible – but as a means to foster overall economic development.

The race to join the EU is becoming tougher for Bulgaria and Romania, and making the best possible use of EU funding is of enormous importance. Reforms are crucial – they condition the capacity to absorb funds. Funds, when used skilfully, support reforms. Clear rules of the game, transparency, and an emphasis on projects of high public utility are likely to trigger a chain of positive effects throughout the economic body of the country and to strengthen the fight against corruption. Such an approach should shape the agenda of policymakers. What happens with Bulgaria and Romania will provide a major lesson for the whole of Southeast Europe.

Setimes 5.04.2004

### **REVENUES AND THE FLAT TAX IN LIGHT OF ROMANIA'S EU ACCESSION**

The presidential and legislative elections of November 2004 resulted in a major political shift in Romania. The new government introduced a radical fiscal reform which relies on a flat tax of 16 per cent on incomes and profits. The reform is best viewed within the wider context of fiscal competition across Europe – wealthy and less wealthy

countries alike are attempting to lure more inward investment at a time when competitiveness challenges are multiplying. Hungary and Poland have led the way in recent years, with the latter country – keeping the experience of Slovakia in mind – contemplating a flat tax. Older EU members have not been insensitive to these measures. Austria has already lowered corporate taxes, and German Chancellor Gerhard Schroeder recently announced plans to do so.

Although the rationale for lower taxes is transparent, the timing of the Romanian government's move has raised questions. The economy has been growing rapidly in recent years, at an average rate of 6 per cent of GDP over the last four years, and more than 8 per cent in 2004. At the same time, external deficits have been on a steady and rapid rise. This context is what lies behind the difficult dialogue Bucharest has been conducting with IMF experts in recent months. The Fund is concerned that budget revenues could be adversely affected by the flat tax in an economy that they view as "overheating".

However, the Romanian flat tax has to be judged in the wider context of Romania's planned entry into the EU in 2007. The country signed its accession treaty on 25 April, but its social and economic performance must bolster its reform efforts in order to avoid having its entry delayed by one year, as provided for by the so-called "safeguard" clause. In the interim, Romania will continue to come under pressure to make its economy more market-oriented.

In fact, the overall picture has been improving substantially. Inflation is at a one digit level for the first time in 15 years, the banking system is on a solid footing, the reserves of the National Bank cover more than six months of imports, and exports have been rising vigorously. But fragile areas in the economy remain, and specific changes, such as full liberalisation of the capital account, are demanded by the

*acquis communautaire*. This, along with tax reform and a number of other institutional shocks – freer floating of the Lei (ROL), administered price and tariff rises, the introduction of the hard ROL, the shifting to direct inflation targeting, a new labour code, and the requirements of the EU competition policy – will test the economy's capacity to adjust smoothly.

The new measures are likely to reveal significant rigidities, which will necessitate adjustments. The National Bank, by maintaining a range of 3 per cent around the annual inflation target of 7 per cent, speaks implicitly about the possibility of an inflation slippage, which could occur at an ill-suited time, in view of the introduction of a monetary policy regime that focuses clearly on inflation.

Data regarding the commercial deficit over the first two months of the year point to the continued growth trend: it is approximately 80 per cent higher compared to the same period in 2004. The current account deficit has also continued to grow at a fast pace, with the non-governmental credit setting the pace. On 1 April, a wave of price and tariff rises began, impacting the dynamics of inflation. The progress of disinflation depends not only on the reverberations of these rises throughout the economy, but also on their impact on inflationary expectations.

The macroeconomic situation sketched above shows why the discussion regarding possible policy slippages is not a mere intellectual exercise. The growth of the economy, the expansion of the non-governmental credit and the appreciation of the ROL lead to larger external deficits. The appreciation of the ROL is helpful for disinflation, but to what extent remains to be seen – hence the concern regarding the "overheating" of the economy. Should slippages occur this year, however, they should not be dramatised. It is not the budget deficit which is to blame for the rise of the current account deficit; the main driving engine, by far, is private

sector borrowing, which accounts for about 85 per cent of the figure. Squeezing the public budget for the sake of limiting external deficits will be of little help.

As the time horizon is extended, the situation becomes more complex. Romania's prolonged dialogue with IMF experts does not centre on this year's numbers, but on the broader perspective, and specifically on the emergence of pressures – unrelated to tax reform – on the public budget. EU accession involves substantial expenditures, including the contribution to the community budget (about 1.3 per cent of GDP) and the co-financing of structural funds (over 1 per cent of GDP). Together with social security reform and the need to supplement the funds allotted for education and health, budget expenditures will grow by at least 3 per cent to 4 per cent annually. Without a better collection of budget revenues, and assuming other conditions remain unchanged, the deficit of the consolidated public budget would reach 4 per cent to 5 per cent of GDP in a few years' time.

The ever-decreasing budget deficits of the last few years have been hiding an important structural problem, arising from two factors. One is the impossibility of repressing expenditures if Romania is to provide a volume of public goods appropriate for an EU member country. The second is that EU accession brings with it requirements for competitiveness and modernisation.

As a new member, Romania will be joining several neighbours which have accumulated high budget deficits due to accession costs. But the situation in the Czech Republic, Hungary and Poland differs significantly from that of Romania. In those countries, budget revenues are larger by a few GDP percentage points, making it easier to enact painful adjustments on the expenditure side of the budget in case these cuts are needed. Moreover, in these countries the "twin deficits" logic is operative, with external deficits co-existing with considerable budget deficits – thus, a major decrease of

the budget deficit would likely lead to an appropriate fall of the current account deficit, were a balance of payments adjustment badly needed.

In Romania, the falling budget deficits of the last few years have cohabitated with swiftly growing current account deficits. Should the budget deficit grow significantly in the years to come, without a reduction in the private sector's appetite for consumption and borrowing, the current account deficit could easily reach over 10 per cent of GDP. Such a level would be worrisome to the extent to which it would involve funding from short term loans and inflows of speculative capital. A massive depreciation of the ROL could then be expected, which in turn would reignite inflation and possibly lead to readjustment of the public budget.

Should EU accession bring about a dramatic improvement in Romania's economic and social performance, the concerns described above will be largely alleviated. More modest improvements could, at the very least, help the country deal with future budgetary issues. It would be unrealistic to expect these issues to disappear miraculously. Romania cannot afford to ignore them during its dialogue with the IMF.

**Setimes 2.05.2005**

## **ROMANIA AND THE LISBON AGENDA**

A third independent report assessing Romania's economic performance in terms of the Lisbon Agenda benchmarks was recently released. It follows up on a November 2004 study, which focused on competitiveness and ways of increasing convergence with EU standards, and

an initial analysis in March 2004, which featured a scorecard based on the main objectives set out in the Agenda.

The new report has been undertaken against the background of the revised Agenda; it uses structural indicators in order to assess the Romanian economy comparatively and examines the linkage between policies and the economic recovery/growth of recent years, the challenge of competitiveness in the local context, and the ability of Romanian policy-makers to foster job creation as a means to mitigate migration.

Broadly speaking, the Lisbon Agenda is an ambitious policy programme meant to combat the low productivity and economic stagnation witnessed in the EU, which has found itself lagging behind the United States and, increasingly, emerging Asian economies. The stated goal is to turn the EU into "the world's most dynamic and competitive economy" by 2010. The programme places a special emphasis on building an information society through computer literacy, technological innovation, and the development of IT-related businesses.

The Lisbon Agenda functions both as an overarching vision and a complex set of policy guidelines. Its priorities can be interpreted by EU member and accession countries differently, national performances and circumstances vary significantly. While the older EU member states are especially focused on job creation and support for R&D as well as reform of the welfare state, for a candidate country like Romania the main priorities are economic restructuring and improvement of the business environment. Although information and communication technologies can sometimes work wonders, development stages cannot simply be leapt over at will. For Romania and other nations in transition, technology absorption will remain essential the foreseeable future.

Embarking on the grand aims set out in the Lisbon agenda may seem a luxury for Romania's emerging economy. Such economies, as is commonly known, rely mainly on the absorption of available modern technologies in their quest to achieve rapid economic growth. Although substantial economic progress has been achieved in recent years (prompting Fitch and S&P to give Romania its first investment grade ever) the structural foundations of the Romanian economy are not sufficiently strong. Moreover, the local financial intermediation is inadequately developed, agriculture remains behind the times, and external deficits have been growing sharply. Under these circumstances, moving towards a knowledge-based economy is a pretty daring endeavour.

In fact, Romania has a long way to go to reach the goals set forth in the Lisbon Agenda. Although progress has been made, it is not even close to approximating the 25 current EU members' performances in most areas. In no small part, this is because Romania has different priorities and challenges.

The good news is that knowledge diffusion – that is, the spread of an information technology – is advancing at a good pace, although knowledge creation indicators are still underperforming. The emergence of software firms signals there is movement in the right direction. The key to longer term growth, however, is the production of higher value-added products and services, and this will require a sustained focus on education, the building up of skills, and expansion of technological knowhow – keeping up with the latest information and communication technologies.

The new report includes a number of policy recommendations for boosting Romania's progress towards the Lisbon goals. Of the greatest urgency is strengthening the country's capacity to absorb EU funds; one way would be

through establishing a special vehicle, such as a Corporation for Infrastructure Development. Public expenditure should be overhauled, redirecting funds towards areas that strengthen the country's human capital infrastructure and administrative capacity. Multi-annual budget programming is a must.

Certainly the road to a knowledge society will not be easy unless the current decline in R&D spending is reversed. The report advocates directing more state aid towards R&D objectives and providing support for businesses to conduct R&D. For example, fiscal incentives could be linked to the share of R&D expenditures in turnover or the share of R&D employees in total employees, or the number of patents registered each year.

Specific Lisbon-related goals also have to be seen within the context of larger policy problems affecting the entire economy. For example, Romania needs a vigorous competition policy to prevent market abuse. The tax base should be broadened and tax collection improved in order to avoid "budget shock" at the time of EU entry. Excessive appreciation of the domestic currency should be prevented through direct inflation targeting. Non-wage components for labour costs should be reduced, especially for low-skill jobs, hiring and firing costs should be reduced, and the Labour Code further improved. Lifelong learning should be encouraged.

Romania's performance should be judged realistically. It will be some time before the country is genuinely in a position to embark on creating a fully-fledged "knowledge economy" or tackle the other long-term Lisbon goals. Nevertheless, the effort needs to be undertaken, though in a form that fits the specifics of the Romanian economy. The reasons are clear. Firstly, the Lisbon Agenda ranks very high on the list of priorities of the club which Romania will soon

join, the EU. Secondly, working towards the long-term vision will spur the country to make needed upgrades to products and services, in turn facilitating growth in all areas. The seeds of change have to be sown starting now.

Setimes 7.11.2005

### **THE ROMANIAN ECONOMY: WHAT TO WATCH FOR IN 2006**

Forecasting Romania's economic performance in 2006 is a risky business. However, we can say with certainty that the outlook depends on a number of specific issues. Among them is the ability of the domestic economy to adapt to changing conditions.

Industrial output grew considerably less in 2005 than in the previous year. For the first nine months, the increase was a mere 2 per cent, while GDP for the entire year will likely not exceed 4 per cent. These unimpressive figures are partly attributable to the heavy rainfalls and floods that affected much of the country. At the same time, Romanian industry – and certain sectors in particular – were hit by the severe appreciation of the domestic currency, the rise in energy tariffs, subsidy cuts and fiercer competition.

In general, the more domestic market conditions match those across the EU, the harder it is for numerous local companies to comply with the new terms of competition. This is reflected in smaller growth of output and GDP. How will domestic companies fare in the period to come? Or, to put it differently, has industrial output reached a bottom, or will downward adjustment, with its related painful costs, continue for a while?

If the bottom has not yet been reached, we may see worsening numbers in the months to come. If the bottom has been reached, the rate of growth in industrial output may rise in 2006, although signs are not likely until the second quarter. A speedier absorption of shocks would help GDP growth to recover as well. A better harvest would assist such a recovery considerably – this year's harvest fell an abysmal 12 per cent compared to 2004. However, too much optimism is not warranted, considering that productivity gains were relatively unimpressive in 2005.

The trade deficit has continued to grow rapidly, and the current account deficit may have exceeded 9 per cent of GDP in 2005. Given that GDP and industrial output growth have slowed significantly, a question is calling out for an answer: are such external deficits sustainable? In fact, there are several aspects related to the rise in external deficits which require clarification. The unimpressive productivity gains of the economy this year seem to confirm the qualms I expressed, in an article a couple of years ago, regarding a major competitiveness challenge. The economy must somehow cope with a sharp exchange rate appreciation resulting from heavy money inflows from Romanians who work abroad and other capital inflows which are attracted by Romania's prospects of joining the EU (the so-called "Dutch disease").

Some would argue that the external deficits are not worrisome, given the "normal" growth of bank credit and the presence of foreign capital in the banking industry, which presumably translates into reliable long-term credit lines. But such arguments have limits. In the real economy there is no one-way street; painful corrections are inevitable once deficits exceed certain thresholds. Were such a correction to happen, it would involve a severe depreciation of the exchange rate that could rekindle inflation.

As for the new monetary policy regime of the National Bank (NBR), namely inflation targeting, the real test will come this year. The final four months of 2005, during which inflation targeting has been practiced, are not conclusive at all and it would have probably been better to postpone its introduction for a while. The test will be highly demanding since conditions are peculiar: Almost half of the money supply escapes the NBR's control (because transactions are euro and dollar denominated); interest rate differentials are still high; and the boom of bank credit and capital account liberalisation has eroded the NBR's ability to control money supply. The 5 per cent inflation target for 2006 is overambitious; 6 per cent to 6.5 per cent would be more reasonable, considering the rise in gas tariffs and the underlying inflationary expectations. Last year's target was missed by a large margin – inflation would have likely been 8.7 per cent to 8.8 per cent in 2005 as against the 6 per cent initial target, prior to the introduction of the flat tax.

Though the public budget envisages a deficit of 0.5 per cent for 2006, some of its underlying premises are questionable – specifically, those relating to GDP growth and inflation. A budget rectification would have to consider a revision of these premises. Budget execution must be tight next year. At the same time, the financing of infrastructure projects has to be increased. And special attention has to be given to raising the capacity to absorb EU funds. An adequate management of the key issues has the potential to enhance Romania's investment grade.

The international environment, meanwhile, is under the spell of major uncertainties, which are rooted in global imbalances and the economic impact of various geopolitical conflicts. Economic stagnation in Europe and elsewhere, as well as the rise of China and other Asian economies, prompts countries to resort to protectionism as a means of defending domestic markets (the gridlocked Doha trade round speaks

for itself). The price of basic commodities and oil will continue to be impacted by the rise of Asian economies. These circumstances will have an influence on the Romanian economy, though it depends greatly on EU markets.

Last, but not least, Romania has to make good on its commitments to the EU; the better we do, the better our chances of getting into the Union. Romania's political and business leaders have the responsibility of better defining national interests better, and in concrete terms. The EU has its specific supranational interests; but it is also a constellation of national interests which often conflict. This reality poses numerous challenges to national decision-making processes. Failure to meet those challenges, however, could carry the price of a delayed membership in the EU, thanks to the safeguard clause. The stakes in 2006 are high.

**Setimes 23.01.2006**

## **NEWS MOSTLY GOOD FOR THE ROMANIAN ECONOMY**

Romania and neighbouring Bulgaria are less than three months away from becoming the EU's newest member states. Much recent discussion has focused on Brussels' insistence on further monitoring and the reluctance of some existing EU members to admit Bulgarian and Romanian workers. But what about the economic situation in the two countries themselves? Ultimately, the ability of both countries to adjust to a new, competitive environment may have more of an impact on labour flow than the policies decided on in Dublin or London.

As it happens, the economic prospects in Romania have brightened just in time for membership. In many respects, the country is booming. The GDP's growth rate was 6.9% in the first quarter of this year, and it sped up to 7.8% in the second quarter. Disinflation has continued. December to December inflation will likely be close to this year's target, 5%, down from 8.6% in 2005.

Industrial production has made a remarkable recovery after a series of heavy shocks. A severe appreciation of the domestic currency (due to massive capital inflows) and a sharp rise in energy prices (as a prerequisite of adjusting domestic relative prices to EU levels) have strained not a few industries in the last couple of years.

Indeed, the growth rate of industrial output slowed down in 2005, and a bad harvest diminished the rise in GDP to 4.5% in 2005 – a sharp fall from the peak of 8.3% in 2004. The speed with which industry has recovered suggests that efficiency reserves are still quite high in the Romanian economy and that shocks can be dealt with adequately, provided management is good and the transfer of new technologies is satisfactory.

Budget revenues have been bulging and may jump above 32% of GDP this year (from around 30% last year). This trend seems to vindicate those who supported the introduction of the 16% flat tax in 2005. It should be noted, though, that additional revenues have been pumped into the budget because of a very high economic growth rate, and also because the flat tax has been implemented in areas where no, or lower, taxes were levied earlier.

Higher budget revenues help finance badly needed investment in education and infrastructure at a time when EU accession is putting pressure on the government to boost the production of public goods. Unemployment is slightly above 5%, though this is due greatly to massive migration. Not

least, rapidly growing exports are to be mentioned; their rise has been over 18% in the first semester of this year.

Overall, the Romanian economy is cruising at a fast pace, defying less optimistic forecasts. However, some things need to be qualified.

To begin with, it is legitimate to ask whether the pace of economic growth is sustainable. There are data that compel a more nuanced view of the inner dynamics of the Romanian economy. For instance, exports have been increasingly outpaced by imports in recent years and the current account deficit has surged to a probable 10% of GDP in 2006. The financing of large current account deficits has not been a problem in recent years, owing to large inward foreign direct investment. But the situation may change in the years to come, following the end of big privatisation deals. Even if greenfield investment grows after EU accession one should not bet on a complete offset effect.

Some analysts have warned of the threats that large current account deficits pose to several emerging economies, including Romania. These dangers must be assessed within the context of free capital account rules (a must for a EU accession country), the tightening of monetary policies in both the EU and the United States, and, not least, the heavy borrowing in foreign currency done by individuals and resident companies.

However, budget policy cannot do much in order to correct rising current account deficits when domestic credit to and external borrowing by the private sector are surging. At the end of July credit to the non-governmental sector grew by over 100% in Romania, as compared to July 2005. The share of internal credit to GDP in Romania is at the low end of the spectrum in Europe, and commercial banks would like to capitalise on the assumed bright prospects for an economy that will become part of the EU in 2007, and that has been growing very rapidly in recent years.

Along with rising deficits, a number of other factors – inflationary pressures due to a rise in aggregate demand after accession, a monetary policy regime (inflation targeting) that implies exchange rate flexibility, and likely increases in the burden on the public budget (due to EU accession commitments and the need to develop domestic infrastructure) – point to a more sober view for the longer term.

A recent World Bank report hails Romania's reforms and fuels high expectations for post-accession years. Arguably, however, a growth rate that ranges between 5.5-6% annually is more in tune with the actual underpinnings of the Romanian economy. Were these underpinnings to move in the right direction, a higher durable economic growth rate would be feasible.

The Romanian economy needs more fixed investment, a better infrastructure and for sustaining growth rates of above 6% yearly, on average, over the longer term. More significantly, it needs faster absorption of new information and communication technologies. R&D is expected to rise to 0.7% of GDP in 2007, but this is still far from the Lisbon Agenda requirement of 3%. Even if the figure came close to 2% by the end of the decade, intensity of economic innovation and the pace of new technology transfers will be essential for Romania. For this to occur widely, good management practices have to be undergirded by better training. High technology absorption would raise overall productivity and allow Romania to catch up economically inside the EU as well as compete better in the global economy.

If the growth differential stays around 4% in Romania's favor, in conjunction with a possible 2% average annual exchange rate appreciation of the domestic currency (until adoption of the single currency), income per head in Romania could reach around 60% of the EU average in a

decade. Meanwhile, a high ratio of EU funds absorption would help modernise the rural economy and reduce migration. This would not be an unsatisfactory performance. Public policy, though, will have to play a major role in bringing it about.

Setimes 30.10.2006

### **EURO ADOPTION IS TO BE APPROACHED CAREFULLY**

Slovenia has adopted the euro recently while Lithuania has been asked by the Commission in Brussels to wait longer. At the same time, Poland, the Czech Republic and Hungary have decided to prolong the timeframe for euro adoption. As a matter of fact several new EU member countries are coming to grips with the reality that the adoption of the common currency is a more complicated endeavour than initially thought.

Romania, too, is supposed to adopt the common currency by the Accession Treaty. Its convergence programme has set as a strategic target the adoption of the Euro and the accession to the Monetary Union by 2012-2014. Arguably, stating this aim unambiguously can help economic policy in Romania be more consistent. However, one should not underestimate the difficulty of making an objective, which is wrapped up in many technicalities, the support for an inherently comprehensive policy platform. Moreover, this platform needs to be easily digestible for the public at large.

But clarity is not enough. There is the experience of the actual functioning of the Monetary Union (MU) that should

ring some bells. Firstly, there are premises that, supposedly, enhance an optimal entry into the Euroland. By this I have in mind not so much nominal convergence criteria (inflation, interest rate differentials, public debt, exchange rate volatility), but rather those that would make a good performance inside the MU achievable: due flexibility on product/service markets and of markets for production factors (including labour), an adequate prior reform of the welfare and pensions system which should take off some of the expected additional burden on the public budget in the future, a tax policy focused on the mobility of production factors under single market conditions (labour migration included). Such prerequisites are not at all easy to meet; they imply a certain development level of the economy that must in no way be accidental if the euro adoption is to be successful. After MU accession the only macroeconomic instrument left to national policymakers, for adjustment purposes, is the public budget. Unless domestic markets function properly to put a too heavy burden on the public budget would have a boomerang effect; the economy could stall in recession if the intention were to reduce excessive external deficits – as shown, inter alia, by the Portuguese experience. Italy, too, indicates how tricky operating inside the MU can be unless markets adjust smoothly, rapidly.

Economic policy after accession has to deal with unavoidable and complicated trade offs, for which theory does not always have clear solutions. For example, major trade offs are entailed by the complete liberalization of the capital account when domestic interest rates are still high (and attract hot money inflows). Let me give another example that regards catching up economies. Emerging economies need massive investment in infrastructure, for overall modernisation. Such investment stands for an important growth of public and private expenditures which,

unless accompanied by corresponding productivity gains, would create inflationary fits while enlarging foreign deficits. I share the view of those who argue that the Maastricht criteria seem to be less applicable to emerging economies, that are growing quite rapidly. And I say it not only because of the Balassa-Samuelson effect (that posts a pretty fast rise in the prices of non-tradeables). I refer in particular to a possible conflict between a considerably larger public budget (with public expenditures that may rise by 4-5% of GDP due to the use of EU funds and required rises in public expenditure following EU accession) and the sustained disinflation that is required by accession into the MU. The more complex and bigger an economy, the more difficult to tackle macroeconomic trade-offs. As I mention above the Czech Republic, Hungary (apart from obvious errors made in the last ten years), Poland are among the new EU member countries that have extended their MU accession time-line because of the inherent difficulties of dealing with major policy trade-offs. For Bulgaria, Romania and other countries another factor worth mentioning here is the upward pressure on wages caused by steady migration, that may make it rather difficult to reach an inflation rate of around 2 per cent on a durable basis.

There is another aspect related to the functioning of the MU that should provide food for thought. There are countries which behave like free riders, counting on an easy financing of their deficits (see bonds issued by government bodies or companies at low spreads) without being able, seemingly, to put their public budgets in good order. A taboo in Brussels and Frankfurt is the viability of the Monetary Union, which is understandable; for the euro is as much a political construct as an economic one. Nonetheless, too many free-riders could bring the Monetary Union into a situation where

the benefits from being a member of the euro zone could be outrun by costs. A one size fits all monetary policy would be increasingly unwelcome under such conditions.

Therefore, the debate on MU accession must address a wide range of issues and circumstances while it has to acknowledge that this target is set forth by the Accession Treaty of the new EU member countries. This debate needs to be accompanied by an analytical understanding of unavoidable trade offs among key policy targets –within the framework of longer term economic policy planning and making. The public policy will have to find the way in order not to sacrifice real convergence for the sake of expediting nominal convergence that, later on, would turn out to be ephemeral.

The adoption of the euro should not be seen as an ultimate target on its own, but rather as a means to diminish the economic divides that separate new member states from the rich member states of the Union. Consequently, euro adoption has to be formulated and made operational in realistic terms. Countries from Southeast Europe should consider carefully the pros and cons of rushing into euro adoption. The functioning of a currency board regime may speak in favour of a quicker euro adoption as would a heavy euroization of the economy (as is the case in Croatia). The size of the economy is also an important element to consider (and most Balkan economies are quite small). But, as I have tried to highlight in this article, this decision hinges on much more. Not least on clear prospects of joining the EU.

**Setimes 12.03.2007**

## **PART IV**

### **THE BALKANS AND THE EU**

## **ECONOMIC RECONSTRUCTION: THE ROLE OF EUROPEAN AID**

The terrorist attacks on 11 September re-ignited the debate on the links between poverty, social destitution and what breeds deep resentments, inter-ethnic conflicts and terrorism. Europe, too, is not devoid of dismaying events, with the Balkans' last decade epitomizing much of what is evil in the contemporary world. It is no secret that the Balkan countries need substantial aid "to come out of the woods". How can one judge aid in the Balkans, which should help achieve peace and enhance economic development?

Some pundits make an analogy with the end of World War II in evaluating the Balkans – even proposing the idea of a new Marshall Plan for the region. But, arguably, one should rather be cautious in making such a comparison, in over-stretching the relevance of history.

There are several motives in adopting a cautious approach. First, at that time there was no process of state-formation and dissolution and, therefore, no ensuing conflicts. This sparked, down the line, the start of the process of economic integration by the formation of the Coal and Steel European Community. Second, the war did not involve revision of borders. This is not the case in the Balkans nowadays, where borders have been and, still are questioned.

Third, the Marshall Plan meant, primarily, an infusion of funds for energizing economic reconstruction in an area which possessed the institutional ingredients of a market

economy. This is clearly not the case with large portions of the Balkans, in spite of the decades of market experience of many of the inhabitants of the states, which previously made up Yugoslavia.

Fourth, there was, at that time, a big common enemy: communism, external and internal. Who is the big common enemy of the peoples in the Balkans, at the start of the new century? The prime candidates would be poverty, underdevelopment and crime in an area, which, yet, belongs to a prosperous continent. But this is an imprecise enemy and not easy to deal with by looking at worldwide experience.

These observations are not meant to downsize the importance of aid for the Balkans. On the contrary, assistance is badly needed, it should be considerable, but it should also be wisely calibrated and provided. Aid needs to take into account the complexity of intra-regional relations, the still murky political geography in parts of the region, the existence of latent conflicts, the prevalence of weak – sometimes failed – states, etc. This extremely complex situation links national economic objectives with other goals, such as peace and security. At the same time, the stability of the region as a whole can be viewed as a collective good, a public good for Europe.

Whereas goals can be easy to define in abstract terms – peace and security, social cohesion, economic growth – they are much harder to formulate and pursue practically. This is particularly hard when the goals imply irreconcilable objectives of governments that do not show a high propensity to co-operate, or when these goals have to be pursued under very adverse circumstances.

In the Balkans, this situation is quite ubiquitous and explains the heavy presence of outsiders, the existence of protectorates both "hard" and "soft". But foreign presence does not simplify the solution to problems automatically, as the experience of Bosnia and Herzegovina indicates.

Tackling the problems of Southeast Europe demands a vision, which should frame the policies of both domestic and external actors. This vision, and ensued policy, needs to consider the consequences of the years of immense destruction brought about by military conflicts; failures of reform efforts; and the still very complicated nature of relations inside the region. All of these factors should be viewed in conjunction with a developmental challenge.

These lessons are most relevant when one considers the distress state of several economies in the region, where unemployment rates hover between 20 per cent and 30 per cent, poverty is widespread and on the rise, current account deficits approach 10 per cent of the GDP, and infrastructure is very precarious.

A development policy needs to take into account what is realistic to achieve without shunning bold action; it also needs to put the whole endeavor into a realistic timeframe, keeping in mind the intricacies of the situation on the ground.

Policymakers should cast their endeavors under three major headings: crisis management; economic reconstruction; and institutional change. Dealing with the Balkans needs to be judged from two inter-related perspectives. One is the exercise in dual (short- and long-term) crisis management, which aims at arresting, and reversing where possible, bad dynamics and path-dependencies.

The second perspective concerns reconstruction, which would have to be a two-pronged strategic endeavor: physical reconstruction and development (including institutional change and the political process).

The Balkan countries need to do the most they can; and their governments bear first accountability for economic performance. But Europeans, in general, have a big stake in

helping the people in the Balkans rid themselves of the demons of the past and the present.

Setimes 14.04.2002

### **UNEMPLOYMENT IN THE BALKANS: HOW MUCH OF A CONCERN?**

Unemployment rates have been persistently hovering around 40 per cent in Bosnia and Herzegovina (BiH), between 30 per cent and 32 per cent in Serbia and Macedonia, between 16 per cent and 18 per cent and even higher in Albania, Bulgaria and Croatia, in recent years. In Kosovo, the rate is very likely to have gone substantially beyond the level encountered in BiH, which is quite ominous.

There is, clearly, significant diversity of conditions in the labor markets of the countries, shown by the range of unemployment rates. But one fact is indisputable: the intensity of the phenomenon is quite unusual by European standards.

Extremely high unemployment rates can mould social and economic dynamics in perverse ways, which may hinder the Balkan countries' quest to embark on sustained economic development.

Overly high unemployment depreciate the high literacy rates and good educational levels of these countries. If unemployment is reduced, these factors will entitle the countries to aspire to rapid economic growth, due to the emergence of knowledge-based economy. In addition, unemployment rates breeds social strife, raise some

individuals and groups' propensity to engage in illegal and criminal activities, and favour the proliferation of non-conventional threats.

Years of devastating wars and interethnic conflicts have taken their toll and explain much of the state of economies in the region, including high unemployment rates. At the same time, the inability of local economies to undergo sufficient restructuring and create new jobs for the labour shed by idle industrial plants adds to the situation. The expanding service sector – as is the case in all transition economies – cannot compensate for the destruction of old jobs, unless new enterprises emerge at a rapid pace.

Many have turned to underground economy [those enterprises that avoid paying taxes], which is not necessarily engaged in socially pernicious activities; the underground economy, at the end of the day, helps people make a living. Nonetheless, low tax revenues undermine state capacity to provide public goods, which further damages social cohesion and overall stability.

This is a catch-22 syndrome, which leads to caution when treating the underground economy as benign. Spain's experience with very high unemployment rates – more than 20 per cent in the late 1980s and the early 1990s – at a time when the country was evincing impressive economic performance, proves this.

Dealing with high unemployment rates is not easy. The Balkan economies need to be able to grow on a sustained basis, and the recipe for rapid growth is not readily available. There is need for much more: clear rules of the game, enforcement of laws and regulations, enforcement of property rights and less bureaucracy simultaneously with state capacity to protect citizens' rights. Local economies also will need substantial infusions of capital from abroad – foreign direct investment, in particular, which should create new jobs.

The Stabilisation and Association Agreements, which are in place by most Balkan countries with the EU, as well as the Stability Pact, have a major role to play in shaping public policies. The World Bank, which is more attentive to fostering "good growth", has an essential role to play as well. Unemployment rates in the Balkans reflect much malaise and social chagrin, and they should become of paramount concern to those who formulate public and economic policies in the region.

Setimes 24.05.2002

### **WILL ECONOMIC RECOVERY LAST IN THE BALKANS?**

The recent annual meeting of the EBRD in Bucharest, brought a big piece of positive news for Southeast Europe: economic recovery seems to be well under way in the region, and the region's overall economic dynamic overcame the pace of growth in Central Europe for the first time.

The numbers, provided by Willem Buiters, chief economist of the EBRD, speak for themselves: last year, the rise in the GDP was 7.3 per cent in Albania, 5.6 per cent in Bosnia and Herzegovina, 5.5 per cent in Yugoslavia, 5.3 per cent in Romania and 4.5 per cent in Bulgaria. Only Macedonia recorded a fall of 4.5 per cent due to the interethnic and military conflicts which ravaged the country last year.

Can this recovery last? Without economic growth, a country can hardly achieve the increase of income per capita, which is a must in order to deal with the frustrations and pains of the population, after so many years of destruction

brought about by interethnic strife and wars. Growth is also badly needed for job creation, in countries where unemployment has climbed to amazingly high rates.

Countries in the region need growth in their quest to join the EU, which has become a paramount foreign policy objective. Only Bulgaria and Romania were invited to start accession negotiations in December 1999, but they will not be included in the first wave of EU eastward enlargement. The rest of the countries have signed Association and Stabilisation Agreements with the EU.

For EU accession to happen, these countries need to embark on growth paths. Against the background of an increasingly complicated internal metabolism of the EU – with many EU citizens voicing their fears about including relatively poor European countries and thus, the subsequent redistribution policies – political realities are forcing Balkan countries to try to "pull themselves by their bootstraps" economically, and show some signs of local economic strength.

There are positive signs in the region, which provide ground for optimism. Price stability is almost general, with inflation rates well under control. Bulgaria and Albania achieved remarkable turnarounds after the financial debacles of 1997. And in Romania and Yugoslavia, disinflation is advancing. The financial and banking systems have made some headway in all the countries. Investment inflows seem to be on the rise – in Romania and Croatia direct investment exceeded \$1 billion last year, and hundreds of millions of dollars were invested in Yugoslavia.

There seems to be a restoration of trade links among neighbors as well. The governments in Zagreb and Belgrade entertain thoughts of jumping on a faster track regarding their goal of joining the Union. Some see this desire as realistic, in view of the resources both these countries benefit from, even after the dire past decade.

Policymakers have to be aware of the fallacy of taking the current recovery for what it is, which is not yet steady growth. Several factors impede growth in the region. The very logic of recovery itself – recovery is not growth. The latter involves substantially higher rates of investment and productivity gains. On both accounts the regions has a long way to go. Another obstacle is the fragility of institutions, which would likely cripple economic policy over the longer run unless this issue is addressed adequately. Weak states do not have a good record of economic development. It is not clear whether the proliferation of protectorates, whether hard or soft, could provide the magical solution in this respect. Another factor to consider is the heavy dependency on external assistance, as in the case of Bosnia and Herzegovina, Macedonia and Kosovo. Should foreign assistance decline, severe crises would erupt.

There is positive economic news coming out of Southeast Europe that needs to be built upon to face the big challenges ahead. Dealing with these challenges effectively will make the difference between embarking on growth trajectories or being mired into stagnation.

Setimes 15.07.2002

### **INFRASTRUCTURE IS KEY TO ECONOMIC DEVELOPMENT AND COOPERATION**

It is no secret that roads, bridges, and ports in the Balkans were severely battered during the past decade of military conflict. In addition, the infrastructure was already quite underdeveloped in some regions of Southeast Europe.

This combination of circumstances has further distanced the Balkans from the economically advanced parts of Europe.

Infrastructure has played an increasingly significant role in fostering economic development; it has also led to discrepancies between various areas of the region. While telecommunications can override the importance of geographical proximity in today's world economy, a broad range of activities still demands quick and flexible movement of people and goods across frontiers. In this respect, Southeast Europe has a long way to go in order to connect with the West and bolster the region's credentials.

The role of infrastructure can be judged from several perspectives. It is hard to sustain economic growth in the absence of adequate infrastructure; bottlenecks easily appear, stifling growth. The region as a whole lacks good road networks (highways, in particular), which would facilitate links with the main western markets.

Bridges, too, are insufficient – not only in areas affected by war, but also in the stretch of the Danube between Bulgaria and Romania. Only lately, as a result of the Stability Pact, a second bridge is to be built between the two countries. Railways need to be modernised all over the region.

One reason for local governments and donor agencies to focus on infrastructure is that most Balkan countries have high levels of unemployment and poverty, and these are the biggest worries of people living in the region. Unemployment rates are in the range of 30 per cent to 35 per cent – high compared to conventional European benchmarks. Such unemployment rates cause hardship and poverty, breed resentment and encourage brain drain and migration. They also steer people towards the underground economy and criminal activities.

Infrastructure development would help deal with massive unemployment. Public works are labor intensive and have spillover effects on other industries. Development would also help restore economic ties among the new states in the Balkans.

Politicians and policymakers frequently invoke regional co-operation and trade as desirable goals. But it is hard to imagine intense co-operation and development taking place unless major infrastructure projects are worked out and developed throughout the region. At the same time, infrastructure development is not easy to undertake – tensions linger and some borders are still contested. Yet there is obvious room for progress, and the EU can play a major role in helping advance co-operation.

Brussels should be interested in fostering the development of adequate infrastructure in the Balkans, as it would help the region join the EU. The prospect of Bulgaria and Romania joining NATO would create a new framework for co-operation in the Balkans; both the old and the likely new members in the region would have strong incentives to develop infrastructure projects for mutual benefit and, consequently, for the benefit of Southeast Europe as a whole.

Aside from vision and good, practical ideas, infrastructure development needs considerable financing. The European Investment Bank, the structural and cohesion funds of the EU, the World Bank and the EBRD can be of much help in providing badly needed financial aid. Likewise, national governments need to plan their budgets accordingly, in the sense of considering the financial requirements of projects which have a regional dimension. For this to happen, there is a need for governments to co-operate more closely and for finance ministries to work together and make necessary provisions in national budgets.

**Setimes 30.07.2002**

## **THE LATIN AMERICAN CRISIS: LESSONS FOR THE BALKANS**

The IMF announced a rescue package, of \$30 billion for Brazil, following an assistance program for Uruguay. Both of these countries have seen their financial markets and banking systems severely and adversely affected by the economic debacle in Argentina. The turmoil in the Southern Cone of Latin America indicates that contagion crises are still very much alive and that the functioning of world capital markets is still fraught with threats. The crisis in this region can serve as an education process for the Balkan countries.

It is clear that contagion containment is quite unfeasible when interdependencies are powerful, as is the case with the three countries mentioned. In this respect, Balkan countries seem to fair well to the extent their capital markets and trade are considerably less integrated. But one should not be complacent about it to the extent, and by assuming gradual peace reconstruction, trade and financial links in the region will develop at a fast pace.

Similarly, low inflation and monetary stability can be pretty deceptive when deep-seated imbalances are not dealt well adequately and in a timely fashion. Sooner or later, tensions surface and crises erupt, possibly violently. In the Balkans, low inflation is ubiquitous. Nonetheless, there is huge unemployment region-wide, which is likely to increase governments' reluctance to undertake painful restructuring programs unless job creation is intense. This is why the current economic recovery in the region would be great to continue, so that further reforms should be accompanied by new job creation. A plus of this recovery would be the development of small and medium sized enterprises.

In several Balkan countries there is heavy dependence on foreign assistance. There are two aspects which merit attention in this respect. Some countries may develop unsustainable patterns of consumption and trade imbalances should aid be discontinued. Bosnia and Herzegovina (BiH), Macedonia and Kosovo are prime candidates in this regard. Another aspect is the capacity to shoulder external indebtedness. Balkan countries are not, on average, as heavily indebted as Argentina and Brazil, and they have been capable of running relatively low fiscal deficits in recent years. But the currency boards, which function in Bulgaria, Montenegro and BiH, can become a liability unless domestic productivity gains are steady and substantial. Trade imbalances must be contained and foreign direct investment (FDI) must hold the lion's share in total capital inflows to keep the currency boards stable.

This is particularly important in view of the size of unemployment and the need to preserve a modicum of social cohesion. As data clearly indicate, productivity gains are feeble – and the rise in exports is insufficient – and FDI is below expectations. However, the current low level of FDI is linked with poor economic conditions in Europe and the United States and the fragility of local institutional set ups. A possible combination of rising external indebtedness with high unemployment, low growth and stagnant exports would be quite explosive.

Balkan countries trade prevailingly with the EU and their pegging – where it is the case – is with the Euro, which makes a big difference as against Argentina's experience. However, productivity gains are a must in order to avert threatening external indebtedness and balance of payments crises. The geographic proximity of the EU is not insignificant, but it is far from providing the kind of shelter these countries need.

Similarly, thinking of early euroisation as a shortcut is not devoid of major risks and may not be, technically speaking, possible unless Brussels condones it, as the US did in the case of Ecuador.

In Argentina and Brazil, provincial governments, by running lax fiscal policies, have put tremendous strain on the federal budgets, which contributed to over-indebtedness. In Southeast Europe, governments are weak and where fiscal deficits are low, they may not be sustainable over the longer term. This reasoning would be reinforced should domestic capital markets further develop and local municipalities start to tap them by issuing bonds. Hard budget constraints have to apply as a basic rule in the economy and that central public authorities have to monitor finances at the local level as well.

Poor public and private sector governance is also to be highlighted, as well as the stemming influence of corruption. Deeply entrenched corruption and the cynicism of politicians can destroy any credibility of public institutions, which can further harm democracy and produce chaos when economic crisis spreads around. Argentina epitomizes such a tragic situation.

In the Balkans, attracting more FDI is a major concern, as it is sorely needed to build up infrastructure, restructure and modernize the energy production and distribution sector. But in order to achieve good economic performance, privatization should be accompanied by good corporate governance and an effectively implemented regulatory framework that can deal with monopoly behavior, secure fair prices for consumers and avoid external over-indebtedness. Privatisation in the energy sector needs to be buttressed by well-balanced contracts, which should reward investors as well as protect the local economy. In Argentina, sweetheart deals in questionable privatizations allowed the charging of

extremely high rates. Arguably, the very high price of services has contributed significantly to the growing loss of competitiveness and the rise in external indebtedness.

At the same time, the flow of foreign capital should be carefully monitored as Balkan economies continue to open to the wider world and fully integrate with international financial markets; much caution should be exercised in opening the capital account.

A final lesson is that brilliant expertise, at the very top level, may not be sufficient to stem the tide. Both Argentina and Brazil benefited on highly trained public servants – ministers or governors of the central banks, some of them with stints in the international financial institutions (IFI). There is need for clever policies, which should be pragmatic and shun intellectual fundamentalism and respond to local circumstances in due time. At the same time, the debacle in the Southern Cone is another lesson for the IFIs about what is wrong with the current international financial system.

Setimes 23.09.2002

### **TAX POLICY IN SOUTHEAST EUROPE: SOME ISSUES**

There are major differences in the effectiveness and efficiency of taxation among transition countries. On the average, Central European governments have been more effective at collecting taxes than the majority of their counterparts in Southeast Europe. Quite likely, this performance has been due to stronger public administration and institutions. Some basic constraints affect taxation in transition economies.

The legacy of a sort of "welfare state" means that many citizens are used to getting abundant public goods in a period of deep retrenchment of public budgets. This legacy is reinforced by a Catch-22 syndrome: the production of private goods is crowded in by basic public goods, but the very expenditure assigned to the supply of public goods may overtax private firms. The fragility of institutions is reflected in a poor capacity to collect taxes or enforce laws and regulations. Substantial hidden, private taxation occurs in transition economies – bribes and protection taxes raise the cost of business. Firms may be willing to pay taxes to a state that can enforce laws or at least enforce them better. But how can this transformation take place, and the deadlock be unravelled? Hidden private taxes combine with the temptation firms have to evade taxes and operate in the underground economy. Last but not least, transition countries differ widely in their ability to raise money on foreign capital markets.

Which structure and level of tax revenues should a tax policy target? OECD member countries generally show a higher level of tax revenues than developing countries. But the OECD area itself presents variety. Some Mediterranean states – Spain, Portugal, Greece – collect less, while their informal sectors are significantly larger. While signposts do exist, one must be careful since there are striking differences even among the countries that supposedly provide good practices.

Wealthy countries used a different level and structure of taxes when they were at an inferior level of economic development. How does this fact bear on the suggestion, which some have made, of using their current taxation systems as signposts for tax reform in transition countries? And which best practices does one have in mind? Can an economy leapfrog development stages just by trying to

imitate institutions? Do best practices mean uniform rates? Does it make sense to look at the experience of the few economies that achieved remarkable economic progress during the last decades? And to what extent do globalisation and the rules and regulations of the international economic system allow an economy room for using fiscal devices with the aim of fostering growth?

The developmental challenge may be less relevant for the accession countries, although they too have to close major gaps with the West. But it is certainly becoming of paramount importance for Southeast Europe. The conventional wisdom and the advice provided by international financial institutions stresses the need for fiscal neutrality. But how can the least distortionary effects of taxes be judged in a world in which there are numerous externalities, asymmetries, adverse external shocks and multiple equilibriums?

The efficiency of national taxation systems should be judged in relation to the international tax regime. One can question the effectiveness of the fight against tax evasion and avoidance when individuals and firms can use tax havens. Likewise, the fight against tax evasion and avoidance should be seen in the context of combating money laundering, as well as against the backdrop of the struggle against international terrorism.

Most Southeast European countries are adjusting their legislation to EU norms in their quest to join the Union. The EU's financial assistance also plays a role, for it can fill in budget holes and mitigate tax reform pains. On the other hand, the financial benefit of this assistance needs to be seen in conjunction with the impact on budget revenues of nominal convergence criteria, which are both quite demanding and highly relevant for the accession countries.

Southeast European countries need to improve taxation efficiency in order to raise budget revenues. To this end, an overhaul of tax administration and simplification of the tax system are needed. But simplification need not turn into policy fundamentalism. EU member countries use the logic of non-distortionary taxation in a flexible way. There is a need for tax regimes that are friendly to investment, from wherever it comes. But this goal does not clash with providing incentives to FDI when the latter engages in greenfield operations, which create jobs, bring in new technologies and have trickle-down effects that benefit the entire economy. These incentives do not harm budget revenues when they genuinely involve new investment. A friendly business environment attracts FDI, but there is a time constraint at work. A proper business environment cannot be created instantaneously, whereas fiscal incentives can sometimes provide a competitive edge to governments that badly need investment from outside.

Low taxation and simplified regulations are essential for the development of small- and medium sized enterprises (SMEs). But good ideas and entrepreneurial spirit may not be enough when there is a need for bank finance and banks demand hard-to-obtain collateral. The Bank for International Settlement's new regulations on banks' provisioning for loans could hit small- and medium-sized firms severely, unless banks find creative ways for financing. Capital markets function poorly in Southeast Europe and self-financing is often not an option. One way to mitigate the difficulties of SMEs is to set up specialised financial institutions to cater to their needs. It is a positive sign that the EBRD is among the sponsors of SME-focused banks set up in the region.

**Setimes 9.12.2002**

## **ABSORPTION CAPACITY OF EU FUNDS PLAYS CRITICAL ROLE FOR MEMBERSHIP SEEKING COUNTRIES**

The capacity to absorb EU funds will play a critical role in Bulgaria and Romania's quest for accession over the next few years. Other Balkan countries are also banking on increased financial assistance from the EU for their development efforts. It makes sense, then, to take a close look at the issue of absorption capacity of external funds.

There are several important considerations. To begin with, the issue is important to all the accession countries. Countries that are more fragile institutionally and have a more difficult time fighting vested interests and corruption are less likely to use EU funds efficiently. Structural funds are more important when the economy is weak, while the marginal benefit of an efficient use of structural funds is higher in less developed economies. Use of EU funds should be seen in the wider context of a country's ability to use all available resources, whether domestic or imported, productively.

A distinction should be made between an acute shortage of resources and the capacity to absorb them efficiently. Poor countries, despite their hunger for resources, generally have a limited capacity to absorb funds efficiently, to a large extent because of their precarious institutions. While absorption capacity can be seen in a static or dynamic way – in both cases this capacity is variable – at any one point in time, a country can use more or less resources less or more efficiently. In both static and dynamic terms, absorption capacity depends on parameters and variables. The institutional setup is a parameter in the short run, but turns into a variable over the longer term. Policy choices are a

variable both in the short and the longer run. Defining priorities (as a policy choice) is also a variable. The formation of coalitions of interested parties in favor of reforms is also a variable.

It is not sufficient to examine a country's absorption capacity in a purely national context. Attention must also be given to the international context and to EU policy dynamics. At the last Copenhagen summit, for example, considerable debate took place concerning the amount of financial assistance to the accession countries. There are powerful voices in the Union that argue that regional policy has not been as successful over the years as some might claim. In addition, mounting economic difficulties in the EU reduce the appetite of the richer countries to assist the poorer ones financially, and this syndrome is likely to shape future choices in the field of regional policy. Some argue that the EU should provide more assistance to the Western Balkans in the years to come, while powerful tensions persist in that region. More resources granted to the Western Balkans would compete with other uses; the outcome would hinge on the way Brussels judges future costs and benefits of its assistance. If Croatia, for instance, achieves better economic performance, its hopes of being put on a faster accession track – on par with Bulgaria and Romania – could turn into reality and the country would be entitled to more assistance.

For reasons such as those highlighted above, policymakers in each country need to better define the challenge of absorption capacity, analytically and operationally. EU funds should be included in the multiannual budgeting of finance ministries. Their use should be considered in an overall framework, accounting for all resources utilised by the public budget. It is important to learn from other countries' track records in using such funds in order to avert avoidable errors.

Absorption capacity should be related to budget policy and its capacity to provide public goods. Tax collection can be much improved, and reforms of the fiscal administration are more than welcome. The tax system needs to be simplified, in order to ease its administration and reduce compliance costs. But the simplification of the tax system should not turn into policy fundamentalism; EU member countries themselves use the logic of non-distortionary taxation in a flexible way. Unless corrected, the significant difference in mobilisable public resources – compared to Central European countries – favors a rise, to Southeast Europe's disadvantage, in income per capita differentials in the years to come. The paucity of public resources is an additional argument for raising awareness about the importance of using EU grants wisely, and for a skillful budget policy which aims at providing badly-needed public goods.

Accessing EU grants productively requires a systematic concern for raising local absorptive capacity; this, in turn, depends on a major overhaul and reform of public administration. Beneficial projects should be embedded into multiannual budgeting programmes of ministries, with careful monitoring of their implementation so that waste and fraudulent diversion of resources can be avoided. Budget policy should focus more on defining priorities, reducing waste and combating corruption.

Setimes -26.05.2003

### **CONFLICTING PERCEPTIONS AND ECONOMIC CHALLENGES**

An apparent clash of social, political and economic dynamics can puzzle attentive observers of the Western

Balkans. There have been a series of positive developments: wars and violent interethnic clashes have been stopped, democratically organised elections have taken place and political legitimacy has been established throughout the region. Inflation has been brought under control, with rates that are amazingly low and some economic recovery has occurred. In fact, Southeast Europe – including the Western Balkans – overtook Central Europe in terms of GDP growth in 2001, and will possibly do the same in 2002.

Such tendencies are frequently highlighted – by international officials such as High Representative in Bosnia and Herzegovina (BiH) Paddy Ashdown and UNMIK chief Michael Steiner; by reports of IFIs (the EBRD's latest annual report, for instance) and by the head of the Stability Pact, Dr Erhard Busek, among others. It would be foolish to underestimate these positive tendencies and not try to capitalise on them. On the other hand, it would be equally foolish to ignore the dark side of the story and the tensions which continue to strain the region.

As a whole, the region is plagued by massive unemployment, totaling about 30 per cent of the entire active population in Serbia and Macedonia, 40 per cent in BiH and more than 60 per cent in Kosovo. Such unemployment helps breed criminality and the underground economy. The staggeringly high rates, together with the decay of industry, recalls the earlier decades of the last century, when the region's economic backwardness prodded the well-known economist Paul Rosenstein-Rodan to speak of the need for a "Big Push" to foster development.

There is an increasing addiction to foreign aid, which is debilitating to the extent that it does not foster viable economies and mainly finances consumption. It is true that this assistance has helped rebuild infrastructure, but consumption-related aid is conspicuous. The migration of

young and skilled labor is gathering pace, depleting the most valuable asset of the region. Low saving and investment ratios throughout the area indicate that current economic recovery has a low chance of turning into sustainable economic growth, unless major technology transfers, which induce substantial productivity gains, occur. But is the latter probable in the short run? Inter-regional trade is still much reduced, undermining production and efficiency of firms which could supply their products and services regionwide. In addition, the region is rife with organised crime which often reaches the upper layers of government.

Many citizens are disappointed with the results of unavoidably slow and vacillating reforms, and this shows up in the polls; there is growing apathy among the electorate (see the latest rounds of presidential elections in Serbia) and nationalistic parties are staging a comeback. Constitutional and status-related issues, as well as continuing interethnic strife, could easily unleash new crises. Against this still very complicated background it makes sense to keep policymakers in the region and abroad alert to the danger of complacency. The region remains Europe's hotbed.

The inherent difficulties of dealing with the unsolved and often seemingly intractable challenges posed by the Western Balkans could be compounded by events taking place outside the region. One such event is the war against terrorism, which sets new priorities and redirects resources among the major outside players. The United States, for obvious reasons, is likely to reduce its military and material presence in the region, which would ask for an offsetting act on the part of the EU; the latter would have to increase its multipronged involvement accordingly. But this is not a clear option or solution at a time of major economic strain in Western Europe as well, and when "the big game in town"

seems to be EU enlargement. Economic pain in the West, combined with a less than smooth unfolding of enlargement, could reduce the amount of concrete attention paid to the Western Balkans. This could happen at a time when there is an acute need to support the still very fragile local democracies and help move forward with economic reconstruction and reforms.

Should the region disappear from the radar screen of the West, it would be a very unfortunate, unintended consequence for the local populations and for Europe as a whole. This is why the EU, in particular, should not let this happen. The summit in Copenhagen seems to have made enlargement in 2004 irreversible. Bulgaria and Romania, meanwhile, were given a time target for accession in 2007. The summit was an excellent occasion to show that European statesmen – in spite of the pressures of such turbulent times – have not lost sight of an unfinished job. And it was wise for the EU's leading politicians to send a message that eventually the countries of the Western Balkans will be invited to start accession negotiations, and that badly-needed assistance will be available, over the long haul, within the framework of a well-defined program. This assistance will hopefully be increased – for the region needs more support – and should be focused on turning economies into viable ones. Rosenstein-Rodan's famous injunction, that Southeast Europe needs a Big Push, has not lost its meaningfulness. Can the EU rise to this historic challenge? Likewise, responsible local politicians in the Western Balkans have to continue the uphill battle of trying to deepen democratic processes, mitigate interethnic animosities and simultaneously improve their economies.

**Setimes 3.02.2003**

## POSITIVE SIGNS OF COOPERATION

A leading international daily, the *International Herald Tribune*, recently published a letter signed by four top politicians from the Western Balkans. The event was highly relevant for several reasons. To begin with, the letter was published after Serbian Prime Minister Zoran Djindjic's assassination, and was meant to show a strong common determination in the struggle against criminal forces. The fact that key decision makers in the region joined together to assert publicly that their countries are ready to co-operate and work hard in order to join the EU is significant. It provided a clear signal that politicians realise their countries' common destiny and the need to mend fences for the sake of a better future, which is inextricably linked with a place in the Union.

Such a letter, signed collectively, in a leading European publication has not been seen in a long time. This fact in itself epitomises an awakening of political elites in the region, which understand that they have to speak up in a forceful and convincing way in order to be heard by their counterparts in the west. The letter indicated a common awareness of the region's essential political and economic needs. These include proceeding resolutely with economic reforms and reconstruction; fighting crime and corruption; dealing with massive unemployment, poverty and social exclusion; promoting regional trade and co-operation; and protecting human rights.

Although it was published at a time when international attention is focused on the aftermath of the war in Iraq and the ongoing fight against terrorism, the letter did not go unnoticed. Renowned financier and philanthropist George Soros subsequently signed a letter to the *Financial Times*,

calling for the EU and International Financial Institutions to grant soft credits to the countries of the Western Balkans in order to aid their quest for economic reconstruction and security building. He also asked for a firmer commitment to the region by the EU. There are signs that the 21 June EU summit in Thessaloniki will focus on the region, and that a stronger commitment will be made with regard to its eventual integration into the Union.

Signs, both inside and outside the Western Balkans, are pointing in the right direction and providing hope. They indicate processes of healing, of increasing co-operation, and of economic reconstruction and assistance. It may be that a sense of urgency has engulfed leading politicians in the Western Balkans, which remains Europe's most volatile area, but is no longer its most pressing problem in terms of transatlantic dialogue.

A large part of the EU is mired in economic stagnation. This has a serious impact on the candidate countries, including those in the Western Balkans, which export primarily to the Union. Economic stagnation in the EU fuels protectionist tendencies, impeding a successful outcome to the Doha trade round. This is an unwelcome development for Western Balkan countries, whose exports are largely agricultural products. Capital flows have been reversing their tendency in recent years, following the bursting of the bubble in the United States and financial scandals on both sides of the Atlantic. As a result, the Western Balkans cannot expect to benefit from private capital flows as needed. The low savings and investment ratios in the region require substantial amounts of capital inflows in order to enhance sustainable growth.

These circumstances compound very difficult domestic situations. Inflation is quite low in most of the countries, but the foundations for steady growth are precarious, and there is

heavy reliance on foreign assistance. Huge unemployment rates and large quasi-fiscal deficits, inadequate infrastructure and fragile institutions complete the picture, which is one of badly-needed reform and reconstruction. Since the international environment is so complex, Western Balkan countries should pull themselves together in order to offset – to the extent it is possible – adverse shocks from outside.

As for the EU, the region provides a clear test for judging the Union's skills in fostering peace, good neighbourly relations and economic reconstruction in its backyard. This is especially true now, since the EU has taken over peacekeeping in Macedonia, and could eventually do so in other parts of the region.

What happens in the region has implications for peace and development in the world as a whole. Failed and rogue states, economic and social decay, and military and interethnic conflicts proliferate in many parts of the world, and action is needed to address such phenomena. The way Europeans, and specifically the EU, deal with the Western Balkans can be seen as a test case. It indicates what lies ahead for all of us.

**Setimes 16.06.2003**

## **EU CONSTITUTIONAL DISPUTES AND SOUTHEAST EUROPE**

Disappointment with December's failed EU summit in Brussels – convened in order to validate the first EU constitution – was apparent in many European circles. Bitterness not only stemmed from the inability to solve the

voting rights issue, but also from the image that EU member countries are seen as projecting to the world.

The key issue wasn't the dispute over the respective provisions, which may have to change in view of evolving circumstances. Rather, it concerned the lack of a rule for changing rules, when the older mandates are no longer appropriate. Crises have erupted before in the history of the Union over the past decades, so it may be incorrect to overestimate the significance of this one. Current conditions may have made it unavoidable. The stakes which member countries have in forging ahead with the Union are high enough that compromises are likely to be found. The power distribution issue does not pit heavyweights against other heavyweights – at least on the surface.

Much more complicated is the issue of which direction the Union should take with regard to further political and policy integration. And here the existence of dissimilar visions is highly visible. This is why the talk about a variable geometry in the making is quite meaningful. Variable geometry is not something new and bits of it already exist in the monetary domain, in the form of two groups of countries: those which adopted the common currency and those which didn't. What degree of variable geometry can the Union bear without irreparable damage? That is a crucial question. How the debate on the EU constitution evolves has significant implications for Southeast Europe – for Bulgaria and Romania, which are slated to join the Union in 2007, and for the Western Balkan countries, which hope to join eventually.

A scenario can be imagined in which compromises are found in the not too distant future and the EU constitution swings into operation under good auspices. This would take place against the backdrop of a quickening economic recovery all over the EU area while the first wave of accession proceeds smoothly. As a result, prospects of

accession for Bulgaria and Romania improve and this process enhances the dialogue between the EU and other aspirant countries. Such a scenario would require a strong convergence of views among key players with regard to foreign and security policy. Convergence of economic conditions would also be a prerequisite. The low probability of such circumstances suggests that variable geometry does in fact operate within the EU. Nevertheless, accepting this dynamic as a working assumption is not the end of the story. Variable geometry, though it can develop into negative forms, can also be of a benign nature.

A positive scenario would be one that combines no (or few) major disputes among the main players in the Union with economic recovery – which would help reconcile different views on economic policy; an improved dialogue among donor and recipient countries; and a smooth absorption of the first wave of eastern enlargement. Should all these developments occur and Bulgaria and Romania make significant economic progress, a second wave of enlargement could take place in 2007. That in turn would turn the focus directly onto the Western Balkan countries. Should they embark on steady economic growth and continue their institutional buildup, while also managing border and political disputes, these countries would see their accession prospects much more clearly. Meanwhile, the EU would be more deeply involved in the region through various forms of assistance. As an exercise in political forecasting, we could say that the Western Balkans arguably have the potential to become an inner periphery of the Union.

The debate on the chances for Turkey's accession would also be facilitated. A less positive scenario would have its roots in multiplying dissonances and frictions in the Union, which would entail several power constellations and induce counterproductive policy bickering. This would

translate into the Union not achieving its established goals of economic performance. A less smooth absorption of the ten countries slated to join in 2004 would complicate matters further. That would impact negatively on Bulgaria and Romania's chances of joining in 2007, especially if the electorates in the EU become highly resistant to further waves of enlargement. Needless to say, it would also have a negative impact on the EU hopes of countries in the Western Balkans, in view of their economic woes and vivid political history. Turkey's chances would be affected as well.

The bottom line is that the internal dynamics of the Union matter extraordinarily for the member countries' political and economic prospects; these dynamics matter enormously, too, for the countries of Southeast Europe. Nevertheless it remains clear that the countries of Southeast Europe have to continue democratic reforms and strengthen the institutional foundations of their economies, regardless of the EU dynamics. The work has to go on.

**Setimes 26.01.2004**

## **EU ENLARGEMENT AND THE WESTERN BALKANS**

An important juncture in Europe's history occurred on 1 May. That day marked the first eastern enlargement of the EU, which now includes eight former communist countries. The significance of this event is enormous, both politically and economically. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia have now completed their journey of transition and have rejoined

mainstream Europe. For the EU, the enlargement amounts to an institutional coupling of the Cold War-era West and East.

Hopefully, this wave of enlargement will proceed smoothly and the new 25-member EU will be able to manage its growing complexity in an effective way. Managing the EU's increasing complexity is important *per se*, as a means of making the EU more competitive, and also in terms of bringing in other candidate countries. The second of these issues relates to the functioning of mature democracy, which entails accountability and the power of citizens.

The enlargement is significant geographically as well. The whole of the central European region has entered the EU. Moreover, the so-called Eastern Balkans – Bulgaria and Romania – are slated to join the EU in 2007, provided reforms continue at an adequate pace. At the same time, Croatia seems to be moving on a fast track, following the European Commission's (EC) declaration that the country is fulfilling the political and economic conditions required to start accession negotiations. That means Croatia can entertain hopes of joining Bulgaria and Romania in the next wave of enlargement.

However, there is bad news as well. Although a sort of intra-regional stability has been achieved, as well as some economic progress, the overall state of affairs in the Western Balkans remains complicated. The political geography has yet to be clarified; the final status of Kosovo is a highly contentious issue. Bosnia and Herzegovina is still plagued by uncertainties concerning its viability as a political entity, and it is very fragile economically due to its extreme over-dependency on aid from outside. Much of the region continues to suffer from high unemployment and "brain drain". Crime rates are high and corruption endemic. Savings and investment ratios are low, and the reconstruction of infrastructure is proceeding slowly.

The bottom line is that the EU has to get more involved in "coaching" and assisting the countries of the Western Balkans in their quest to achieve durable economic growth and improve their institutions. To be fair, it must be said that the EU already has a multi-pronged presence in the area, including a peacekeeping role. Bosnia and Herzegovina is providing a test ground for the EU's ability to act forcefully and effectively in situations of need. However, there are lessons which must be learned in order to achieve better results.

One lesson is that a visible and strong EU anchor is crucial for the stability of the region and its economic development. Another is that the EU's approach to the Western Balkans should not be based on the idea of an economic level playing field. The oft-cited distinction between "fair" and "free" trade is applicable here. The countries of the Western Balkans need strong institutions that will ensure effective private and public sector governance. Domestic endeavours have an important role to play in this regard. In practical terms, though, more is required.

The region needs assistance from the EU that will help it defeat the traps of high unemployment, worsening social cohesion and rising criminality. For development to take root, well-conceived financial assistance should be accompanied by adequate trade arrangements (preferential agreements), regional infrastructure projects (roads, bridges, power networks and airports), and measures to stimulate inward foreign direct investment. Likewise, strong co-operation – intra-regional and with the EU authorities – is needed to combat criminality. It goes without saying that the economic development of the Western Balkans would also bolster the fight against terrorism.

Europe's agenda is manifold, and increasingly includes political and economic dynamics in the Western Balkans. Therefore, the first wave of eastern enlargement is also a

reminder of how much remains to be done on the European continent.

Setimes 11.05.2004

## **WORLD BANK FORUM TARGETS GROWTH IN SOUTHEAST EUROPE**

The World Bank Forum convened in Munich, Germany, at the beginning of May. The gathering brought together top economic officials from Southeast Europe, Germany and the World Bank. Ministers from Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Macedonia, Romania, Serbia-Montenegro and Slovenia took part, and hundreds of German businesspeople were in attendance. The forum's theme, Responsible Growth in Southeast Europe, was quite telling.

During the last few years, economic growth has been a general feature across the region. Economic reforms have been advancing, to a greater or lesser extent, in all countries. A perceptible change of climate has stimulated Foreign Direct Investment. However, the Western Balkans still have a long path ahead of them when it comes to institutional build-up, premises for durable growth and social cohesion. These issues made up the building blocks of the conference in Munich, and were the focus of several panels: governance; connectivity (infrastructure); human development and social cohesion; and private sector development.

World Bank President Jim Wolfensohn has frequently made the case that social and economic issues are inextricably interwoven in development, that growth can happen under various conditions and that its effects on

people at large are not inconsequential. In the late 1990s, the Comprehensive Development Framework was put forward as a matrix for thinking about growth strategies. The framework was resuscitated during the Munich conference, in terms of the emphasis placed on social issues. Wolfensohn's keynote speech at the Forum was an application of this vision to a region where unemployment remains high by European standards, where crime is widespread and where hopes have yet to brighten for large segments of the population.

The Forum was quite indicative of the variety of conditions in Southeast Europe. Slovenia and Hungary are now EU member countries, and see themselves as a "springboard" for investments in the region. Romania and Bulgaria are focusing on closing the remaining negotiating chapters of EU accession, and hope that 2007 will be the year of their membership. For both countries the terms of accession are of great importance, given the size of their rural sectors, the need to modernise energy sectors and infrastructure, and the very demanding EU competition policy, which could bring many local companies to failure unless competitiveness challenges are addressed in a timely manner.

Croatia, which was recently put on a fast track to EU membership, hopes to join along with Bulgaria and Romania. Macedonia, too, has high hopes. In general, the countries of the Western Balkans, in spite of political uncertainties and status-related questions, are driven by the guiding belief that, sooner or later, they will join the EU. They view membership in the Union as the best anchor for stability and economic development. The EU's engagement in the region is crucial, and can be judged in terms of a strategic vision – assistance, economic and trade arrangements and labour flows.

At the Forum, Wolfensohn noted that there are 5 billion poor people around the world who badly need the World Bank's attention. While this does not mean that the

Bank is relinquishing its various assistance windows to the region, his observation was a stark reminder that Europe should not think about itself only, and that the EU has to shoulder more responsibilities where it can and where its strategic interests are unambiguous.

Debates were held on how to stimulate the development of the private sector; on whether public-private partnerships – in the field of infrastructure development – can work in countries where income per capita is low; and on ways to foster small- and medium-sized enterprises. The discussion on improving public and private sector governance showed that high-level policymakers and business people know what the major challenges are; less known are the best venues for overcoming obstacles.

In the end, tenacity, persistence, open-mindedness and intelligence should carry the day. There is an enormous amount of political, institutional and economic work to do in Southeast Europe; miracles cannot be achieved overnight. But the change is there and palpable, and joining the EU is a beacon which stimulates further political and economic transformation.

**Setimes 21.06.2004**

### **NATO MEMBERSHIP: WHAT IT MEANS FOR ECONOMIC DEVELOPMENT**

NATO and EU membership have been the twin strategic goals of most European post-communist countries since 1989. Entry into these two Western clubs signifies belonging to an area of economic prosperity and political

freedom, secured by institutional and military links among the member states.

It is easy to see why joining NATO is regarded as a milestone in a country's economic and political development. Membership requires meeting certain conditions that demonstrate a country has reached a high level of economic progress and political maturity. A well-functioning market economy ensures a strong economic performance, which is essential for supporting military infrastructure and contributing to the Alliance's needs. Meanwhile, democratic institutions secure individuals' fundamental rights and help preclude domestic and regional conflicts.

However, questions can be raised concerning the degree to which NATO membership impacts economic development. The Alliance is no longer what it was during the Cold War. The major ideological foe, Soviet Communism, no longer exists. As a result, it has become harder to articulate common interests in operational terms, or to define concrete missions.

The impact of globalisation must also be considered. With capital now flowing to all parts of the world, the most dynamic economic area now appears to be the Pacific Rim. The region is attracting enormous amounts of capital, with China receiving the lion's share. Geopolitics cannot avoid the need to assess the relative military, strategic and economic weight of the main players; as these change, so does the outlook for the Alliance.

In the evolving climate, NATO membership is only one of the ingredients which can foster economic progress. There are countries in the world which do not have the benefit of being members of the Alliance, yet have made great strides economically. Moreover, the key player in NATO – the United States – must balance its huge technological, military and economic resources against the

risk of overstretch. That impacts its ability to provide material assistance to allies, as it did during the Cold War, unless adequate quid pro quos can be established.

One avenue may lie in the "strategic partnerships" which have proliferated in recent years and which increasingly shape bilateral ties. But these partnerships are insufficiently defined when it comes to concrete economic co-operation and mutual gains. In some cases, they may clash with the rules set by other organisations, particularly the EU. A case in point is the Braşov-Borş highway project, which has become an object of scrutiny by the European Commission after Romania gave the contract to Bechtel without a proper tender.

For Bulgaria, Croatia and Romania, NATO membership needs to be viewed in conjunction with entry into the EU. The latter is a formidable stimulus for institutional change and modernisation. The prospect of EU entry is driving the pace of change in these countries and bringing in substantial capital. The target date of 2007 has proved to be a catalyst for reform.

In the Western Balkans, the goal of NATO membership is a powerful anchor of stability, helping to defuse lingering interethnic animosities and disagreements over national boundaries. Here too, however, the EU is increasingly becoming an engine driving democratic change and fostering economic progress. The Union is also a major provider of economic assistance to the region.

NATO membership does matter greatly to the economic development of Southeast Europe. In an increasingly complex geopolitical environment, however, joining the Alliance is not a catch-all solution. Moreover, neither NATO nor EU membership should be regarded as a substitute for astute and consistent local policymaking. Ultimately, long-term economic progress – and the ability to

meet the requirements for Euro-Atlantic integration – depends on the countries themselves. The energy driving reform must come from within.

Setimes 26.07.2004

## **FIGHTING CORRUPTION IN SEE COUNTRIES: THE EU FACTOR**

Romania's expected entry into the EU in 2007 is proof of the dramatic progress the country has made. But several areas of concern still exist, with one of the most important being the widespread problem of corruption. Polls repeatedly show that corruption – especially as it applies to the judicial system – is among the top frustrations and concerns of the country's citizens. While optimists are confident in the ability of structural and institutional reforms to reduce unethical behavior, others point with alarm to the problems of "path dependency" and traps of underdevelopment. The EU itself could become the catalyst needed to force a breakthrough in problem areas.

EU country reports underscore Romania's progress in the quest to join the EU in 2007, but they also single out corruption as a damaging social and economic phenomenon. There is hardly a domestic poll that does not mention corruption and the poor functioning of the judicial system as one of the top frustrations and concerns among the country's citizens. What, then, are the prospects for tackling these problems?

Two trains of reasoning can be detected with respect to explaining behavioral patterns during transition. Both can be extrapolated to developing economies in general. The first,

more optimistic one emphasises the institutional weakness of post-communist societies, the precarious functioning of checks and balances, and a corrupted judiciary combined with feeble law enforcement capacity. Ideally, the steady advance of structural and institutional reforms would allow transition societies to reduce unethical behavior considerably over time. Both micro-inefficiencies and resource misallocation would diminish and economic performance would gradually improve. The rule of law would also become a reality.

One version of this hopeful line of reasoning points to the strong performance of a series of emerging economies – especially in Southeast Asia – that have had problems with wide-ranging corruption and cronyism. These examples suggest that corruption, on a massive scale, may be an inescapable companion of the transition out of poverty, while reducing it is a time-consuming affair.

Joining the EU can be seen through the lens of this upbeat logic. Membership would, arguably, provide an extraordinary anchor for systemic transformation and economic progress. Accession would mean the "Big Push", that the economist Paul Rosenstein Rodan mentioned more than six decades ago in the British *Economic Journal*, highlighting what Southeast Europe needs in order to defeat the traps of underdevelopment. Indeed, Romanian citizens are counting on EU accession to help deal decisively with the country's social and economic weaknesses, including widespread "rent-seeking" and other forms of corruption. The entry of eight transition countries into the Union on 1 May 2004 seems to substantiate this line of reasoning.

However, there is also a more pessimistic vein of thought which stresses "path dependency" and points to the persistence of widespread corruption, precarious institutions and malfunctioning markets in large parts of the world. Latin America offers a glaring example in this regard. What

explains the persistence of bad social equilibrium and poor economic performance over long stretches of time? Why is it that vicious circles and traps of underdevelopment are so hard to break away from? Why has the economic rise of a series of Asian countries been more the exception than the rule in modern history, even though their advance has not been devoid of corruption and cronyism?

The experience of Latin American countries provides a cautionary tale for less advanced transition countries in Southeast Europe and the former Soviet Union. In the Balkans, for instance, weak state syndrome and the fragility of institutions, as well as the large degree of criminality in economic life should be a cause of deep concern for those who hope to reverse an unfavorable path dependency. True, the EU can provide an extremely powerful anchor and transformation tool for the whole region, as it has done for Central Europe. But there is little doubt that the process could be made more time-consuming and painful because of specific local conditions, including political and interethnic conflicts.

Joining the EU will offer Romania an extraordinary opportunity to improve its public policies and, consequently, its economic performance; in addition, it will have the chance to combat corruption more effectively. The "social engineering" inherent in implementation of the *acquis* is bound to change institutional structures (the judiciary included) for the better. More transparency, more rule of law, more clear rules of competition (and state aid) are part and parcel of this process.

The change of government in November 2004 was made possible by Romanians' longing for truth and fairness, but decisive progress has not yet been seen. The ineffectiveness of the special bodies that were set up to deal with corruption is notorious, while media reports have

exposed the unsavory links between politics and justice. To put it bluntly, Romanian politics abounds with hypocrisy, prevaricating rhetoric, arrogance and lack of accountability. More than a few top notch officials are indifferent to conflicts of interest; some nonchalantly use their office for the pursuit of private gain. The fuss and procrastination surrounding lawmakers' declarations of personal wealth was quite telling. Again, one thinks ahead to EU entry as the event that is most likely to trigger the needed change in mindset.

Certainly, the country needs better trained, more responsible people at the very top – people with a sense of the urgency of the times and of the challenges facing Romania's endeavour to join the EU under the best possible premises. For EU accession, of course, will not shape Romania's future in a predetermined manner. Much would stay in the hands of Romanian policymakers, and much will depend on responsible politicians pursuing intelligent and effective public policies; policy ownership is far from being a meaningless concept.

Romania's Western counterparts, whether in the state or private sector, should do their part by being more candid and by abiding by the same rules of transparency and ethical behaviour which they encourage transition countries to emulate. If, for instance, a Romanian policymaker continually shuns the correct tender procedures for handling public money, Western colleagues should not hesitate to inform that person that such an approach is not acceptable. While corruption is also found in affluent countries of Western Europe and in the United States, in those societies the rule of law is solid, and checks and balances operate effectively in the end.

For this reason, the West should always use "best practices" when they deal with Romanian officials or companies. When *raison d'état* impedes what is meant by

"best practice", this should be stated clearly, with justification. In this way, Romania's progress toward accession and what follows would be enhanced, for the benefit of its citizens. Consequently, the propensity for playing unethical games would be kept under control. After 15 years of transition, Romanian citizens deserve a better functioning democracy and economy.

Setimes 6.06.2005

### **EU PRESIDENCY HOLDER AUSTRIA HAS CLOSE TIES TO SEE COUNTRIES**

At the start of 2006, Austria took over the six-month presidency of the EU. Its task has been made easier by the fact that Britain was able to settle the EU budget issue during its mandate, although the budget must still be validated by the European Parliament. The budget, covering years 2007-2013, allots substantial structural and cohesion funds to Romania and Bulgaria. Croatia, too, can look forward to considerable financial assistance as an accession country.

One of the key events expected to take place during the Austrian presidency is the decision on when Bulgaria and Romania will join the EU. That will come in May, when the European Commission (EC) releases its report, after which the European Council will make a formal determination about whether to activate the "safeguard clause" delaying entry by one year.

Along with the Netherlands and Sweden, among others, Austria is part of the group of EU member states that is opposed to major issues being decided by the bloc's "heavyweights". We can expect to see this point of view

receive a higher profile during the coming months. Vienna has also been critical of the larger member states for their approach to the Maastricht rules, such as the Financial Stability pact – requirements imposed on smaller states are softened when it comes to Berlin or Paris.

With regards to enlargement, Austria is among the EU states where public opinion harbours reservations about bringing new states into the Union, and its leaders have called for taking into account "absorption capacity" before stretching the boundaries further. Recently, the country's justice minister indicated that it is in no hurry to ratify the accession treaties of Bulgaria and Romania, and will wait to do so until the EC report.

At the same time, however, Austria is close to Southeast Europe geographically and has close historical, political and economic ties to the region – a fact that bodes well for the EU prospects of Balkan states.

In January, Chancellor Wolfgang Schuessel insisted that the commitments Brussels has made to the Balkan countries must be respected. "The countries in the Balkans have a clear European perspective. They belong to the European context without any doubt." Schuessel told *Le Monde*.

Austria is now the country with the largest volume of investments in Romania, a status it gained when Erste Bank won the race for the privatisation of the Romanian Commercial Bank (BCR) – the largest external acquisition ever made by an Austrian company. Austrian capital is decisive in the oil industry, especially in the wake of OMV's acquisition of 51 per cent of Petrom, as well as in banking, insurance and other industries.

In a sense, this economic presence ties Romania closely to "Mittel Europa" (Central Europe). Austrian banks have also made important inroads into Bulgaria, Croatia and

Serbia, signaling an overall strategy of economic expansion in the region. Vienna's attitude towards Bucharest could be influenced by the stake held by Austrian capital in the Romanian economy.

Arguably, the advantageous inclusion of Romanian companies into European industrial networks is key to the country's steady development and its chances of catching up economically. Such inclusion brings with it the transfer of high technologies, rising productivity, the creation of new jobs and higher incomes for Romanian citizens. This logic should apply to other emerging economies from Southeast Europe as well.

Vienna's economic and political interest in this region goes back centuries. Some Western media have even been making fanciful comments about the reconstruction, by economic means, of the Austrian-Hungarian Empire. Such talk is an exaggeration, of course. Nevertheless, the fact is that Austrian companies are very active in the Balkans, just as German companies have been active in Central Europe. Dynamic areas of influence exist across the EU, and it is reasonable to guess that Austria places a high value on Southeast Europe's membership prospects.

From the point of view of the EU as a whole, the accession of SEE countries has a number of important implications. In the short term, it means substantial outlays of financial assistance to help with the development of infrastructure and the enhancement of economic progress. It also sharpens anxieties over labour flow, a concern which has helped fuel anti-enlargement sentiment in the older EU member states and contributed to the defeat of the proposed constitution.

Over the longer term, however, this problem should be defused as countries improve their economic situation – an expected benefit of accession. With economies growing and

living standards on the rise, the new EU members will no longer function as major suppliers of labour.

EU prospects are also vital to maintaining regional stability, especially in the face of thorny issues such as the status of Kosovo. Such issues will be considerably easier to resolve if the countries involved see a clear path to EU membership in the not too distant future. By contrast, obstacles on the path increase the risk of countries turning inward and becoming more vulnerable to nationalist myths. The best way to discourage dwelling on the past is to offer a promising future.

**Setimes 27.02.2006**

### **WHICH WAY AHEAD FOR THE WESTERN BALKANS?**

In general, recent developments in the Western Balkans have prompted more than a few pundits to sound alarm bells concerning the relative neglect of the region by Brussels and the main European capitals. The last report of the Amato Commission – which is made up of top European politicians – sent a strongly worded message in this regard. Several times lately the European Stability Initiative, an NGO whose work is dedicated to the western Balkans, has issued similar warnings.

Various factors are influencing the course of events in the Western Balkans, some which move things in the right direction, and others which keep the region in the grip of serious traps – whether political, economic or interethnic. In

the recent past, one could sense a more forceful march in the right direction. The attraction of joining the EU, though a distant goal, played a decisive role. Good economic signs multiplied: inflation was coming down dramatically all over the region and, more importantly, economic growth was picking up strongly.

The referendum in Montenegro captured the attention of many European chancelleries. Some hailed it, while others were cautious. Would it help find a solution to the Kosovo issue? Would it put other forces into motion that would enhance the quest for EU accession in the region? These are questions that automatically come to mind.

The banking sectors in the region were being cleaned up and able, after a long time, to fund growth via investment and consumption credits. Intra-regional trade started to grow, as local politicians acknowledged that Chinese walls do not make sense for their small economies. Domestic politics strengthened the hand of democratic forces.

What about the situation now? Economic data, at least on the surface, do not indicate a worsening of the overall state of affairs. Economic growth has continued, apparently unabated. During 2005, the rise in GDP was 5 per cent in the Western Balkans, except in Macedonia (where it was 3.5 per cent). Inflation has been in the single digits, at the very low end of the range – except in Serbia, where it stood at over 16 per cent in 2005. And the strengthening of banking sectors has continued, owing to the enforcement of better prudential regulations and the inroads made by Austrian, Greek and Italian banks.

However, there are areas where the data looks less bright, illustrating an eye-catching variety of circumstances.

Aid addiction has not diminished in Bosnia-Herzegovina (BiH), where the current account deficit totaled almost a fourth of GDP, while FDI amounted to less than 4

per cent of GDP. In Kosovo, the current account deficit has been even higher – over 30 per cent of GDP last year. Remittances are high in the province (over 14 per cent of GDP). But as an economist would point out, they do not cover the current account deficit; the latter needs stable capital inflows in order to be sustainable.

Unemployment remains high in BiH, Kosovo and Macedonia, although local economists and officials dispute the numbers and cite the vibrant informal sector. What is not in dispute, however, is the propensity among citizens – especially youth – to migrate and seek work abroad, due to the high wage differentials. Substantial economic fragility exists in the region and inward FDI, though increasing in recent years, is not yet a driving force for creating jobs and underpinning stability. Can the current positive trends be sustained unless they are backed by a strong capital formation process? Probably not. Furthermore, domestic investment hinges on the prospects for joining the EU in the not too distant future.

Across the region, the message is the same: The only game is EU accession. The rationale for this quest is economic, political and geopolitical. At a time when Montenegro has broken loose completely, when Kosovo's status is heatedly debated, when the economic fragility of BiH poses a continuing headache, the heavyweights of the Union should pay more attention to the region.

According to some Western policymakers, the Salzburg EU summit again pledged the Union's support for the region, renewing the commitments made in Thessaloniki. And yet it is not unfair to say that the support shown in Salzburg was more tepid. Western politicians have had to respond to the change of mood in their electorates. The

referenda in France and the Netherlands signaled considerable anguish regarding immigration, globalisation and the fate of the welfare state.

The irony is that the EU enlargement of 2004 has not been, on the whole, a nuisance to the old EU member states; the latter are running trade surpluses with the former communist economies and have relocated factories there so they can compete better in world markets. In addition, whatever some say about the "Polish plumber", the fact is that workers from Poland, Bulgaria, Romania and so on fill important niches in western labour markets and help those economies function better.

Still, it is hard to deny that fatigue exists in the West. Several top-notch politicians are lame ducks, and not a few governments are reluctant to undertake painful reforms. On the other hand, it is important not to misread the themes of public debate. In truth, it is not the last wave of enlargement that has triggered the fatigue in the "Old EU". Rigid labour markets, unreformed educational systems, underfunded welfare systems, insufficient spending on R&D, and an inability to come to grips with the reality of a global economy are the real root of the problem.

Romania and Bulgaria will most likely join the Union in 2007, in spite of critical reports from the European Commission. This should embolden Paris, Berlin, London and others to be more forthcoming when it comes to the prospects for Western Balkan states. A substantially eased visa regime, more assistance for boosting the capacity to absorb EU funds, and more clearly formulated messages would help greatly to this end. How Brussels approaches these issues will prove a key test of EU statesmanship.

**Setimes 17.07.2006**

## **ECONOMIC, POLITICAL, AND INSTITUTIONAL ADJUSTMENTS NEEDED FOR COUNTRIES JOINING THE EU**

Two countries in Southeast Europe – Romania and Bulgaria – are expected to join the Union on 1 January 2007. Another, Croatia, is likely to be put on a faster track. Despite worries about the EU's commitment to the enlargement process, the Balkan countries still appear to be moving closer to their accession goals. Assuming that remains the case, it will be up to regional governments to make the necessary economic, institutional and political adjustments. Let us consider, for instance, the implications for economic policy.

To begin with, it is important to distinguish between a "functioning market economy" and one that has the capacity to absorb shocks in a highly competitive environment, as is the case with the Union. Moreover, economic competitiveness must be understood in a profounder sense. Joining the European club demands compliance with a set of rules that dent traditional policy prerogatives. For instance, free capital movement (liberalisation of the capital account) is a must in the EU, whereas a premature opening is dangerous.

Likewise, new entrants are bound to enter the eurozone sooner or later. An economy that is not competitive enough would have a very hard time inside the single currency area.

It is imperative for countries joining the EU to have key institutions and mechanisms in place: a financial intermediation sector and an independent central bank, a substantial private sector where property rights are clearly defined and protected, a functioning judiciary and enforceable laws. Being able to fight corruption and organised crime effectively is also a prerequisite.

The economy needs to be stable. That means bringing down inflation to a reasonable level in a consistent manner, and maintaining low budget deficits while quasi-fiscal deficits are under control. Premises for economic stability are the operation of hard budget constraints and the spread of good governance practices in both the public and the private sectors. Low budget deficits imply coming to grips with the ballooning pressure on the pension system.

Public utilities are an important area of concern. It is unwise to privatise them blindly. As a matter of fact, there are utilities which should stay in the public domain; what has to be done in their case is to introduce good governance. Those utilities which are turned over to private hands need to be well-regulated, so that consumers are not abused by excessive tariffs.

However, some cautionary remarks qualifying the above observations are needed. The fact is that economic policymaking always involves tradeoffs.

Low annual inflation, at rates of 2 per cent to 3 per cent, is not easy to achieve in economies that are catching up, where income per capita is 5 to 10 times lower than the average EU figure (in PPP terms). In more rapidly growing economies, demand pressures collide with disinflation. This can also happen because prices of domestic services (non-tradeables) go up unabatedly – the so-called Balassa-Samuelson effect. As in Central and Eastern Europe, the Balkan economies have grown by more than 5 per cent on average in recent years. It is fair to acknowledge, however, that sustained growth asks for more fixed capital formation and human capital investment.

The currently low budget deficits may be misleading for two reasons. One is that they are likely to hide chronic serious under-funding of essential public goods, such as infrastructure, education and health care. Another reason is

that after entry in the EU the new members have to boost public spending for the sake of complying with their obligations under the *acquis*. Therefore, one may confront situations where budget deficits get out of control.

Unless policymakers succeed in improving tax collection and reforming the welfare state (including the pension system) rising budget deficits can cripple overall economic stability. Rising deficits with growing current account deficits are not an anomaly in rapidly expanding emerging economies. Actually, current account deficits are increasing in most of Central and Eastern Europe because of economic growth differentials, compared to the older members of the EU, and surging bank credit extended to the private sector.

Against the background of capital account liberalisation, current account deficits that are not financed mainly by inward direct investment bring significant risks. It is the size of external deficits that complicates the task of policymakers when they have to decide on what is a prudent budget policy. This explains why the IMF has insisted that Bulgaria should run a surplus budget – current account deficits have gone beyond 12 per cent of GDP lately and the currency board does not permit a fluctuation of the exchange rate.

Here we return to the issue of competitiveness. Because capital inflows can be quite substantial, or inflation differentials fairly high, the exchange rate may become excessively over-appreciated. This can erode competitiveness and destroy jobs. The effect would be particularly bad in economies that are plagued by very high unemployment, as in the Western Balkans. Low wages are not a panacea when Chinese and other Asian goods flood European markets. To a large extent, globalisation annuls the competitive advantage of low wages in Europe. The transfer of new information and communication technologies, combined with heavy

investment in human capital buildup, are a must for securing long-term competitiveness.

Last but not least, massive migration can bring about important benefits, but it can also be a nuisance. Large remittances (to the tune of billions of euros for Romania and Bulgaria) can finance between 25 per cent and 40 per cent of trade deficits. But they imply the loss of highly skilled labour and, in numerous cases, disruption of family life. This said, for economies that suffer from huge unemployment, such as those in the Western Balkans, labour export is positive in net terms.

The bottom line is that policymakers in the Western Balkans must look beyond the economic numbers of recent years, understand the deep currents at work, be pragmatic, and learn from the experiences of current EU members, both old and new.

**Setimes 14.08.2006**

## REFERENCES

- Bell, Daniel (1974), *The Coming of Post-industrial Society*, New York, Basic Books.
- Blanchard, Olivier (1997), *The Economics of Post-communism*, London, Clarendon Press.
- Ellis, H.S. (ed.), (1961), *Economic Development for Latin America*, New York, St. Martin Press.
- Fukuyama, Francis (1990), *The End of History*, New York, Free Press.
- Giddens, Anthony (1998), *The Third Way*, New York, Blackwell.
- Gilpin, Robert (2001), *Global Political Economy*, Princeton, Princeton University Press.
- Hayek, Friedrich von (1972 edition), *Individualism and Economic Order*, Chicago, Henry Regnery Co, M.E. Sharpe.
- Helpman, E. and Krugman, Paul (1985), *Market Structure and Foreign Trade. Increasing Returns, Imperfect Competition and the International Economy*, Cambridge (Mass), MIT Press.
- Hutton, Will (2002), *The World We'Re In*, London, Abacus.
- Keynes, John Maynard (1936), *The General Theory of Employment, Interest and Money*, New York, Harcourt, Brace & World.
- Kirszner, Israel (1973), *Competition & Entrepreneurship*, Chicago, Chicago University Press.
- Kornai, Janos (1980), *The Economics of Shortage*, Amsterdam, North-Holland.
- Krugman, Paul (1994), *Geography and Trade*, Cambridge, MIT Press.
- Krugman, Paul (1999), *The Return of Depression Economics*, New York, Norton.
- Leibenstein, Harvey (1957), *Allocative Efficiency vs. X-Efficiency*, American Economic Review, vol. 56, no. 3.
- Mises, Ludwig von (1949), *The Logic of Human Action*, New Haven, Yale University Press.

- Myrdal, Gunnar (1957), *Economic Theory and Underdeveloped Regions*, London, Duckworth.
- North, Douglas (1981), *Structure and Change in Economic History*, New York, Norton.
- Nye Jr., Joseph (2004), *Soft Power: The Means to Success in World Politics*, New York, Public Affairs.
- Ohmae, Kinichi (1995), *The End of the Nation State The Rise of Regional Economies*, New York, Free Press.
- Olson, Mancur Jr. (1982), *The Rise and Decline of Nations. Economic Growth, Stagflation and Social Rigidities*, New Haven, Yale University Press.
- Porter, Michael (1990), *The Competitive Advantage of Nations*, New York, Free Press.
- Rodrik, Dani (1996), *Understanding Economic Policy Reform*, Journal of Economic Literature, vol. XXXIV.
- Rodrik, Dani, (1998), *The Global Economy and Developing Countries: Making Openness Work*, Washington DC, Overseas Development Council.
- Rodrik, Dani (2000), *The New Global Economy and Developing Countries. Making Openness Work*, Washington DC, Overseas Development Council.
- Rosenstein-Rodan, Paul (1943), *Problems of Industrialization of Eastern and South-Eastern Europe*, Economic Journal, 1943, Vol. 53 (June-September), pp. 202–11.
- Rosenstein-Rodan, Paul (1961), *Notes on the Theory of the Big Push*, in H.S. Ellis(ed.), pp. 57–81.
- Samuelson, Paul (2004), *Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization*, Journal of Economic Perspectives, vol. 18, no. 3, pp. 135–147.
- Schreiber, JJ Servan (1968), *Le défi américain* (The American Challenge), Paris, Gallimard.
- Summers, Larry (2006), *The Global Middle Cries out for Reassurance*, *Financial Times*, 30 October.
- Schumpeter, Joesph (1934), *The Theory of Economic Development*, Cambridge, Harvard University Press.
- Stiglitz, Joseph (2002), *Globalisation and its Discontents*, New York, Norton.
- Weber, Max (1958 edition), *The Protestant Ethic and the Spirit of Capitalism*, New York.