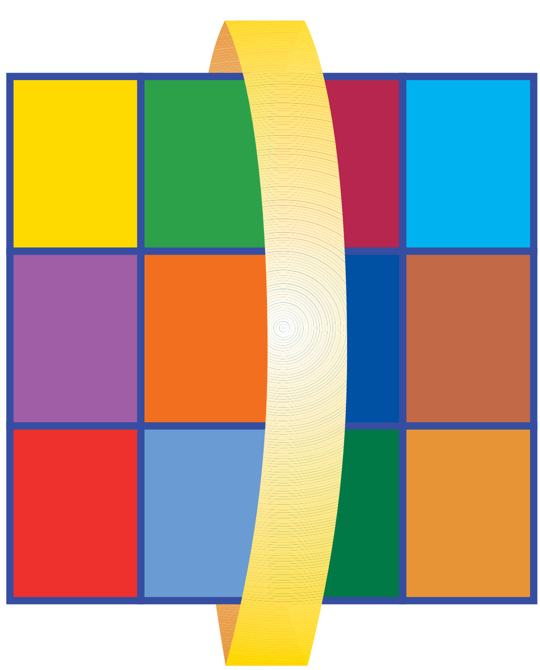
Oesterreichische Nationalbank

30. Volkswirtschaftliche Tagung 2002

30th Economics Conference 2002

# Wettbewerb der Regionen und Integration in der WWU

# Competition of Regions and Integration in EMU



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Klaus Liebscher

Klaus Liebscher
Gouverneur,
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# Wettbewerb der Regionen und Integration in der WWU

## Eröffnungsrede

Die Volkswirtschaftliche Tagung findet heuer bereits zum 30. Mal statt; mit diesem bemerkenswerten Jubiläum nimmt die Oesterreichische Nationalbank (OeNB) mit Sicherheit eine außerordentliche Stellung unter jenen nationalen Zentralbanken ein, die derartige Veranstaltungen organisieren, und es ist auch ein geeigneter Anlass für einen kurzen Blick in die Vergangenheit.

Im Mai 1973 kamen 17 OeNB-Mitarbeiter und acht geladene Gäste in der Krainerhütte in der Nähe von Baden bei Wien zur ersten Volkswirtschaftlichen Tagung der OeNB zusammen. Auf Initiative und unter dem Vorsitz des damaligen OeNB-Generaldirektors Heinz Kienzl setzte man sich mit dem damals wie heute sehr aktuellen Thema der „Möglichkeiten und Grenzen der Stabilisierungspolitik“ auseinander. Redner aus Deutschland, Schweden und Ungarn gaben schon der ersten Volkswirtschaftlichen Tagung eine internationale Dimension. Ab 1975 wurden die Beiträge in Form von Konferenzbänden der Öffentlichkeit zugänglich gemacht.

Lassen Sie mich nun einen großen Sprung von dieser ersten Konferenz zur 10. Volkswirtschaftlichen Tagung der OeNB tun, die im Zeichen von „Forschung und Wirtschaftswachstum" stand. Auch hier wurde, so scheint mir, das Thema treffsicher gewählt, stellt es doch nach wie vor eine zentrale Frage der Wirtschaftspolitik sowohl in Europa als auch in Österreich dar.

Dasselbe gilt auch für die 20. Volkswirtschaftliche Tagung der OeNB im Jahr 1992. Sie war der „Zukunft regionaler Finanzmärkte in einem integrierten Europa" gewidmet.

Wenn Sie einen Blick auf das diesjährige Programm werfen, so sehen Sie, dass auch diese Frage nichts an Aktualität verloren hat. Die Tatsache, dass viele der bei unseren Volkswirtschaftlichen Tagungen aufgegriffenen Themen uns auch heute – Jahre oder sogar Jahrzehnte später – noch bewegen, könnte einerseits auf den bemerkenswerten Weitblick der Organisatoren zurückgeführt werden. Andererseits kann man wohl auch argumentieren, dass wir immer wieder gefordert sind, neue Antworten, neue Lösungen, auf noch nicht bewältigte Aufgaben und Themenstellungen zu finden.

Welche Antwort nun auch immer zutreffen mag, unsere Tagung hat sich im Lauf der Jahrzehnte ausgezeichnet entwickelt und profiliert. Dies zeigt sich auch, so meine ich, in der Liste der hervorragenden Redner, die wir heuer willkommen heißen dürfen sowie in der hohen Qualität und wirtschaftspolitischen Relevanz der Beiträge und in der ständig steigenden Teilnehmerzahl – in diesem Jahr darf ich mehr als 350 Gäste hier begrüßen – unter ihnen Repräsentanten der Politik, der Wirtschaft, in- und ausländischer Banken, der Wissenschaft ebenfalls des In- und Auslandes, diplomatischer Vertretungen und, was mich besonders freut, auch eine große Anzahl von Gouverneuren und Mitarbeitern befreundeter Zentralbanken – sie alle seien herzlich willkommen geheißen.

Das 30-jährige Bestehen der Volkswirtschaftlichen Tagung spiegelt auch drei Jahrzehnte erfolgreiche österreichische Währungspolitik in der Post-Bretton-Woods-Ära wider. Wie Sie wissen, verfolgte die OeNB wie die Zentralbanken anderer kleiner, offener Volkswirtschaften niemals ein System frei schwankender Wechselkurse. Die Hartwährungspolitik, wie die österreichische Währungspolitik ab den späten Siebzigerjahren bezeichnet wurde, war der österreichischen Wirtschaft, im Nachhinein betrachtet, von großem Nutzen. Während die Anbindung an eine andere Währung chon per definitionem impliziert, dass sich die Zentralbank mit ihren Geschäften und Analysen sehr stark international orientiert, erhielt diese Internationalisierung ab den frühen Neunzigerjahren insbesondere mit Österreichs Beitritt zur Europäischen Union, dem Start der Wirtschafts- und Währungsunion und der Ostöffnung neue Impulse. Ich bin überzeugt, dass die weitere Entwicklung der EU, des Euroraums und Europas als Ganzen auch weiterhin die Zukunft Österreichs und der OeNB wesentlich mitbestimmen wird.

Natürlich könnte diese Konferenz nicht ohne die Beiträge einer Reihe außerordentlicher Redner stattfinden. Sehr geehrte Damen und Herren, ich freue mich – und es ist mir eine große Ehre – den Bundeskanzler der Republik Österreich, Herrn Dr. Wolfgang Schüssel, bei unserer Konferenz begrüßen zu dürfen.

Da Bundeskanzler Schüssel im Anschluss anderen terminlichen Verpflichtungen nachkommen muss, möchte ich an dieser Stelle meine Begrüßung unterbrechen und den Herrn Bundeskanzler ans Rednerpult bitten. ❧

Wolfgang Schüssel

Wolfgang Schüssel
Bundeskanzler der Republik Österreich

# Eröffnungsrede

Sehr geehrte Damen und Herren! Ich darf Sie sehr herzlich in Wien willkommen heißen. Es freut mich besonders, den Präsidenten der Europäischen Zentralbank Wim Duisenberg zu begrüßen und ich möchte diesen Anlass nutzen, um meinen tiefen Respekt vor der Arbeit dieser wichtigen Institution auszudrücken. Im Namen aller Österreicher und Österreicherinnen danke ich Wim Duisenberg für sein Engagement für die europäische Währungspolitik, das von Feinfühligkeit und großem Verantwortungsbewusstsein geprägt ist.

Und das führt mich zu der zentralen Thematik der diesjährigen Veranstaltung – den Zukunftsperspektiven für Europa. Erlauben Sie, dass ich zur Einführung einen österreichischen Beitrag gebe.

Das wahre und einschneidende Ereignis der letzten Monate war nicht eine der diversen aufgeregten, virtuellen Debatten innerhalb und außerhalb Europas, sondern vielmehr die Einführung des Euro am 1. Jänner 2002. Diese Währungsumstellung ist eine von der Öffentlichkeit selbstverständlich angenommene und aufgenommene Erfolgsgeschichte. Der Grund dafür liegt in der professionellen Vorbereitung. Dazu kommt, dass sich innerhalb von wenigen Wochen und wenigen Tagen die psychologische Akzeptanz der Bevölkerung gegenüber der neuen Währung so verbessert hat, dass der Euro eine perfekte Annahme gefunden hat. Ein besonders schönes Signal für Österreich war, dass Kommissionspräsident Romano Prodi Sylvester und Neujahr in Wien gefeiert hat. Mit diesem Besuch und dem Neujahrskonzert, das auch im Zeichen des Euro stand, wurde von Wien aus eine positive Botschaft dieser europäischen Währung in die ganze Welt gesandt. Ich halte das für wichtig, denn mittlerweile ist der Euro in rund 50 Ländern eine Leitwährung. Das zeigt, dass hier eine beachtliche zweite Weltleitwährung zur Verfügung steht, die sich mit Sicherheit bewähren wird. Positiv war auch, dass in Österreich innerhalb kürzester Zeit der Großteil der Bargeldtransaktionen in Euro abgewickelt wurde.

Wichtig zu erwähnen ist, dass mit der Einführung des Euro eine noch unterschätzte Langfristigkeit verbunden ist. Eine gemeinsame Währung verlangt nach einem voll entwickelten Binnenmarkt. Dieser ist gegenwärtig zwar in weiten Teilen verwirklicht, weist aber nach wie vor große Lücken auf. Eine gemeinsame Währung erfordert auch eine harmonisierte kohärente Wirtschaftspolitik, die über den Stabilitätspakt, so bedeutsam dieser natürlich ist, hinausreichen muss. Es bedarf vielmehr eines gemeinsamen abgestimmten Vorgehens in den Offensivbereichen der Wirtschaftspolitik sowie in wesentlichen wirtschaftlichen und sozialen Themenschwerpunkten.

Die Europäische Kommission und die 15 Mitgliedsstaaten messen beispielsweise der Ausgestaltung der Pensionssysteme eine immer größer werdende Bedeutung bei, da dieser Bereich massive Auswirkungen auf die Stabilität, auf die Verteilungswirkung und damit letztlich auch auf die Währung und auf den gesamten Wirtschaftsraum hat. Die langfristigen Wirkungen sind nicht zu unterschätzen.

Diese Neuorientierung kann nicht radikal geschehen, sondern wird schrittweise passieren, wobei diese Entwicklung ganz klar in Richtung gemeinsamer Regelungen, engerer Bandbreiten auch in den steuerlichen Richtsätzen gehen wird. Wichtig ist in diesem Prozess eine gemeinsame europäische Außenvertretung. Ein höchst erfolgreiches Modell der gemeinsamen Bündelung europäischer Interessen und einer europäischen Stimme gibt es bereits in der internationalen Handelspolitik. Kommissar Pascal Lamy vertritt in diesem Bereich in guter Koordination mit den 15 Mitgliedsstaaten perfekt europäische Interessen. Diese effiziente Bündelung von europäischen Interessen wird auch in den Finanzinstitutionen mittelfristig ein Thema werden.

Bei dieser Neugestaltung arbeiten wir auf mehreren Ebenen. Das macht das Thema und den Traum oder die Vision von Europa auch manchmal sehr kompliziert. Die eine Ebene ist jene der Kommunikation zwischen den nationalen Mitgliedsstaaten, den europäischen Institutionen und den europäischen Bürgern. Die zweite Ebene stellt der europäische Konvent dar, dem für die Zukunft Europas eine besonders wichtige Bedeutung zukommt. Denn der Konvent ist eine Plattform, wo frei, ohne Fraktionszwänge, ohne Bindungen durch die jeweils entsendenden Gruppierungen über Optionen, über Bausteine, wie ein künftiger Verfassungsvertrag oder ein verfassungsähnlicher Grundvertrag aussehen könnte, nachgedacht und diskutiert wird. Diese wichtigen Zukunftsfragen, mit denen sich die Konventsmitglieder beschäftigen, sind aber zugleich auch sehr substanzielle Souveränitätsfragen, die sich für uns alle stellen. Und diese Fragen lauten: Wo braucht es mehr Europa? Wo braucht es mehr Bürgernähe?

Nach meiner Überzeugung braucht es mehr Europa in der gemeinsamen Vertretung der Außenpolitik. Es wäre unsinnig, würde man weiterhin 15 oder später 25 nationale Außenpolitiken formulieren. Es bedarf vielmehr einer starken, koordinierten Stimme, einer Stimme Europas, die von allen Mitgliedsstaaten mitgetragen und unterstützt wird. Ein fataler Fehler wäre aber, die nationalen Außenminister ihrer horizontalen Koordinationsfunktion zu entkleiden. Eine logische Konsequenz müsste eher sein, darüber nachzudenken, die europäischen Koordinatoren – das sind für mich die Außenminister – zu stärken, ihnen aber zugleich auch auf europäischer Ebene ein klares Visavis gegenüberzustellen. Das wäre meines Erachtens ein vernünftiges Konzept. Ebenso sollte man die Außenvertretung und die Koordination innerhalb der europäischen Institutionen besser ordnen. Ich halte nichts davon, eine Konkurrenzinstitution zur Kommission zu schaffen, indem man die Funktion eines direkt gewählten Präsidenten des Rates, der diese Funktion fünf Jahre lang innehat, kreiert. Das wäre vielmehr ein Modell, das sehr stark in die Nähe eines Directoire der Großen über Europa führen würde und nicht mehr mit dem Prinzip der Gleichberechtigung und Gleichbehandlung der Mitgliedsländer vereinbar wäre. Vielmehr ist ein klares Abstimmen bei den verschiedenen Funktionen der Räte notwendig. Wir haben gegenwärtig in diesem Bereich eine merkwürdige Mischung. Der Europäische Rat, der eine sehr wichtige Motorenfunktion und eine strategische Planungsfunktion innehat, zum Teil aber auch Controlling- und Aufsichtsrechte für sich in Anspruch nimmt, um Europa weiter zu entwickeln, wird immer stärker zum Detailentscheidungsorgan. Grund dieser Entwicklung ist, dass die Fachministerräte beinahe jedes Problem, auch wenn es mit Mehrheit entscheidbar wäre, auf die Ebene des Europäischen Rates hinaufheben. Das halte ich für unklug, denn der Europäische Rat sollte das Steuerungsinstrument bleiben.

Ein weiterer wichtiger Punkt wäre, eine klare Abfolge, eine Choreographie der wichtigen Themen zu erstellen.

So sollte der Europäische Rat sich etwa im Frühjahr sehr stark dem gemeinsamen Wirtschaftsmodell widmen und die wirtschaftliche strategische Planung erörtern. Bei den anderen Themenbereichen sollten Schwerpunkte gesetzt werden, um die europäische Agenda weiter voran zu treiben. Ich glaube auch, dass man letztlich mit weniger Ratsformationen auskommen sollte. Vor allem eine stärkere Fokussierung, die sich mehr an der Kompetenzlage in den Mitgliedsstaaten orientiert, wäre mit Sicherheit sinnvoll.

Die andere zentrale Frage ist: Wie kann man all das, was für Europa wichtig ist, bürgernäher, dezentraler, subsidiärer organisieren? Das muss nicht zwingenderweise eine Umkehr der Kompetenzlage bedeuten. Es wäre aber sinnvoll, darüber nachzudenken, ein Modell ähnlich der österreichischen Verfassung, die in den Kompetenzartikeln in gewissen Bereichen die Grundsatzgesetzgebung als Bundeskompetenz und die Ausführungsgesetzgebung als Landeskompetenz vorsieht, zu entwickeln. Das würde bedeuten, die Prinzipien, die Standards auf europäischer Ebene festzulegen, die Umsetzung, die Durchführung und das Controlling aber stärker den Mitgliedsstaaten oder vielleicht sogar den Ländern, Regionen und Gemeinden zu überlassen. Gerade in den Bereichen der Regionalpolitik, der Natur- der Umweltrichtlinien findet sich dafür sehr viel Spielraum. Ich bin der Auffassung, dass manches, wenn es bürgernahe, also dezentral organisiert wäre, mit Sicherheit eine bessere Akzeptanz und eine praxisnähere Umsetzung fände.

Ein weiteres großes Thema, das ich heute ansprechen möchte, ist die Erweiterung. Ich habe als Ratsvorsitzender der Europäischen Union im Herbst 1998 die Verhandlungen begonnen. Ende des Jahres 2002 werden wir die Beitrittsverhandlungen mit der ersten Gruppe der Beitrittskandidaten abschließen. Wir sind im Plan und besser unterwegs, als noch vor drei oder vier Jahren Optimisten gedacht haben. Dazu möchte ich klar sagen, dass für mich die Substanz wichtiger ist als der Zeitplan. Die Erweiterung ist ein so bedeutsames Projekt, dass wir all unsere Kraft und Energie für die Lösungen der noch offenen Probleme aufwenden müssen.

Wir haben jetzt noch drei heikle Themenblöcke vor uns: Die Landwirtschaft, die Finanzen und die Regionalförderung. Meiner Meinung nach werden wir mit unseren Zahlungen unter den in Berlin festgesetzten Finanzobergrenzen bleiben. 1˙27% des Bruttosozialprodukts war vorgesehen. Der österreichische Beitrag beläuft sich zurzeit auf 1˙1% des Bruttosozialprodukts. Diesen Prozentsatz werden wir bis 2006 nicht überschreiten. Mit der Differenz von 0˙17% sparen wir somit eine beachtliche Summe.

Darüber hinaus gibt es Reformbedarf in vielen Bereichen. Besonders die Regionalpolitik müssen wir an die neuen Gegebenheiten nach dem Beitritt der neuen Mitgliedsstaaten anpassen. In der Landwirtschaft sollten wir versuchen, nach 2006 die Säulen zu verändern. Jetzt werden 90% für die Direktzahlungen ausgegeben und nur 10% für die Entwicklung des ländlichen Raums, wie zum Beispiel für Umweltprogramme. In diesem Bereich würde eine Umschichtung ökologisch und marktwirtschaftlich eine positive Entwicklung bedeuten. Das gilt auch für die Verwaltungsbereiche der Europäischen Union.

Meines Erachtens ist es wichtig, den Zeitplan für die Erweiterung ernst zu nehmen. Es ist aber auch notwendig, dass wir gerade in den nächsten Monaten weniger über den Zeitplan als über die Substanz der Verhandlungskapitel diskutieren. Das ist ein guter und richtiger Weg. Das ist auch die gemeinsame österreichische Position.

Dabei sollte man jedoch nicht vergessen, dass es auch bedeutsam für die europäische Zukunft ist, dass wir jenen Ländern, die gegenwärtig weder einen Kandidatenstatus noch eine Beitrittsperspektive haben, eine Zwischenlösung, einen Warteraum zur Mitgliedschaft anbieten. Wir brauchen ein Netzwerk, das Länder wie die Ukraine oder Weißrussland oder Moldawien einbindet. Es muss ein europäisches Netzwerk, vielleicht eine Art europäischer Wirtschaftsraum, maßgeschneidert für diese Partnerländer gefunden werden.

So viel zum Thema Europa. Nun möchte ich noch kurz auf die österreichische Entwicklung eingehen. Von der internationalen Konjunkturabschwächung konnte sich auch Österreich nicht abkoppeln. Die österreichische Wirtschaft ist stark mit der von Deutschland verflochten. Dennoch haben wir trotz Konjunkturabschwächung ein höheres Wachstum und bessere Arbeitsmarktdaten als in Deutschland. Einer der Gründe dafür liegt in den bereits einsetzenden positiven Effekten der Erweiterung. Österreich hat die Chancen der Ostöffnung und der Erweiterung perfekt genutzt. Wir haben die Exporte, Importe sowie die Investitionen vervielfacht und uns damit den Platz im Herzen Europas geschaffen, der uns zusteht. Deshalb ist es umso wichtiger, dass wir zu dieser Erweiterung „Ja“ sagen, weil sie sowohl politisch, als auch wirtschaftlich, sozial und kulturell in unserem Interesse ist.

Ebenso verbessert sich Österreich schrittweise und sehr kontinuierlich in den Weltranglisten, in den Rankings. Außer Finnland ist Österreich das einzige Land, das diese stetige Verbesserung aufweisen kann. Österreich befindet sich vor allem in wichtigen Bewertungsdaten wie bei innerer Sicherheit, Lebensqualität und auch bei der Qualität der medizinischen Infrastruktur im Spitzenfeld der internationalen Rankings. Eben deshalb sei den Kritikern unseres Gesundheitswesens gesagt, dass dieses in Österreich zu günstigen Beitragskonditionen sehr gut organisiert ist.

Schwachstellen gibt es jedoch in manchen innovatorischen Bereichen, wie etwa im Bereich Forschung und Entwicklung. Dort holen wir jetzt auf. Dafür möchte ich mich auch ausdrücklich bei der Oesterreichischen Nationalbank bedanken.

Positive Effekte konnten wir auch auf Grund der Privatisierungserlöse erzielen. Ebenso hat die Bundesregierung ein Konjunkturpaket zum richtigen Zeitpunkt beschlossen. Dieses Paket zielt nicht auf kurzfristige Maßnahmen, die ökonomisch nicht sinnvoll sind, sondern auf mittel- und längerfristige Weichenstellungen in Richtung Forschung, Entwicklung und Bildung ab. Unter anderem wurden beachtliche Forschungsprämien und Forschungsfreibeträge für die Unternehmen geschaffen; Ausbildungsanstrengungen für Mitarbeiter können steuerlich geltend gemacht werden. Diesen Weg sollten wir weitergehen.

Hinsichtlich der konjunkturellen Entwicklung wird man vorsichtiger sein müssen, als Optimisten angenommen haben. Die Erholung der Konjunktur wird sich voraussichtlich um ein, zwei Quartale verzögern. Ich bin aber überzeugt, dass wir Ende des Jahres 2002 und vor allem im Jahr 2003 mit einer befriedigenden Konjunkturentwicklung aufwarten können.

Es ist unbedingt notwendig, den klaren Weg in Richtung Privatisierung und Liberalisierung der Rahmenbedingungen fortzusetzen. Die Öffnung des Gasmarktes und des Strommarktes ist in Österreich früher erfolgt als in anderen Ländern. Die damit verbundenen Positiveffekte sind bereits für die Haushalte, vor allem aber auch für Wirtschaft und Industrie spürbar. Die Bundesregierung konnte auch im Bereich der Privatisierungspolitik der ÖIAG bereits vieles umsetzen. Zwei Drittel der Schulden von einst sind nun abgezahlt; die Entpolitisierung bei der Postenbesetzung hat sich gerade in diesen Bereichen bewährt. Auf

diesem Weg sollten wir in Österreich weitergehen.

In diesen Tagen wurde im Parlament ein sozialpolitischer Meilenstein – die betriebliche Mitarbeitervorsorge, die langfristig zur 2. Säule der Altersvorsorge werden kann – einstimmig beschlossen. Dieses Konzept ist auch für den österreichischen Kapitalmarkt eine sehr interessante Sache.

Ein Bereich, der noch unerledigt ist und in dem wir nachlegen müssen, ist die große Entlastungsstrategie. Wir wollen die Steuer- und Abgabenquote auf unter 40% bis zum Jahr 2010 senken. Das ist für ein Land, das nie eine besonders niedrige Steuer- und Abgabenquote hatte, eine gewaltige Anstrengung. Die Bundesregierung versucht hier, auf allen Ebenen schrittweise Spielräume zu erkämpfen. Im Bereich der Lohnnebenkosten ist ein Drittel bereits abgearbeitet, zwei Drittel stehen noch aus. Die vollständige Umsetzung wird in einem Etappenplan erfolgen.

Im Steuerbereich sehe ich in diesem Jahr noch keinen Spielraum. Für eine etappenweise Entlastung müssen wir einen Spielraum durch zweierlei Maßnahmen schaffen. Einerseits durch eine forcierte Wachstumsstrategie: Ich habe bereits die Präsidenten der beiden Wirtschaftsforschungsinstitute gebeten, uns dabei behilflich zu sein. Ich möchte auch die Notenbank und die interessierten wirtschaftspolitischen Kreise zur Mitarbeit einladen. Ich bin der Meinung, dass eine kreative Wachstumsstrategie ein halbes bis ein dreiviertel Prozent zusätzlichen Spielraum durch mehr Einnahmen bringen könnte, die wir dann in Form einer Entlastung weitergeben. Handlungsbedarf ist auch in den Bereichen Bildung, Qualifikation und Forschung gegeben. Ich habe in den letzten Tagen eine sehr ausgedehnte Österreich-Tour unternommen und vor allem Bildungsinstitutionen besucht. Da gibt es sensationelle Beispiele. So ist zum Beispiel in Vorarlberg die Kooperation der Eisen-, Metall- und Elektroindustrie zur Ausbildung von Lehrlingen ein nicht vom Staat, sondern von der Wirtschaft finanziertes Modell. Das Engagement und die Begeisterung dieser jungen Menschen, die an diesem Programm teilnehmen, sind beeindruckend. Dieses Vorarlberger Modell auf andere Bundesländer zu übertragen, wäre eine faszinierende Aufgabe.

Das gilt auch für den Bildungsbereich. Vergleicht man die Fachhochschulen mit den Universitäten, dann wird deutlich, dass die Universitäten gegenüber den Fachhochschulen an Bedeutung verlieren werden, da Fachhochschulen kundenorientierte und maßgeschneiderte Programme anbieten, die auch auf die Bedürfnisse der Berufstätigen eingehen. Ein Beispiel dafür ist die Fachhochschule Techno-Z in Salzburg. Ein Drittel der Studierenden ist berufstätig, weil geblockte Kurse für diese Zielgruppe am Wochenende angeboten werden. Derartige Möglichkeiten könnten auch Universitäten anbieten. Doch nur wenige tun dies tatsächlich. Hier herrscht eindeutig Reformbedarf. Daher dürfen wir im Interesse der Jugend nicht in den Reformambitionen nachlassen. Österreich soll auch in diesem Bereich zur Weltklasse gehören.

Als zweite Maßnahme müssen wir uns einen Ausgabenspielraum erkämpfen. Hier haben wir mit den ersten Schritten zu einer Pensionsreform, der Anhebung des Frühpensionsalters und mit der Verwaltungsreform schon einiges getan. Doch die Ausgabenspielräume müssen mit Hilfe von weiteren Maßnahmen nachdrücklich und nachhaltig geschaffen werden. Denn eines muss klar sein: Das Ziel, die Abgabenquote in Etappen bis zum Jahr 2010 auf unter 40% zu senken, ist nur mit Hilfe einer Wachstumsstrategie und eines Ausgabenspielraumes verwirklichbar. Wichtig ist aber auch, dass die Steuersenkung sowohl der Wirtschaft als auch den Arbeitnehmern zugute kommen soll.

Zum Abschluss möchte ich den Finanzinstitutionen ein großes Dankeschön für ihre Arbeit, für die professionelle Vorbereitung der Einführung des Euro, für die Betreuung des Wirtschaftsstandortes und für ihre wichtigen und entscheidenden Expansionen nach Mittel-, Ost- und Südosteuropa aussprechen. Gerade im Hinblick auf die Verurteilung einiger Banken durch die Europäische Kommission sollte man deutlich sagen, dass die Zeiten von Absprachen schon lange vorbei sind. Heute ist eine neue Generation von Bankern tätig, die sich ausschließlich auf dem Markt bewegt, marktorientiert handelt und keine Absprachen hinter den Kulissen oder hinter dicken Polstertüren braucht. In Österreich haben wir professionelle und produktive Finanzinstitutionen, die für den Standort Österreich besonders bedeutsam sind. Deshalb darf die Substanz der Finanzinstitutionen nie in Frage gestellt werden. ❧

Klaus Liebscher

Klaus Liebscher
Governor,
Oesterreichische Nationalbank

# Conference Opening

# (continued)

To me, among many other things, these remarks of the Chancellor convey a deep-rooted conviction that there is no way around actively further pursuing the process of European integration, while taking seriously the need for high-quality policy at the national and regional level. And this idea may be seen as the overriding theme of our conference.

In our program, we address three major issues, which – in my view – are essential to the European Union's further development, in both political and economic terms:

– The first group of issues is institutional. With enlargement approaching, the European Union has to further develop its institutional foundations and the efficacy of its decision-making. We will address this topic at fundamental level, for the EU as a whole, later this morning. Specific institutional and practical issues arising within the realm of the European System of Central Banks (ESCB), and in particular the experience gained so far in the Eurosystem, will be addressed tomorrow morning.
– The second area of topics deals with the economic structures in the face

of ever-closer integration among EU Member States. In a first tranche, right after lunch today, we will ask how much further hitherto national policies, notably social policy, should be harmonized, or whether competition among systems might continue to be useful also in the future. In a second tranche, tomorrow afternoon, we will discuss how much macroeconomic divergence among euro area countries is sustainable.

– The third group of issues relates to financial markets. For one thing, we will investigate the scope of regional financial institutions and stock exchanges in the single market and with a single currency. For another, we will take up the much debated issue of centralized versus decentralized models of supervision. We have bundled these issues together to be treated later this afternoon and tomorrow before lunchtime.

In my introductory remarks I will certainly not attempt to elaborate on each of these issues in detail. But let me pick out a few ideas which in my view deserve our particular attention.

Our conference takes place at a time at which Europe is at a crucial crossroads in several respects. A key issue is how fast further economic integration should proceed in order to best exploit Europe's potential. Clearly, this is a very far-reaching subject. The answer depends on the aim of integration. From the point of view of economics, the further integration goes, the better.

If we focus more narrowly on the needs arising from the *single monetary policy,* the issue of whether the euro area forms an "optimal currency area," as defined by Nobel Prize winner Robert Mundell, has been an ongoing debate ever since the very idea of a single European currency was born. It is interesting to note, however, that after three and a half years of practical experience with Economic and Monetary Union (EMU), this no longer seems to be much of an issue for the countries within the euro area. Still, as an immediate and ongoing prerequisite for success, the euro area's monetary policy needs to be accompanied by responsible fiscal and incomes policies that are able to absorb so-called asymmetric shocks beyond the purview of the single monetary policy.

In the medium and long run, structural reforms including the further integration of product and labor markets need to ensure that European economies themselves become more similar, and that they are able to absorb remaining asymmetric shocks more smoothly. While a certain degree of homogeneity among countries forming part of a monetary union is necessary, it is above all the willingness of policymakers, economic agents and the public at large to accept the consequences of EMU and to address the reform requirements it imposes that determine the success of the single currency.

EMU is certainly a harbinger of a political union within Europe – as history shows, national territories and currency areas are, as a rule, identical. For this reason it is fundamentally important that national interests be overcome in favor of a single European policy and that the cooperation between

Member States on a common foreign and security policy and internal security policy be reinforced.

I therefore welcome the EU's special constitutional convention. The assembled politicians and officials have the task of proposing a concept of the EU which will match our continental dimension and the requirements of the 21st century. I acknowledge that this convention is a bold experiment in consultative democracy.

However, we need to define what kind of institutional arrangements will be the prerequisite to meeting our aspirations, what kind of society and what kind of economy we want to build. I do not think that the real question is of federalism versus national sovereignty. The EU is federal already. It divides power between different levels of authority. Rather, the questions now are what the most effective and legitimate way to divide that power is, so that national sovereignty is preserved within an integrated system. If those questions can be resolved, Europe will earn the voice it seeks on the world stage.

The need for other European policies, and especially economic policies, to accept the consequences of a single currency and to step in line with its requirements naturally leads to the issue of political governance in the European Union. There, a number of open, unresolved issues are obvious. I will name just the Stability and Growth Pact, which also includes the question of the "quality of public finances," and the need for further structural reforms.

– I regard the *Stability and Growth Pact* as crucial for the smooth functioning of EMU. European governments need to put more emphasis in their fiscal consolidation measures on the welfare and growth impact of our tax and social benefit systems.
  Therefore, I fully support the Austrian government's aim of slashing the tax burden to 40% of GDP by the year 2010 – while sticking to a balanced budget. Probably, this is easier and more successful if done jointly, following agreed standards and benchmarks. In this context, I would like to repeat what I already mentioned on previous occasions. I regard a "zero-deficit" as very attractive, of course, but it is primarily the expression of a political intention and not an economic requirement – since the Stability and Growth Pact as such requires a budget "close to balance" or surpluses over the cycle.
– With regard to *structural reforms,* potential growth in most EU countries has considerably lagged behind that in the United States in the 1990s. What is even more worrisome, there is a consensus among the economics profession and – it seems – policymakers alike that this growth gap will persist over the years to come. Therefore we need more incentives for entrepreneurial initiative and for flexibility in our legal, tax and social welfare systems.

These particular areas of economic policy also demonstrate that the EU's institutional setup for economic and political governance will by necessity have to develop further as European integration deepens. But it remains an open issue how far the coordination or even centralization of policies should go.

A related issue is to what extent regional divergence among EU member countries – and, in particular, among euro area countries – might be a cause of concern. Studies suggest an asymmetric, convergence-stimulating impact of EU membership on long-term growth. Thus, we believe that EU integration in its present form supports catching up and a narrowing of initially different income levels. But it does not – and should not – prevent the specialization of certain regions and the working of agglomeration effects.

Competition among regions – also within the EU and the euro area – is in principle useful, as long as it does not prompt governments to enter into "competitive subsidization" and similar policies. The EU's competition policy, however, should prevent such a course. In the end, regional competition also supports our joint efforts towards EU competitiveness at the global level.

The EU's enlargement puts the issue of regional convergence into the limelight again. This wave of enlargement is unprecedented in at least three respects. First, it is the biggest wave of enlargement in terms of the number of entrant countries and the population size of the candidate countries – maybe also in terms of future, potential GDP. Second, the gap of economic development between the current EU Member States and the accession countries – at least most of them – is higher than with previous enlargement waves. Third, the level of EU integration to which the accession countries need to adjust is unprecedented, both in terms of market integration and in terms of joint economic policy decision-making.

This integration project is just as impressive and far-sighted as EMU, and it holds both enormous opportunities and challenges – challenges that must not be underestimated, as I mentioned before.

Let me finally touch upon a further focus of our conference, namely the issue of financial integration and the future of regional financial centers.

The link between financial systems and economic growth has become a very topical issue over the past few years. Various studies have suggested that more developed financial systems support economic growth. Further developing efficient financial markets thus ranks high on the European policy agenda.

The questions that we want to address at our conference are more specific, namely whether the euro will lead to more concentration among European financial centers, institutions and stock exchanges, to what extent regional financial development matters for growth at the regional level, and how financial market supervision should best be structured in the face of these developments.

Given the increased importance of efficient and stable financial markets in the operation of monetary policy and the overall European nature of the single monetary policy, the close involvement of central banks in financial market supervision is a must. Hence, I think Austria's new Financial Market Authority Act, which establishes an independent, separate, single supervisory agency and closely involves the central bank, is a right step in that direction.

The purpose of my short introductory remarks was to sketch avenues along which our discussions might evolve over the next two days. If we succeed in inspiring discussion, then we have achieved our aim of contributing a little to European and international integration by bringing together people and views.

In this context, I regard it as a great privilege and as a sign of the excellent cooperation within the Eurosystem that I may welcome at our 30th Economics Conference the President of the ECB, Willem F. Duisenberg, who will give a keynote speech today, and two of my fellow members of the Governing Council of the ECB, Jean-Claude Trichet and Arnout Wellink, who will speak tomorrow.

It is now my great pleasure to welcome Heinrich Neisser, who will share with us some possible scenarios for future institutional arrangements in the European Union. ❧

Heinrich Neisser

Heinrich Neisser
Professor, Jean Monnet Chair,
Leopold-Franzens University of Innsbruck

# Institutional Arrangements of the European Union – Scenarios for the Future

It seems to me that the European Union discovers or – one may say – rediscovers from time to time its own future. The Union's future is becoming more and more an issue of particular interest discussed in many institutions and political groups, in parliaments as well as in governments, universities and particularly in nongovernmental organizations.

In connection with the Treaty of Nice, the third amendment of the Maastricht Treaty, the European Union adopted a "Declaration of the Future of Europe" covering a program for a broad debate between political representatives, representatives of the universities, of business and of the so-called civil society. The topics of this debate are:

– the division of competences between the Union and the Member States in accordance with the principle of subsidiarity,
– the status of the EU Charter of Human Rights proclaimed in December 2000 in Nice,
– the simplification of the Treaties, and
– the role of national parliaments in the architecture of Europe.

A further step in the future debate was made at the European Council in Laeken in December 2001. The Presidency's conclusions contain another "Declaration on the Future of the European Union."[1]) This Declaration characterizes the current Union's situation with the words "Europe at a Crossroads." In this document three dimensions are stressed:

– first, the democratic challenge of the political community: Within the Union the European institutions must be brought closer to its citizens;
– second, Europe's role in a globalized world: Europe is a continent of human values. The European Union is fully committed to democracy and human rights. Europe must be a power seeking to set globalization within a moral framework, to anchor it in solidarity and sustainable development;
– third, the expectations of the citizens have to be considered: Citizens are calling for a clear, open, effective, democratically controlled Community approach, developing a Europe which points the way ahead for the world.

Continuing and intensifying the debate about the future of the Union, the European Council decided to convene a Convention. This Convention is expected to consider "the key issues arising for the Union's future development and try to identify the various possible responses." It will draw up a final document which may either comprise different options (including the degree of support which they received) or recommendations (if consensus is achieved). Together with the outcome of national debates on the future of the Union, the final document will provide a starting point for discussions in the Intergovernmental Conference, which will take the ultimate decisions (in 2004).

Although the institutional reform is not explicitly mentioned in the declarations described above, there is no doubt that the reform of the institutional framework is a "key issue." The future of the European integration process is determined by the tensions between supranationality and intergovernmentalism. Since the Treaty of Nice, intergovernmentalism seems to be in advance.

## 1 The Institutional Framework of the European Union

The European Union has a special institutional framework which cannot be compared with states or other international organizations. The German Constitutional Court stated in its remarkable decision of October 12, 1993,[2]) that the European Union is neither a federal state nor a confederation. It is rather an association of states "sui generis." This statement can be verified by looking at EU institutions. The *Treaty* on European Union *(TEU), also known as the Treaty of Maastricht,* set up a particular structure of the Union, namely a combination of supranational and intergovernmental elements. Pillar 1, Economic and Monetary Union, is organized at a supranational level, pillar 2 and 3[3]) are based on intergovernmental cooperation. All three pillars have the same institutional framework, but the position of the single institutions is different: in pillar 2 and 3 the Council is

1 *http://europe.eu.int/futurum/documents/offtext/doc151201_en.htm.*
2 *BVerfGE 89, 155.*
3 *Pillar 3 covers Police and Judicial Cooperation in Criminal Matters.*

prevailing and the Commission, and particularly the European Parliament, have a weak position.

The center of institutions within the first pillar is an institutional triangle consisting of the Commission, the Council and the European Parliament. Between these institutions there is a balance of power: the Commission has the right to take initiatives, it is described as the engine of the integration process. The Commission is also the guardian of the Treaties and may bring cases before the European Court of Justice. The Council has the main responsibility in taking decisions. The European Parliament has become more and more of a factor in the decision-making process, participating in various procedures of the legislative process; the strongest is the codecision procedure, where it can block any final decision by veto.

The dualism of supranational and intergovernmental elements consequently leads to two types of institutions: the Commission and the European Parliament represent supranational interests; the Council, the Committee of Permanent Representatives (COREPER) and the European Council are intergovernmental bodies. The balance between these two institutional types is the key issue of institutional agreements. Especially the relations between the Commission and the Council can be seen as a parameter of power between the supranational and the intergovernmental sides within the political system of the European Union.

## 2 Institutional Arrangements and Institutional Reform

Institutional reform is increasingly being discussed. Not only because of the enlargement process and the growing number of Member States but also to make the institutions more effective. Effectiveness alone, however, is not the problem. Within the European Union there is an ever more intense debate about the importance of its institutions and their functions. The

following questions are discussed most frequently:

- What is the future of the Commission? Should its position vis-à-vis the Council (European Council) be strengthened? Should the Commission become the Council's secretariat or a European Government in the real sense of the word?
- How should the President of the Commission be appointed: by the European Council, by the European Parliament, or should he be directly elected by the European citizens?
- The European Council, consisting of the heads of state or government, lacks effectiveness. It is not able to give "the necessary impetus" to the Union. What is the relation between the European Council and the Council (particularly the Council of General Affairs)?
- The Council has a horizontal and multidisciplinary function, which is not satisfactorily fulfilled.

- The European Parliament has to maintain the focus of democratic legitimacy. Its legislative power is of a participatory nature, therefore its position is weaker than that of national parliaments. Improving the legislative function of the European Parliament means that every time the Council decides with qualified majority the codecision procedures should be applied.
- Should the way in which we elect the members of the European Parliament be reviewed?
- Should the role of the Council be strengthened?
- With a view to greater transparency, should the meetings of the Council, at least in its legislative capacity, be public?

Another question relating to democratic legitimacy involves the role of the national parliaments. Should they be represented in a new institution, alongside the Council and the European Parliament? Should they have a role in areas of European action in which the European Parliament has no competence?

A third set of questions concerns the improvement of the efficiency of decision-making and of the workings of the institutions in a Union of some thirty Member States. In concrete terms, the issues in question are:

- How could the Union set its objectives and priorities more effectively and ensure better implementation?
- Is there a need for more qualified-majority decisions?
- How can the codecision procedure between the Council and the European Parliament be simplified and speeded up?
- What is the advantage of the six-month rotation of the Presidency of the Union?
- How should the coherence of European foreign policy be enhanced?

Many questions, different answers. If you have to decide on institutional arrangements, it is necessary to have a clear picture of the main institutional structure. A German economist recently published a book in which he elaborated two alternatives.[1]) One of them is the way to a European "superstate." That means a very strong European level: the Commission as a Government of the Union, the European Parliament as a legislator, combined with the Council of Ministers as a second chamber. This way would lead the European Union toward becoming a European central state like France or the United Kingdom.

The alternative will fight against the progressive process of centralization. Therefore a system must be established which is based on the principles of the separation of power, democracy and subsidiarity. The proposals for a new organization made by Roland Vaubel are somewhat astonishing:

- the Commission should be reduced to purely executive matters, without having the right of initiative;
- the Council of Ministers should not have legislative authority, the Council members should be the heads of the Directorates General;
- the parliamentary institutions consist of the European Parliament and a second chamber with delegates from the national parliaments.

What Vaubel is suggesting seems to be merely a theoretical concept but it mirrors the controversial positions above described between supranationalism and intergovernmentalism.

1 *Vaubel, R. (2001). Europa-Chauvinismus. Der Hochmut der Institutionen. Munich.*

Obviously an institutional reform will result in a power struggle between the institutions and between different interests: in terms of the European integration process, this will be a struggle between the Community's interests and the interests of the Member States. Thus the key question of the institutional reform is the following: To what extent will the Member States relinquish power and influence? To what extent are the national governments ready and willing to give up further parts of their sovereignty?

## 3 Reforming Political Leadership

The institutional reform debate concerns many institutions with different goals. The necessity of the parliamentarization and democratization of the European Union affects particularly the European Parliament and the role of national Parliaments. Improving the political leadership focuses on the institutions representing the governmental side: Council, European Council and EU Presidency.

In the following section, I will deal with reform suggestions that are being discussed more and more within the European Union.

### 3.1 The General Affairs Council

The Council of the European Union, composed of the Ministers of Member States and usually called the Council of Ministers or simply the Council, is the Union's main decision-making body. In reality there are several distinctly specialized Councils (Council for Agriculture, for Transport, for Environment etc.). The General Affairs Council, which brings together the Ministers for Foreign Affairs, plays an important role. It not only deals with foreign affairs or external relations, but it also is in charge of dealing with institutional questions and other general perspectives. The General Affairs Council has a horizontal and multidisciplinary function (institutional questions, the financial framework of the European Union, enlargement, the preparation of the European Council, etc.). That function is not being satisfactorily fulfilled.

The "Solana paper,"[1]) elaborated by the present Secretary General of the

Council, seeks to remedy this situation by making suggestions which would not require an amendment of the Treaty:

- creation of a new formation of the Council, composed of Deputy Prime Ministers; this proposal has met with strong objections;
- creation of a special new formation of the Council, composed of Ministers/State Secretaries for European Affairs;
- splitting the present General Affairs Council into two formations: one to deal with external relations, the other responsible for horizontal questions. These two formations would have separate and different timetables, rules of procedure and methods of preparation.

### 3.2 The European Council

The European Council is the core of the EU executive bodies. Its position is described outside of the regular

1 *Preparing the Council for Enlargement. Report by Javier Solana, 11 March 2002 (OR. fr) S0044/02.*

framework of the EU institutions. Article 4 TEU lays down the tasks and composition of this leading institution:

"The European Council shall provide the Union with the necessary impetus for its development and shall define the general political guidelines thereof. The European Council shall bring together the Heads of State or Government of the Member States and the President of the Commission. They shall be assisted by the Ministers for Foreign Affairs of the Member States and by a Member of the Commission. The European Council shall meet at least twice a year, under the chairmanship of the Head of State or Government of the Member State which holds the Presidency of the Council."

In practice the European Council has got a comprehensive responsibility on a strategic as well on an operational level. It has initiated major developments on its own account. It was acting as a trouble-shooter in many ways. And nothing of any importance has happened in which the European Council was not involved. It was the steering platform dominated by predominant leaders like François Mitterrand and Helmut Kohl.

The European Council was considered as a forum for free and informal exchanges of views between the leaders of Member States. The heads of state or government do not adopt legal acts that are formally binding for the Member States, except for the Common Foreign and Security Policy, where the European Council can decide upon joint actions or common positions binding the Member States politically (Article 13 para 1, 2 TEU).

The European Council is the Union's supreme political authority.

This record is now in danger. During the last years the European Council's meetings showed that this institution is caught in a field of increasing tension and different opinions. Furthermore, over the past few years, it tended to disperse its energies on an ever more extensive agenda dealing with many things without relevance for the integration process.

Therefore, there is a close link – in reform matters – to other bodies: the General Affairs Council, the COREPER and the General Secretariat.

The Council's General Secretariat elaborated a special report "Preparing the Council for Enlargement."[1]) This paper includes "possibilities for discussion," which do not require a revision of the Treaty. It mentions three possibilities:

"Refocussing the European Council on its original purpose:

- concentrating on its role of coordinator and driving force, avoiding as far as possible making it an appeal body for the Council; the European Council must devote its meetings and its debates to framing Union policy and major strategic decisions; i.e. the key political decisions that will be crucial to the future of the Union;
- abolishing all reports, conclusions or parasitic procedures that clog up meetings.

1 *Report by Javier Solana, 11 March 2002 (OR. fr) S0044/02.*

Better organisation
of European Council meetings:

- regular European Council meetings (4 per year) conceived as working meetings forming part of the normal pattern of the Union's activities;
- application of certain procedural provisions relating to Council meetings (e.g. agendas);
- replacement of the present "Conclusions" by a brief summary of decisions adopted and the agreed strategic guidelines;
- radical reduction of the size of delegations and, as a general rule, no more ancillary activities (meetings with third parties etc.).

More structured preparation:
Preparations for the European Council must not be seen as a prenegotiation of the outcome. The European Council must instead be provided with all the relevant background information needed to discuss the dossiers submitted to it and to take decisions in full knowledge of the facts. This will be achieved first of all by greater efficiency in the Council's various formations, the number of which should be reduced. That presupposes, secondly, a methodical approach to preparation which is lacking at present and which could be the task of a new formation of the General Affairs Council."

**3.3 The Presidency**

The role of the Presidency is laid down in Article 203 para 2 TEC: "The office of President shall be held in turn by each Member State in the Council for a term of six months in the order decided by the Council acting unanimously." Presidency means chairmanship in the Council, the European Council and in all the Committees that are involved in the preparatory works, first of all the COREPER.

The Presidency as an institution is important for the political leadership within the European Union. But there are serious problems. They stem from the increasing mismatch between the scale of the Presidency's task and the brevity of each Presidency's tenure. On the one hand, Member States are investing time and resources to achieve a good Presidency, on the other hand, every six months the Union has to deal with new presidencies which are different in many ways: they have different programs and a different main focus. Thus Ludlow concludes, "The Presidency as currently organised is therefore inherently costly and inefficient." But simultaneously he underlines: "If it did not exist, the Union would nevertheless have to invent it. A system that is founded on the states can only function if the states acquire a sense of ownership of, and responsibility towards, the system as a whole … The Presidency is in other words one of the most powerful signs and tokens that the EU is a method of government of the member states, by the member states for the member states."[1])

To hold the current Presidency has become a matter of national prestige. Each Presidency established its own priorities. The Presidency was conceived as an element of balance and continuity, but now it became a source of permanent imbalance and controversy within the Union.

1 *Ludlow, P. (2001). A Commentary on the EU. In: A View from Brussels. Centre for European Policy Studies No. 12, June: 17.*

Therefore it is understandable that the above-mentioned Solana paper deals with ideas and proposals to reform the current system of the Presidency. This paper offers different proposals; one part is concerned with suggestions that can be realized without any amendment of the Treaties:

- improved cooperation between successive Presidencies by longer forward-scheduling of meetings, laying down specific functions for the subsequent Presidency or Presidencies;
- appointing the chairman of certain working parties or committees for a period longer than 6 months;
- specific committees or working parties could be chaired by the Secretariat General of the Council.

The proposals requiring an amendment of the Treaties are of more significance:

- Discussions revolve around the idea that the President of the European Council is elected by European Council members for a term of more than 6 months, possibly 2 or 2.5 years.
- An alternative could be an appointment of the President of the Council formations for a term of over 6 months. This appointment might be through elections or – this is the better idea – on the basis of a rotation between five or six groups of states which would hold the Presidency concurrently; those groups should be composed in such a way as to ensure representativity and maintained strict equality between states. I absolutely agree with Peter Ludlow, who wrote in his Commentary on the EU, "The most elegant solution would undoubtedly be the adoption of the idea of team presidencies, which Niels Ersbøll and I advocated before the 1996 IGC. Under this scheme, the member states would be divided into a number of groups, each consisting of governments from north and south, east and west, rich and poor. Every team would be in office for two or even three years, thereby reducing the problems inherent in six-month rotation. Responsibilities would be allocated in the teams by mutual agreement, though every head of government or state concerned might be given a chance to chair the European Council, during which period his or her country would play host to non-Brussels/Luxembourg events, as Presidencies currently do. Most if not all other Councils, committees and working groups would however have the same president for the duration."

### 3.4 National Parliaments – a New Competitor

The role that the national parliaments should play in the system of the European Union is a matter that concerns the Union or rather the Member States themselves. National parliaments have their own distinct constitutional history and political structure. But they play roles with different functions. Three of them have to be mentioned:

- First, each amendment of the Treaties must be accepted by the Member States "in accordance with the national constitution." Therefore the national parliaments usually have to ratify the agreements elaborated and agreed by the Intergovernmental Conference.[1])

*1 See Article 48 TEU.*

- Second, national parliaments are a fundamental element for the Union's democratic legitimacy. The mediate democratic legitimacy of the Council, which comprises the government representatives of the Member States, is derived from the national parliaments. If the European Union wants to cope with the "lack of democracy," the parliaments of the Member States must be included in such a process of gaining more democratic legitimation.
- Third, the national parliaments immediately influence, to a certain extent, the decision-making process in the Council of Ministers and in the European Council. The Member States established special committees in the national parliaments, European Affairs Committees, etc., having the possibility to make binding statements for their government representative in Brussels.[1]) That means the government representatives have to respect the Parliament's will in their voting behavior.

For years the national parliaments have tried to gain more influence in the decision-making process of the Community. There was an initiative by Gaetano Martino to establish permanent and direct talks between the presidents of the national parliaments and the president of the European Parliament on topics of common interest particularly concerning

- the coordination of the European Parliament's activities and those of national parliaments;
- research activities aiming to give more resonance to the initiatives of the European Parliament within the national parliaments;
- to ensure a better harmonization among the legislative bodies.

This Presidents' Conference became a platform of political discussions in general, not on special topics.

At the end of the 1980s, a new step was taken toward a closer cooperation between the national parliaments. The "Conférence des organes spécialisés dans les affaires communautaires" (COSAC) was established in November

1989. Since then, the national parliaments have aimed at a more intense participation in EU activities. The Treaty of Amsterdam includes a protocol on the role of the national parliaments within the European Union.[2]) They now have the ability to express their opinions about issues of particular interests. The protocol contains a list of documents of reference and legislative proposals which shall be timely transmitted to the national parliaments. Moreover, COSAC is entitled to submit its contributions to the institutions of the EU and may make initiatives and proposals in connection with the creation of an area of liberty, security and justice as well as the application of the principle of subsidiarity and fundamental rights issues.

1 *See Weber-Panariello, P. (1995). Nationale Parlamente in der Europäischen Union. Baden-Baden.*
2 *Protocol No. 9 on the role of national parliaments in the European Union.*

**3.5 Role and Significance of the Regions**

Article 158 TEC stipulates: "In order to promote its overall harmonious development, the Community should develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas."

This article describes the fundamental guideline of "Economic and Social Cohesion." It is the basis of the "Regional Development Policy." European regional policy coordinates national regional policies by formulating guidelines and establishing certain principles in order to avoid competition for regional aid between Member States. It also coordinates the various policies and financial instruments of the EU to give them a "regional dimension" and thus more impact on regions most in need of care. European regional policy is an essential instrument of economic and social cohesion, necessary for the progress of Economic and Monetary Union, implying the convergence of the Member States' economies.

The achievement of Economic and Monetary Union promises enhanced prospects for the developed and the less favored regions alike. The reduction of transfrontier transaction costs and the elimination of exchange rate risks may promote regional specialization and intra-Community trade in goods and services. The weaker regions can benefit from this specialization by exploiting more fully their comparative advantages.[1])

Since the Treaty of Maastricht regions have not only been relevant for the regional policy, but have started to play a more and more important role in the political system of the European Union. There are two levels where the regions try to improve their influence. On the one hand, the integration process had impacts on domestic regional issues (like in Spain, Italy, Austria, Germany, and United Kingdom), while on the other hand, the regions of the Member States make many efforts to strengthen the representation of their interests in Brussels. The Committee of the Regions is only an advisory board and therefore not really effective. More important are many offices, missions and representations established by the regions in Brussels.

The future debate must deal with the role of regions, cities and municipalities. The main question will be: How should the Treaties be reformed to guarantee that the local and regional authorities be better represented in EU institutions?

One of the most relevant perspectives within the European Union will be the transnational cooperation between regions (for instance the "European Region Tyrol"). To promote this opportunity, the regions must be provided with more autonomy in shaping their own transregional relations.

I started my presentation by quoting the future declaration of Laeken: "Europe at a Crossroads." Being at a

1 *Moussis, N. (2000). Guide to EU policies. 6th ed., Rixensart: 150.*

crossroads means to make a decision among alternatives and options. As I pointed out, the main decision is whether the European Union should go into the direction of either supranationality or intergovernmentalism.

In the Treaty of Nice, the European Union adopted provisions preparing European institutions to function in the context of a Union composed of 27 Member States. The Treaty of Nice has not yet been ratified – the Irish referendum prevents ratification. Moreover, this Treaty is just a relatively simple adjustment that merely considers the enlargement process. It is not or cannot be the final point of institutional reform.

The process of European construction has never halted. The Union is in perpetual movement. The Member States have united their currencies and closely coordinated their economic policies. They are willing to place under common command certain units of their armies. They have to create federal institutions that are able to compensate for the losses of national sovereignty these changes entail.

In the declaration of Laeken many goals are mentioned that are also significant for institutional arrangements:

– a better division and definition of competences;
– a simplification of the Union's instruments;
– more democracy, transparency and efficiency;
– elaborating the text of a European Constitution.

What is the priority among these topics? The urgent matter is the improvement of the Union's democratic structures. All those measures able to reduce the democratic deficit within the European Union have priority.

The main goals are transparency and openness in the decision-making process. Therefore, the following measures are inevitable:

– meetings at which the Council acts as a co-legislator should be open to the public;
– EU citizens' right of access to documents of the European Parliament, Council and Commission must be safeguarded;
– strengthening the regional representation within the EU. For implementing a strategy "closer to the citizens," regions are necessary as an element of transmission between the Union and its citizens. European identity must be based on national and regional identities.

We cannot create a European identity without respecting national identities. Article 6 para 3 TEU makes it clear, "The Union shall respect the national identities of its Member States."

In a multilevel governance system, the identity of the Community is also a multilevel one. Institutional arrangements have to make visible the necessity and the complexity of European identity. ❧

Willem F. Duisenberg

Willem F. Duisenberg
President, European Central Bank

# The Euro as a Catalyst for Integration and Competition in EMU

Here in Vienna, exactly one hundred years ago, Joseph Schumpeter embarked upon his university studies at the School of Law and Political Science. He was a promising young student with ambitions in academics, politics and business. Already, at the age of 22, he had published his first works and would soon become one of the youngest holders of a doctorate, the youngest private teacher and the youngest professor in Austria.

Joseph Schumpeter has become known as one of the foremost representatives of the famous Austrian School of Economics. He has influenced economic thought, in particular, by introducing innovation as a source of economic dynamics. According to Schumpeter, economic development was a dynamic process, a disturbance of the economic status quo. The real challenge for capitalism, therefore, was to create and destroy economic structures in a process he called "creative destruction". This, he maintained, was the essence of economic development, a process defined by the implementation by the entrepreneur of new production combinations.

I believe that Schumpeter would be very interested in the topic I want to discuss today. My speech is about the euro as a catalyst for integration and competition in Economic and Monetary Union (EMU), or, in other words, about economic growth and adjustment in the euro area. Both high, sustainable economic growth and the ability to adjust smoothly to changes in the economic environment require further economic integration and competition. This, in turn, is closely linked to the process of structural reform, which, to use Schumpeter's words, can be seen as a necessary precondition for a dynamic economic process, a disturbance of the economic status quo. The introduction of the euro acts as a catalyst for this dynamic process of structural change.

In my speech today I will address the following topics. I will first talk about the link between European integration and the euro, and then argue why an increasingly competitive and dynamic society raises the need for further structural reforms. However, reforms are also important for the smooth functioning of a monetary union, a point I will discuss next. Finally, I will assess the progress that has been made with the structural reforms in the euro area so far and discuss how the single currency has already benefited the euro area's economy, acting – as formulated in the title of my speech – as a catalyst for integration and competition.

## A Single Currency for a Single Market

A natural starting point for my topic today is the adoption of the Single Market Programme in 1985, paving the way for the famous four "liberties" established in the European Treaties: the free movement of goods, services, labour and capital.

After the adoption of the Single Market Programme, it became increasingly clear that the potential of the internal market could not be fully exploited while the relatively high transaction costs linked to currency conversion and the uncertainties associated with exchange-rate fluctuations persisted. Indeed, the single currency should be seen as a necessary complement or, in fact, the crowning achievement of the Single Market.

That said, we have not reached the end of the development of the Single Market. Instead, I see the euro as facilitating further economic integration. For example, countries with the same currency tend to trade more with each other than they would with countries with different currencies. In addition, a single currency fosters the formation of a single financial system. By increasing price transparency, reducing transaction costs and fostering competition, the euro acts as a powerful catalyst to the economic integration process in the euro area. Last, but not least, our common currency is also a powerful symbol for all citizens of the euro area that integration has reached a new level. As we approach the first summer holiday season since the introduction of euro notes and coins, increasing numbers of people in Europe will, themselves, experience the practical advantages of a single currency.

The impetus the euro gives to economic integration and growth should not only be regarded as an opportunity for Europe, but also as a necessity in a world of innovation and globalisation. Over the last few decades, the world economy has become ever more integrated. We have witnessed a strong expansion of international trade and capital flows and an increase in competition. Behind these changes there are several underlying factors. Among the most important is rapid technological progress, leading to dramatic reductions in transportation costs and an unprecedented increase in information processing capabilities. Policy measures have also supported the globalisation trend, with the loosening of restrictions to trade and the liberalisation of capital movements.

This panorama shows that we live in a dynamic and competitive world, where the ability to innovate and adjust to changing economic circumstances has become even more important than before. In this respect, Schumpeter's thoughts haven't lost anything of their relevance. On the contrary; in a dynamic, ever-changing economic environment, entrepreneurs have to be all the more innovative and sensitive to new opportunities. The regulatory framework formed by the laws, rules and regulations that influence economic behaviour, should thus provide the right incentives for innovation, dynamism and economic growth.

The EU Heads of State and Government have recognised that, in order to improve the functioning of the Single Market and to enhance the economic growth potential of the EU, its regulatory framework has to be modernised and reforms are needed. Somewhat more than two years ago, the Lisbon European Council formulated a strategic goal for this decade, namely "to become the most competitive and dynamic knowledge-based economy in the world". The Lisbon strategy established a comprehensive reform agenda which aims to overcome existing fragmentation and inefficiencies in many different areas. This has provided a major political impetus for further progress in the field of structural reform that I very much welcome. The European Council aims to increase the potential GDP growth rate to around 3% per year, an objective which can only be achieved if steady progress on a broad range of reforms is made. Whether or not this objective is met hinges partly on the capacity to improve mobilisation of available labour resources. In this regard, one of the explicit objectives set at the Lisbon summit is to raise the EU-wide employment rate to 70% of the working age population by 2010.

In order to achieve the Lisbon objective, it is crucial that progress is systematically controlled and evaluated. In this context, the Broad Economic Policy Guidelines for the Member States and the Community play a particularly important role. This is the overall framework for the coordination of economic policies, in particular, those related to fiscal and structural policies. In order to fulfil this role, the Broad Economic Policy Guidelines have, in recent years, been enhanced in several ways. They have become more operational through the use of more concrete recommendations in both the general and country-specific parts. Moreover, within the overall process of policy co-ordination, increased emphasis is being placed on implementation. To this end, the European Commission has introduced a

comprehensive implementation report that assesses the extent to which EU Member States have followed the policy recommendations. I fully support these changes.

As you know, the most recent Spring Meeting of the European Council, the second "follow-up" meeting to Lisbon, took place in Barcelona earlier this year. The conclusions of the Barcelona Summit demonstrate that a strong political will and thorough preparation of the technical details are needed if the European Union is to meet the ambitious economic, social and environmental objectives that it set for itself at the Lisbon Summit. The successful introduction of the single currency is the best proof that these ingredients are indispensable. The main point now is that the relevant Council formations, the European Parliament and the Member States take the necessary steps to rigorously implement the structural reform agenda agreed in Lisbon and confirmed in Barcelona.

## Why Are Structural Reforms Important?

Structural policies cover a wide range of areas and instruments. Among the most commonly discussed are microeconomic regulations implemented in product, labour and financial markets. Among other things, such regulations encompass competition policies, entry barriers, tax and benefit systems, state aid, employment protection rules, education and training, as well as incentives given to research and development. They are important for two main reasons since they enhance the economic growth potential and facilitate the adjustment to economic change. Let me say a few more words on these two reasons.

First, structural policies are just one of many factors determining the rate at which the economy can grow, although there are many other factors which influence the rate of economic growth. Some factors, such as changes in demand conditions, have temporary effects on economic growth, whereas others, such as the rate of growth of the working age population and capital stock, as well as the increase in productivity, have long-lasting effects. It is this latter type of factor, however, that determines the potential growth rate of an economy. These components, in particular the growth of employment and productivity, can be influenced by structural policies. Changes to tax and benefit systems, for example, can help to mobilise the unused labour potential in the economy by making it financially more attractive to accept a job. This could lead to a better use of the supply side potential of the economy. The third factor, productivity growth, can be influenced in several ways: by increasing competition, facilitating investment, encouraging enterprise and innovation and improving the workforce's skills.

Structural policies have particular importance for monetary policy. They allow the economy to grow at a higher rate, on a sustained basis, without creating inflationary pressures.

However, structural reforms are not only important for economic growth, they also increase adaptability to economic shocks. Adaptability concerns the economy's ability to adapt and respond to changing economic conditions. It is the ability to shift resources from areas in recession to booming areas, something which is essential to the successful functioning of a monetary union. Under EMU, member countries are unable to use country-specific monetary and exchange rate policies to address country-specific shocks. The adjustment to such economic fluctuations will therefore have to take place through other adjustment mechanisms. Without price and wage flexibility and mobility of production factors, economic shocks would lead to lower economic growth and higher unemployment. Let me say a few more words on the important role of these adjustment mechanisms in a monetary union.

## The Theory of Optimal Currency Areas

Ever since the idea of EMU was launched, a discussion has ensued as to whether the whole or part of Europe would be an optimal currency area. The optimal currency area theory defines a set of mechanisms that might be set in motion when a participating country or region, in a monetary union, is hit by an asymmetric shock. First, adjustment to the shock might come from domestic price or wage changes, thereby altering the real exchange rate without changing the nominal exchange rate. Secondly, migration of production factors might act as an adjustment channel. These flows of labour and capital are facilitated by a high degree of economic and financial integration of the countries participating in the union.

In addition to this, the theory of optimal currency areas has also something to say on the similarity of shocks affecting countries or regions in a monetary union. In this respect, the degree of trade and financial integration are often considered. Trade and financial integration may tend to lead to more similar economic developments in the respective countries or regions in a monetary union, reducing the likelihood of asymmetric shocks and increasing the economies' abilities to adjust to these shocks.

So far the theory, let me now move on to the practice. I will now focus on two adjustment mechanisms: price-wage flexibility and factor mobility. A host of empirical studies on these mechanisms has been undertaken for the euro area. How well does the euro area measure up against these two criteria?

### Price and Wage Flexibility

There is broad agreement that price flexibility is low across euro area countries in comparison with the United States. In the euro area, price flexibility for goods and services is hampered by trade barriers, continuing state aid to several sectors and, more generally, a lack of competition in sectors that have been dominated by monopolies or state owned enterprises.

Low wage flexibility is also an important factor behind the lack of price flexibility in the euro area. Many studies indicate that in comparison with the United States, real wages are relatively inflexible in Europe. More specifically, I mean that the downward responsiveness of real wages to the level of unemployment is more limited in Europe than in the U.S. There are, however, notable differences across countries in the euro area.

Let me also mention the potential links between the flexibility of product and labour markets. Reforms in one area are likely to have effects across markets. For example, reforms leading to more flexible product markets might improve the performance of the labour market. If regulations on setting up a business are loosened, employment creation is also likely to increase. Similarly, labour market reforms might also have an impact on product markets. For example, labour market reforms may improve the extent to which differences in skills or productivity are reflected in wage differentials, which could affect prices. More generally, more flexible labour markets allow companies to adjust to economic changes with greater ease.

**Factor Mobility**

Let me now turn to the second adjustment mechanism, the mobility of factors of production. Changes in price levels, in product and labour markets, can also be triggered by a migration of factors of production. If a country or region is affected by a negative output shock and markets do not clear instantaneously, unemployment will rise. Workers will, therefore, tend to migrate to other regions. The same might be true for capital: if a negative output shock made capital obsolete and reduced profitability, investors would tend to move their funds to other regions. This adjustment mechanism has two limitations. First, the migration of labour and capital involves transaction costs. Moreover, it is doubtful whether this mechanism is very efficient when a country or region is hit by a temporary shock. Therefore, factor mobility seems a suitable adjustment mechanism only in case of a permanent shock and if prices or wages are rigid.

Several studies have found that labour mobility within the United States is two to three times higher than in Europe. This result is confirmed by the persistence of regional unemployment differences in Europe.

Overall, it can be concluded from empirical studies that the degree of wage-price flexibility and factor mobility is relatively limited in the euro area. The lack of adjustment mechanisms in the euro area should, however, not be exaggerated. Euro area countries are highly integrated both in terms of trade and financially. As I have just explained, a high degree of trade and financial integration may lead to more similar economic developments across euro area countries.

In addition, the optimal currency area properties are likely to evolve over time. The irrevocable fixing of exchange rates and the introduction of the single currency may lead to a convergence in the production and export structures of economies in the euro area, thereby reducing the risk of future asymmetric shocks. This argument is often referred to as the "endogeneity" of the optimal currency area hypothesis. Hence, according to the endogeneity literature, the euro area could gradually become more of an optimal currency area, after the introduction of the euro. More generally, it has to be borne in mind that all empirical studies on whether the countries that have entered the euro area constitute an optimal currency area are based on historical data. These data refer to regimes with flexible or fixed-but-adjustable exchange rates. In short, the regime shift to a monetary union may have an impact on economic structures and may alter some of the conclusions drawn on the basis of these historical data.

## Progress Made with Structural Reforms in the Euro Area

Some people say that central bankers are professional sceptics whose job it is to point to economic risks and weaknesses. Having listened to me so far, I can imagine that you may find some degree of truth in this. Let me tell you, however, that the euro area has recently seen many changes and innovations that go in the right direction. And I am pleased to be able to tell you that many of these changes are directly, or indirectly, related to the euro. Let us have a closer look at three areas of change: financial markets, product markets and labour markets.

### Financial Markets

The first area I want to discuss are financial markets. There is ample evidence that financial markets have some way to go before national demarcation lines will effectively disappear. Henceforth, there is still a significant potential for further financial market integration in the euro area. Financial market integration has been driven by global developments, such as advances in information technology, falling communication costs and standardisation of products. It has also been supported by European Commission initiatives.

A main policy initiative that has contributed to financial market integration is the Financial Services Action Plan. EU Heads of State and Government have agreed to implement the Financial Services Action Plan by 2005, at the latest, and to achieve fully integrated risk-capital and securities markets by 2003. The groundwork for the latter was prepared by a Committee of Wise Men called the Lamfalussy Group. On wholesale markets, measures to facilitate raising capital on an EU-wide basis, through common rules concerning prospectuses, is targeted for adoption in 2002. In addition, legislative proposals on financial statements for listed companies and a common legal framework for a single market for securities and derivatives are close to being adopted. We, at the European Central Bank (ECB), fully support these initiatives. I would like to stress, however, that the successful and timely implementation of the Financial Services Action Plan will be very difficult without the continuing commitment of the Member States.

The integration of financial markets would not only facilitate cross-border capital flows towards their most productive uses, but it could also serve as a catalyst for structural reform in other markets. For example, the impact of product market reforms, aimed at easing the restrictions on creating a business, are likely to be reinforced if a well-functioning risk capital market, which efficiently channels the necessary funds from investors to beginning entrepreneurs, is in place.

The euro has made a spectacular impact on financial markets in the euro area. Concrete examples of its impact are the integration of the money market, the explosive growth of the euro-denominated corporate debt market and a wave of consolidation among intermediaries and exchanges.

These are very fundamental changes. The surge of euro-denominated corporate debt, for example, has helped to finance the wave of mergers and acquisitions in the European corporate sector and shows how a larger and deeper single financial market can help to strengthen Europe's competitiveness.

**Product Markets**

Let me now turn to product markets. The pace of liberalisation has differed considerably across countries and sectors in the euro area, leaving ample room for further reforms. Whereas the integration of goods markets is relatively advanced, shortcomings still exist with regard to the integration of service industries. Most of the barriers to integration in the service sector appear to be due to national regulations, for example administrative procedures for setting up subsidiaries in other euro area countries. Regulatory barriers along these lines reduce competition in services, thus keeping prices above the level that would be expected in a fully integrated market.

More progress has been made with regard to the integration of goods markets and regulatory reforms in network industries. Here too, positive macroeconomic effects can be discerned. Owing to an increased number of competitors, prices in some network industries, such as telecommunications, have started to decline, in particular in those industries and countries which liberalised earlier. The initiatives in the telecommunication sector show how reforms that succeed in increasing competition in previously sheltered sectors considerably enhance productivity and lower prices. As network industries provide inputs to the rest of the economy, this may also increase the rate at which the economy can grow without creating inflationary pressure. Nevertheless, an important unfinished agenda remains to be tackled in almost all network industries. In order to reap the full economic benefits, it is important that reforms in network industries are accompanied by an appropriate regulatory framework which ensures non-discriminatory access to the bottleneck infrastructure and more generally, a "level playing field" for all market participants. The quality of the regulatory framework has a considerable impact on the extent to which potential price falls due to structural reforms in network industries will be achieved.

Another instrument available to reduce distortions to competition is state aid policy. State aid subsidies weaken the incentives for companies to improve their efficiency, enabling the less efficient to survive at the expense of the more efficient. Although there are still substantial differences between euro area countries, the overall trend is towards a reduction in state aid levels. Another positive development is that the transparency of state aid policies has improved as a result of the publication of a new state aid register and a state aid scoreboard by the European Commission.

The impact of the euro on these processes, which has led to more competition, cannot be overestimated and goes far beyond the mere abolition of intra-European exchange rates and the introduction of common notes and coins. The single currency opens up the euro area product markets further and will be a major impetus to competition and integration by increasing the transparency of prices across borders. Investment will also benefit as euro area companies no longer have to insure against exchange rate movements within the euro area and there are indeed indications that direct investment into the euro area has strongly increased since the start of EMU. Overall, the euro will give new impetus to the initiatives taken in the 1980s to establish a truly integrated internal market.

**Labour Markets**

Progress with labour market reforms has become evident from the increase in employment-intensive growth in the euro area. It is very interesting to note that job creation has held up reasonably well over recent years. During the first three years of EMU, some 6 million jobs have been created in the euro area versus 3.5 million in the U.S. The unemployment rate in the euro area has declined from almost 11% in 1997 to slightly more than 8% in 2001 (which is still too high). On the supply side, the employment rate, particularly in the case of women, has increased considerably, along with the proportion of part-time jobs and temporary contracts in total employment. Euro area average participation rates are, nevertheless, still below those of the U.S. or the Scandinavian countries.

The explanations for this job-rich growth lie in structural changes in the labour market and wage moderation. Government policies have generally improved labour market performance in euro area countries. A number of countries have lowered marginal tax rates in order to make their tax systems more employment-friendly. Many countries have targeted tax cuts at the lower end of the labour market in particular. These measures have contributed to a higher demand for low-skilled workers. Nevertheless, marginal tax rates still remain high in some countries. Some progress has also been made with the introduction of part-time or more flexible working contracts and practices.

In addition to government policies, there are signs of a gradual change in labour market behaviour related to the wage formation process. Discipline seems to have improved in that field over the past decade. Such a change, resulting from lower inflation expectations, is important. Furthermore, there seems to be a growing awareness that, in a single currency environment, the price increases and loss of competitiveness generated by excessive wage settlements cannot be compensated by an exchange rate depreciation and may directly result in a loss of jobs.

Looking ahead, it is crucial that social partners continue to adhere to moderate wage developments, since this is one of the prerequisites in fostering employment and maintaining a favourable outlook for price stability in the medium term. In this respect, there is some cause for concern with regard to ongoing wage negotiations.

The wage formation process also seems to have undergone changes. In a majority of euro area countries, there are signs of a gradual trend towards more decentralised bargaining and more flexibility at lower bargaining levels. This seems to happen, mostly informally, through clauses that allow firms to deviate from the sectoral or central wage agreements according to the financial situation of the firm or sector. This is encouraging. The outcomes of wage bargaining should allow not only for appropriate wage developments in the overall economy, but also for adequate wage differentiation across sectors, regions and firms. This will make it easier to account for local conditions, such as unemployment, productivity or profitability differentials across sectors, regions and firms.

In short, labour market reforms have, in general, been going in the right direction in recent years and the benefits of these positive developments are clear. However, progress has been rather uneven across countries and areas. In many areas important reforms have not yet got off the ground. For instance, few changes have been made regarding employment protection policies in euro area countries, which remain amongst the strictest in the industrial countries. Furthermore, in almost all euro area countries, reforms targeting unemployment benefit systems have only made slow progress. At the same time, significant mismatches between labour demand and supply are still present along a number of dimensions. All this shows that large structural problems remain and need to be solved.

What needs to be done to speed up labour market reforms? This is a difficult question, not least because the euro area labour markets are still very heterogeneous. Each country should identify the root causes of its labour market deficiencies and implement appropriate corrective measures. However, there are some areas of reform that apply to many, if not all, euro area countries. Improved job mediation, education and training, to mention just a few examples, all help towards making the matching process more efficient. In addition, euro area countries need to ensure that tax and benefit systems make work pay. Reforms to tax and benefit systems should increase work incentives, profitability and competitiveness and consequently labour supply and demand. At the same time, it is important to ensure that tax-benefit reforms are undertaken without jeopardising the long-term sustainability of public finances.

## Conclusion

Joseph Schumpeter taught us that economic development consists of the continuous introduction of new combinations of products and means of production. He taught us that this process involves the incessant mutation of the economic structure from within, destroying the old and creating a new. In today's dynamic, ever-changing economic environment, entrepreneurs have to be all the more innovative and sensitive to new opportunities. The regulatory framework has to be designed in such a way that it allows this to happen by providing the right incentives for innovation, dynamism and economic growth.

Today's dynamic society also requires an increased ability of markets to adjust smoothly to changing economic circumstances. This is all the more true of a monetary union, where member countries are no longer able to use country-specific monetary and exchange rate policies to address country-specific shocks. In such an environment, other adjustment mechanisms are needed such as price and wage flexibility and factor mobility. Structural reforms can contribute to a better functioning of these adjustment mechanisms by fostering integration and competition. The relationship between integration, competition and the single currency works in both directions. The euro itself has already contributed to more integration and competition and will continue to do so in the future. Its impact is most clearly visible in financial markets, where a single money market has been created and a deep, liquid bond market has encouraged a surge in debt issuance by the corporate sector. In product markets, the euro has an important impact on the cross-border transparency of prices, acting as a catalyst for trade. Finally, with regard to labour markets, the wage formation process shows signs of increased flexibility and labour market reforms are starting to go in the right direction. Overall, the single currency contributes forcefully to more integration and competition, acting as a powerful driver for the further enhancement of the Single Market and creating an environment which – I am sure – Schumpeter would have enjoyed. ❧

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# The U.S. Experience with a Federal Central Bank System

## Introduction

The role of national central banks in Europe has been a subject of much deliberation, especially since the introduction of the euro. The euro area constitutes a vast geography and much economic diversity – characteristics not unlike the United States. It is an honor to participate in this event, which brings together so many prominent individuals from various nations, to discuss this important and timely topic.

As a former academic with considerable European experience and a current central banker in the U.S. system, I would like to share with you my perspectives on the U.S. experience with our central banking system. I will leave it to my audience to make the parallels and contrasts with the current and still emerging structure in Europe. However, I will try, by topic selection, to spotlight relevant points of comparison.

As you all know, the Federal Reserve System (Fed) serves as the central bank of the United States – the epicenter of our financial system. It controls the monetary base of the economy to affect interest rates and inflation; it provides liquidity in times of crisis; and, it ensures the general integrity of our financial system.

The Federal Reserve's decentralized structure has been a positive force in the U.S. economy. I believe it has proved a vital, and indeed very practical, structure for our central bank. Throughout its history, decentralization has provided the local context and contact necessary for effective policymaking.

A key to the success of our decentralized structure is its flexibility. To be sure, there is no single model that works everywhere, or all of the time. In fact, it is just the opposite. The structure of a central bank must fit the economic and political realities of the time, or it will not survive. It must evolve in response to the unique features of the economy it serves. This adaptation is a constant challenge with new twists and turns along the way.

## The Establishment of Decentralized Central Banking in the U.S.

Let me begin with some history. In 1913, the U.S. Congress established the Federal Reserve System to serve as our central bank. The System comprised twelve independently incorporated Reserve Banks spread across the United States, operating under the supervision of a Board of Governors in Washington, D.C.

Why did the central bank come along so late in the economic history of the United States? Moreover, why was it given such a decentralized structure?

The answers to these questions are interconnected. In fact, the United States had made two previous attempts to establish a central bank. The First Bank of the United States was established in 1791, and the Second Bank of the United States was established in 1816. Congress gave each an initial 20-year charter. Yet, neither was able to muster the political support to have its charter renewed. Therefore, the United States spent most of the nineteenth century without a central bank.

By the early twentieth century, a series of financial panics and economic recessions further demonstrated the need for a central bank. It became widely recognized that the nation required a more elastic supply of money and credit to meet the fluctuating demands of the marketplace. It also needed a more efficient infrastructure for transferring funds and making payments in the everyday course of business, particularly by check.

While the need for a central bank was clear, so were the reasons to be wary of one. Many people, particularly small businesspeople and farmers across the South and West, were concerned that a central bank headquartered "back East," in either the financial center of New York City or the political center of Washington, D.C., would not be responsive to their economic needs.

In some sense, this was a replay of the broader governance issue the United States wrestled with from the beginning of its short national history. The thirteen colonies saw the need to bind together and form a nation, but they were wary of ceding power to a national government. It was out of that tension that the federal government of the United States was forged in my hometown of Philadelphia, Pennsylvania, with the establishment of the U.S. Constitution.

The Constitution provided for the establishment of a federal government that acknowledged and preserved the rights of the states, and a system of checks and balances within the Federal government. In this way, power was not unduly concentrated in any one individual or group.

To galvanize the necessary political support to establish a central bank, President Woodrow Wilson and Congress drew on the now familiar model of a federal structure. That structure, embodied in the Federal Reserve Act of 1913, essentially remains intact today.

Overseeing the System is a seven-member Board of Governors appointed by the President of the United States and confirmed by the United States Senate. The twelve Reserve Banks, spread across the country – from Boston to San Francisco – each serve a defined geographic area, or District. Each Reserve Bank is overseen by its own local board of directors, with some elected by the local District banks and some appointed by the Board of Governors in Washington, D.C. The Reserve Bank board of directors selects a president, in consultation with the Board of Governors, who serves as CEO and chief operating officer.

Our founders' original vision was that the "central" in the central bank would be minimized. That is, the Reserve Banks would be relatively autonomous bankers' banks providing a full array of services to the banks operating in their Districts. The Reserve Bank would extend credit directly to District banks with short-term liquidity needs on a collateralized basis through rediscounting. Banks would also maintain reserve accounts at their Federal Reserve Bank and use those accounts to clear checks, move funds and obtain currency for their customers.

Of course, the original vision of self-contained regional banks began to erode almost as quickly as the System was established. Technological change and the dynamics of the marketplace were driving the U.S. economy, particularly its financial and payments systems, into a more fully integrated entity. The Federal Reserve System would have to integrate the activities of its various components as well. Indeed, this is exactly what has happened in the Fed over the course of its history, and what continues to happen today.

This integration has occurred on all levels, from making policy decisions to managing backroom operations. It occurs through all our central bank lines of business – monetary policy, bank supervision and regulation, and payment system support.

Yet, the integration continues to evolve within the context of the "federal" structure established almost 90 years ago. I consider this a testament to the Federal Reserve's flexibility, and also to the value of its structure in achieving the Fed's mission.

Let me be specific about how the Fed has evolved its decentralized structure in each area of its operations.

## Monetary Policy

When the Fed was founded, the notion was local economic conditions generated local credit conditions, and regional Reserve Banks would help the regional banks address them. Meanwhile, with the nation on the gold standard, the overall supply of money – and hence the long-run price level – was out of the central bank's hands.

Today, we think of monetary policy as an independent tool at the central bank's disposal to help stabilize overall economic performance. The establishment of the Federal Open Market

Committee (FOMC) was the pivotal event in the evolution of the Fed to an independent, activist, monetary policymaking body with national macroeconomic objectives.

Although not formally established until 1935, the history of the FOMC begins in the 1920s, when regional Banks began looking for a source of revenue to cover their operating costs. As you may know, the Fed does not receive an appropriation from Congress. Instead, it funds itself from the return on its portfolio. In fact, it was with the intention of funding their operations that each of the Fed Banks began to purchase government securities. Eventually, these assets were managed collectively by the Federal Reserve Bank of New York. This portfolio became the System Open Market Account, through which the Fed now conducts open market operations.

Gradually, it was recognized that the Fed's open market securities transactions had a powerful and immediate impact on short-term interest rates, and the supply of money and credit. Over time, open market operations became the central tool for carrying out monetary policy.

Congress created the structure of the FOMC in the midst of the Great Depression. As you all know, the FOMC consists of the seven members of the Board of Governors and the twelve Reserve Bank presidents. Because the FOMC is a mix of Presidential appointees, the members of the Board of Governors, and Reserve Bank presidents, who are selected by their respective Boards of Directors, the FOMC is a blend of national and regional input of both public and private interests.

The fundamental insight is, while there can be only one national monetary policy, making the right policy decision is the product of sharing perspectives from different regions of the country.

The Reserve Bank presidents provide both valuable up-to-date intelligence about economic conditions, and the perspective of businesspeople about prospects going forward. They glean these from their meetings with their Bank's board of directors, advisory councils, informal "town meetings" around their Districts, as well as the contacts they make in the everyday course of operating a Reserve Bank.

Some of this finds its way into our regional reviews, the so-called Beige Book, but even this suffers from time lags and a formulaic approach to gathering intelligence. Our real time grassroots perspective is valuable for helping to overcome the fundamental challenge to monetary policy – the effects of long and variable lags on its impact.

Beyond this, the Reserve Bank presidents can also bring broader perspectives on monetary policy. On a theoretical level, differences can coexist on the structure of the economy and the role of monetary policy, with well-known examples of the monetarist perspective championed by the St. Louis Fed, and the real business cycle perspective supported by research at the Minneapolis Fed. On a more practical level, differences still exist in the geographic distribution of industries across our nation. The perspective of some regions give particularly useful insight into certain parts of our economy, for example, San Francisco's technology focus and Chicago's heavy industry concentration.

Decisions are usually made by consensus, so unanimous decisions are usually the rule rather than the exception. Nonetheless, we do have a voting procedure. The twelve voting members make the formal decision of the FOMC. All seven governors vote at all times, while only five of the twelve presidents vote, on a rotating basis. Philadelphia happens to be a voting member in 2002. In any case, we all participate on equal terms in the discussion and consensus building that leads to the formal policy vote.

Once the FOMC has made its decision on the appropriate target level for the federal funds rate, it is up to the Fed's trading desk located at the Federal Reserve Bank of New York to achieve the objective. To facilitate that process, a policy directive is drafted requesting the appropriate action by the New York Desk to achieve the overnight borrowing rate target.

Time has shown that the structure of the FOMC uses the decentralized Federal Reserve to its best advantage. This structure allows for the generation of well-informed monetary policy decisions at the national level, plus an ability to communicate our decisions and rationale to various parts of our nation. This two-way exchange of information enhances our capability to monitor the economy, and build consensus for the needed policy action.

## Payments Infrastructure

Monetary policy is the role for which central banks are best known. But, the Fed also plays an integral role in the U.S. payments system. In fact, payments processing is the largest component of Fed operations. System-wide, the Federal Reserve Banks employ over 23,000 people. Of these, about 12,000 – roughly half – are involved in payments.

Over the years, the Fed's decentralized structure has given us an advantage in supporting the payments system. The U.S. has long been a nation of many small banks serving relatively limited geographic areas. Establishing a network for the efficient movement of money among them is one reason the Fed was founded. One of the Fed's first projects was setting up a check

clearing system. In that system, each Reserve Bank provided the banks in its District with a local clearinghouse, and access to a national clearing network through its sister Reserve Banks.

As early as 1918, the Reserve Banks also gave the banks in their District convenient access to a national electronic funds transfer network – Fedwire. At that time, the transfers were via telegraph connection among the Reserve Banks.

The traditional paper-based means of payment – cash and check – still require a decentralized delivery network. However, over time the movements toward electronic payments and mergers in the U.S. banking industry have been driving the Fed toward greater coordination and consolidation of payments services. Accordingly, the Fed has reorganized to provide nationally managed services through the decentralized structure of the regional Reserve Banks.

First, at the strategic level, the Federal Reserve has established the Payments System Policy Advisory Committee (PSPAC). Its mission is to set the direction for Fed payments activities System-wide. Like the FOMC, the PSPAC is a committee of Fed governors and Reserve Bank presidents.

Second, at the operational level, the Reserve Banks coordinate their payments operations through national product offices, reporting to the so-called Financial Services Policy Committee. By this means each payments product is centrally managed by one Reserve Bank and delivered as appropriate through the Reserve Bank distribution network.

## Supervision and Regulation

I have discussed the benefits of the Federal Reserve's decentralized structure on the monetary policy decision process, as well as on its evolving role in the nation's payment system. This structure has also served us well in our third area of responsibility, bank supervision and regulation.

As noted a few moments ago, the U.S. has long been a nation of many small banks, serving local communities in narrow geographic areas and offering relatively limited product lines. This was primarily the result of government regulation. Long-standing state laws prohibited banks from branching across state lines, and frequently other political boundaries as well. Then, in reaction to the Great Depression, the U.S. Congress passed legislation prohibiting commercial banks from engaging in investment banking or insurance activities.

During this period in our history, under delegated authority, local Reserve Banks kept a close watch on the safety and soundness of the local banks under their jurisdiction.

But, recently, in the U.S. and around the globe, a deregulation wave has cut away the thicket of limitations on banks' activities. Now technology and the marketplace are driving banking organizations to expand their geographic reach and diversify their array of product offerings. The result has been the growth of larger and more complex banking organizations with national or international scale and scope.

Through this process of change, the Federal Reserve's role in the regulatory structure has been expanding. Congress first entrusted the Fed with the responsibility of regulating all bank holding companies, and more recently we have been assigned the additional role of "umbrella supervisor" for newly formed financial holding companies. As such, the Fed aggregates the assessments of other financial service industry regulators to form an enterprise-wide view of risk and protect depository institutions.

To fulfill our responsibilities in this new environment, the Federal Reserve has been transforming its supervision and regulation function. Our focus has shifted from point-in-time financial statement reviews to continuous risk-based assessments; from on-site examinations to early warning systems; from strictly financial evaluations to ones that include increased emphasis on community lending and technology. Furthermore, in light of the shift toward broad financial holding companies, we are working in closer cooperation with other banking and financial industry regulators.

In addition, to properly oversee larger, more complex organizations, we have employed new and more sophisticated analytical tools, and have consolidated examination reports from geographically dispersed subsidiaries into overall financial profiles.

Our approach has been the System-wide coordination of bank supervision to achieve efficiency in staff deployment, yet still gain the benefits of specialized knowledge. Still, we have maintained face-to-face contact with the regulated institutions, as well as the use of on-site examinations. In the end, even with all the changes in the financial services industry, there is no substitute for first-hand knowledge of the organization and its leadership. Our Reserve Bank network allows the Fed to have geographic proximity, which substantially improves our ability to know the institutions we regulate.

## Lessons from 9/11

Before closing let me say a few words about September 11. The events of that day, and the days and weeks that followed, put many aspects of the U.S. financial system to the test, and demonstrated its resiliency.

At the Fed, our response to those events was a coordinated effort across all its areas of responsibility and across our entire Fed System. We kept the payments system operating, provided access to credit for affected banking institutions, and implemented aggressive monetary expansion. Our ability to feel the pulse of financial activity across the country, operate in multiple locations, and coordinate our efforts to assure financial stability is a testimony to our present organizational design.

Looking ahead, the terrorist attacks on New York and Washington, D.C., have caused many organizations, public and private, to see new value in a decentralized operational structure. A recent Fed assessment of the lessons from 9/11 reached a conclusion that applies not only to financial institutions in general, but to the Federal Reserve System as well: "geographic diversity for critical operations and backup facilities should be a key consideration of business-resumption plans."

## Conclusion

Since its creation almost 90 years ago, the Federal Reserve has survived, and succeeded, by evolving. Through Congressional mandates and its own internal restructuring, the Fed has proved an ever-changing entity, decentralized yet coordinated. The trends in the financial sector imply a continuation of the move toward a single national market, with a growing number of national and international players. As a result, further coordination and consolidation of activity is inevitable.

Yet, even as we develop into a more fully integrated organization to better address our central bank responsibilities, we continue to extract value from our decentralized structure.

Today, the regional structure of the Federal Reserve System is one of its greatest strengths. This has proven true both in normal times and times of crisis. While the process of change will continue to challenge the Fed, it is worthwhile to reflect on our strengths and our successes. The System's structure fits both categories. ❧

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# Does Europe Need a Harmonised Social Policy?[1])

## Introduction

The EU Convention is experiencing a slow start. It is quite unlikely that the Convention will actually take off before the German elections. So far, the reference document is the "Project for the European Union" issued in May 2002 by the Commission, which argues in favour of a co-ordination of social policies. Co-ordination is a rather loose concept which can be located along a wide spectrum, ranging from the "open co-ordination" method of the Luxembourg process to something in a close neighbourhood of a "harmonisation" of social policies, that is, substantially a levelling out of cross-country differences in the scope and composition of social spending.

In this paper I try to (normatively) reduce the indeterminacy of the notion of "co-ordination". In particular, I take a clear stance in favour of social policy co-ordination as a way to promote a more effective competition across systems.

1 *I would like to thank Fritz Breuss for comments on an initial draft and Mauro Maggioni for tireless research assistance.*

While it may sound as a contradiction in terms, it is not. Insofar as my notion of co-ordination allows for more mobility of the European workforce, it implies that EU citizens can "vote with their feet" enhancing competition among systems. However, a better term than co-ordination would be perhaps "co-competition" in social policy provision.

These issues are typically dealt with by economists as a problem of allocation of tasks among different levels of government. Fiscal federalism theory, in particular, offers a powerful framework to assess what should be assigned to central, supra-national, bodies and what should instead be left as a prerogative of decentralised policy-making, such as national governments.

When dealing with social policies, however, this framework appears too narrow. The relevant issues in this domain concern more the governance structure, the rules of co-ordination, than the degree of centralisation or de-centralisation by themselves. Due to the absence of significant spillovers and economies of scale in social security provision, the case for reallocating tasks to EU supra-national authorities is weak. The most relevant issues concern, instead, the scope of competition that should be promoted and allowed across the various "Social Europe(s)" nowadays characterising the institutional landscape of the Old Continent.

The plan of the paper is as follows. Section 1 characterises the different "Social Europe(s)" and discusses whether or not they are converging to a unique model. Once established that this is not the case, section 2 addresses the issue assigned to this paper, that is, whether or not EU-level decision-making should pursue a harmonisation of these different "Social Europe(s)". Since the answer is "no", section 3 concludes arguing about the scope of competition among the different restrictions that should be imposed on competition among the different social security systems and the role that EU supra-national authorities may play in this context.

## 1 Are "Social Europe(s)" Converging in Any Event?

Before discussing whether harmonisation of social policies is desirable or not, it is important to evaluate the scope of the adjustment that would be required to level out differences in the size and composition of social spending in Europe. Equally important is to assess whether or not a convergence is occurring across the various systems which can nowadays be identified in Europe.

It is customary (e.g., see Ferrera, 1998, and Bertola et al., 2001) to divide Europe into four social policy models. The first group is represented by the *Nordics* (Denmark, Finland and Sweden, plus the Netherlands) which is a hybrid between the Scandinavian and the Continental models and has recently moved northwards[1]) featuring the highest levels of social protection expenditures, and universal welfare provision based on the citizenship principle. Extensive fiscal intervention in labour markets, based on a variety of "active" policy instruments, substantial tax wedges, and relatively extensive

1 *I refer, in particular, to the decision, made in the year 2000 in the Netherlands, to adopt a universal pension scheme and extend the sickness insurance scheme to the self-employed.*

employment in the public sector also belong to this model while unions' presence in the workplace and involvement in the setting and administration of unemployment benefits generate compressed wage structures.

The second cluster includes the *Anglo-Saxon* countries (Ireland and the U.K.), which are closer to the Beveridgian tradition and feature relatively large social assistance of the last resort schemes. Cash transfers here are primarily oriented to people in working-age. Activation measures are important as well as schemes conditioning access to benefits to regular employment. On the labour market side, this model is characterised by a mixture of weak unions, comparatively wide and increasing wage dispersion and relatively high incidence of low-pay employment, half a way between Europe and the U.S.

*Continental European* countries (Austria, Belgium, France, Germany, and Luxembourg) are the third group, relying extensively on insurance-based, non-employment benefits and old-age pensions. Large invalidity benefit schemes are also present, which draw on contributions on employment income, along the Bismarckian tradition. While unions' membership rates have been falling quite dramatically in the last 20 to 25 years (Boeri et al., 2001), a strong unions' influence has been to a large extent preserved in these countries by regulations artificially extending the coverage of collective bargaining much beyond unions' presence.

Finally, we have the *Mediterranean* countries (Greece, Italy, Spain and Portugal), concentrating their spending on old-age pensions and allowing for a high segmentation of entitlements and status.[1]) Their social welfare systems typically draw on employment protection and early retirement provisions to exempt segments of the working age population from participation in the labour market. Also in this case, strong unions' influence has been preserved by practices (e.g., jurisprudence) artificially extending the coverage of collective bargaining. As a result, wage structures are, at least in the formal sector, covered by collective bargaining and strongly compressed in these countries.

Table 1 provides a simple characterisation of the four models, grouping the various social policy items into four main policy domains: pensions (encompassing old-age and survivors' provisions), non-employment benefits (unemployment benefits, sickness benefits, invalidity pensions and early retirement, whenever listed separately from old-age pensions), family allowances (child-care benefits and family benefits) and social assistance (including means-tested housing benefits). Social expenditure is normalised by GDP in the first column, while information on the percentage distribution of social spending is provided in the second column. Data are drawn from the European Commission ESSPROS database which offers, to date, the best framework to assess the size and composition of social spending in the EU area.

As is apparent from table 1, differences in levels and composition are not of a second order of magnitude and

1 *Note that these countries have implemented universal national health-care systems in between the 1970s and the 1980s. However, I do not deal with health spending in this paper.*

Table 1

**Four „Social Europe(s)"**

| | Continental | | Northern | | Anglo-Saxon | | Southern | |
|---|---|---|---|---|---|---|---|---|
| | *% GDP* | *% tot. exp.* | *% GDP* | *% tot. exp.* | *% GDP* | *% tot. exp.* | *% GDP* | *% tot. exp.* |
| Social assistance | 0.95 | 3.32 | 1.67 | 5.97 | 1.73 | 6.93 | 0.18 | 0.79 |
| Family | 2.88 | 10.14 | 2.36 | 8.41 | 2.26 | 9.07 | 0.82 | 3.65 |
| Pensions | 12.33 | 43.32 | 11.14 | 39.72 | 11.31 | 45.28 | 12.92 | 57.36 |
| Non-Empl. benefits | 12.29 | 43.23 | 12.87 | 45.91 | 9.67 | 38.73 | 8.60 | 38.19 |
| Totals | 28.45 | 100.00 | 28.05 | 100.00 | 24.98 | 100.00 | 22.52 | 100.00 |

*Source: Eurostat, ESSPROS Database (2001).*
*Notes: Figures weighted by GDPs. The country groups are defined as follows: Continental: Austria, Belgium, France and Germany; Northern: Denmark, Finland, the Netherlands and Sweden; Anglo-Saxon: Ireland and United Kingdom; Southern: Greece, Italy, Portugal and Spain.*

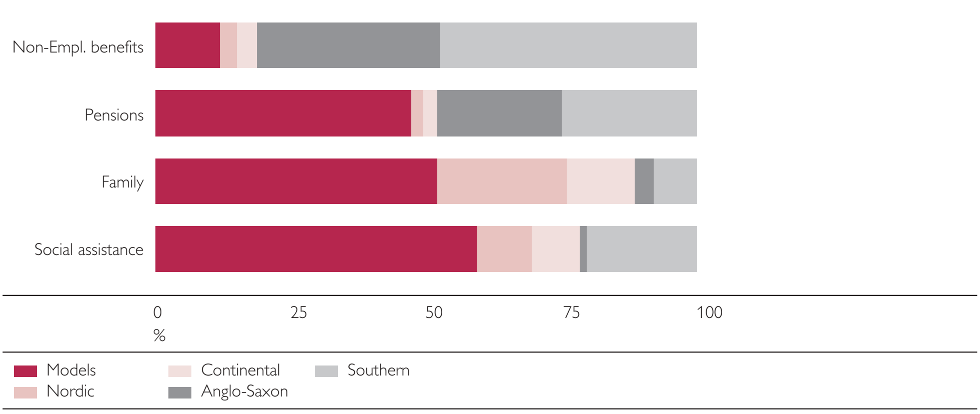
broadly in line with the taxonomy offered above (although not all institutional features can be measured). Universal non-employment benefits are what distinguishes the Nordic model from the Continental model, which is focused more on pensions than on transfers to individuals in working age. The Anglo-Saxon world (mostly the U.K. as we are dealing with a GDP-weighted average) displays a smaller welfare state and one which devotes comparatively more resources to social assistance of the last resort. Finally, Southern Europe displays the smallest welfare state, almost sixty percent of which goes to public pensions, whilst social assistance is negligible.

These country groupings should not conceal important differences in the policy mix which are present within each model. Yet, in three policy areas out of four, differences across models capture from 45% to 60% of the total variation in the composition of social spending. This can be gauged by decomposing the total weighted (by GDP) sum of squared deviations of social expenditure shares (to social expenditure, rather than GDP in order to eliminate variation due to income levels) into a within-models and a cross-models mean variation (chart 1). The only area where within-models variation dominates is non-employment benefits, which is the most heterogeneous set of measures of the four and the one most affected by the underlying labour market conditions.

Are these four "Social Europe(s)" converging in terms of size and composition of social spending? In order to shed some light on this issue in a

Chart 1

**Decomposition of the Differences in the Social Policy Mix**



companion paper (Boeri, 2002 a), I regressed the growth in social expenditure as a percentage of GDP over two sub-periods: the period from 1980 to 1990 (where we can draw on the OECD Social Expenditure database) and the period from 1990 to 1999 (where ESSPROS data are available). In particular, I regressed the average yearly growth rate in social spending over GDP against its initial level for the cross-section of countries provided by the two datasets. Convergence in the unconditional sense is implied, according to this methodology, if the coefficient for spending in the base year is negative and statistically significant.

I could not reject this *beta unconditional convergence* for the OECD countries as a whole. However, the beta coefficient implies a very low convergence rate (less than 0.2% per year) and is barely statistically significant. The same type of conclusion can be obtained with reference to the second sub-period and for the ESSPROS country panel (which includes the EU-15, plus Iceland, Norway and Switzerland). Furthermore, in both cases interaction variables capturing the effects of EU or EMU membership on convergence were not significant, which suggests that there has not been an additional effect of European integration or the Economic and Monetary Union (EMU) on the convergence in the size of the welfare state.

As far as convergence in composition is concerned, beta convergence would seem to be occurring only in two policy areas, namely social assistance and non-employment benefits.[1]) At a closer look, it appears that in the first case convergence is towards the top levels of provision while for non-employment benefits convergence involves a retrenchment of this programme category (Bertola et al., 2001) which is also consistent with the reduction in unemployment.

In order to evaluate convergence in composition, it is preferable to adopt another definition of convergence, that is, *sigma convergence*. The latter occurs when the standard deviation in the logarithm of social spending decreases over time. Significantly, I found that *sigma convergence* occurred mainly *within* the various "Social Europe(s)", namely the four groups of countries typically used by taxonomies of the European welfare states rather than between them: the cross-country variation between social expenditure as a percentage of GDP decreased over the period from 1980 to 1996 in all these groups of countries.

Finally, I looked at an inventory of reforms assembled at Fondazione Rodolfo Debenedetti. The latter is based on a variety of sources (including country economic reviews carried out by OECD, Income Data Source studies, EC-MISSOC reports, etc.), and takes stock of reforms carried out in Europe over the period from 1987 to 1999 in three domains: non-employment benefits, employment protection and pensions. Reforms are classified on the basis of their broad orientation, that is, whether they tend to reduce or increase the generosity of non-employment benefits and make employment protection more or less stringent, and their radical or marginal nature.[2])

1 *Also these results are available, upon request from the author.*

2 *Details on the inventory of social policy reforms produced at the Fondazione Rodolfo Debenedetti are available at www.frdb.org.*

Contrary to popular wisdom and to the belief that labour market and social welfare institutions cannot be modified, many institutional changes have occurred over the observation period. I counted almost 200 reforms, that is, more than one per year and country. However the changes have often been marginal (172 out 198 reforms, that is roughly 85% of the regulatory changes did not pass our two-stage procedure identifying radical reforms). Moreover the reforms are almost evenly split between those reducing generosity and protection (107 out of 198, that is, about 55%) and those increasing generosity and employment protection. It is also not infrequent to find reforms going one against the other just a few years apart. These inconsistencies and the marginal nature of most reforms have significantly increased the institutional complexity of the European landscape.

*To summarise the results in this Section, there are at least four different "Social Europe(s)" and a very mild convergence in the size of social programmes is occurring among them. To the extent that the cross-country variability in the composition of the welfare states is decreasing, this is occurring mainly within the various "Social Europe(s)" rather than across them. Institutional changes are occurring at (unexpectedly) high frequencies, but reforms are rarely comprehensive. Overall, there are no indications that differences in the size and composition of social spending across EU Member States are being levelled-out automatically.*

## 2 Should Then These Persistently Diverse "Social Europe(s)" Be "Harmonised"?

There are no a-priori arguments for having EU supra-national authorities levelling out differences in the size and composition of social spending across EU Member States. The various "Social Europe(s)" described above may simply reflect heterogeneous preferences of EU citizens and the two standard arguments for centralised provision of public goods (Oates, 1999) – the presence of significant spillover across jurisdictions and economies of scale – have limited application to the case of social policies.[1])

A powerful argument in favour of the *de-centralisation* of social spending can actually be made on the grounds that local provision of social security can better exploit local information and deal with the large informational asymmetries jeopardising the effectiveness of redistributive policies. The relevance of this argument can be grasped by considering the relative effectiveness of the redistribution operated in the smallest EU countries. Chart 2 plots differences between pre and post tax/transfers Gini coefficients (vertical axis) against the social policy expenditure to GDP ratio.[2]) As one would expect, redistribution is larger in the countries devoting more resources to redistributive policies. More importantly, the most effective redistribution (the larger difference between pre and post tax/transfer inequality per any given level of social

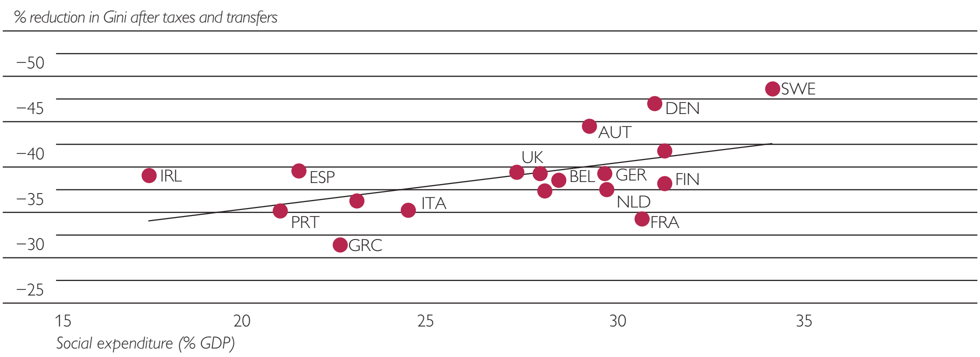
1 *See also Fatás (1998) for an assessment of the economies of scale attainable by adopting a common European social security model.*

2 *Pre tax and transfer incomes are constructed making use of the European Community Household Panel, a longitudinal dataset providing income and labour market information on about 60,000 individuals across the entire EU. Pre tax and transfer income is calculated as total disposable income minus social transfers divided by a "net/gross ratio" factor provided by Eurostat in the European Community Household Panel (ECHP).*

Chart 2

**Redistributive Efficiency of Social Expenditure**

**(Entire Population)**




spending) is observed in the relatively small European countries, while the largest nations – with the exception of the U.K. – perform rather poorly in this respect, as they all lie below the regression line.

This type of conclusion is supported also by analyses with micro data, notably (probit) regressions of the probability of receiving different types of cash transfers against family characteristics and income. Targeting on the basis of income and house ownership typically works better in the Nordics, Ireland and the U.K.

There are also important political and political-economic counter-indications to imposing convergence "from the top". Firstly, such a harmonisation would run against democratic rules on highly sensitive issues, given that most EU supranational authorities lack, as yet, political accountability. This may result in stronger pressures for the break-up of the Union. Secondly, there is evidence of path dependency and status quo bias in social welfare reforms. They also work better when they are comprehensive (Coe and Snower, 1997), which means that they need to operate on country-specific institutional clusters.[1]) As "Social Europe(s)" are so different (and still so) one of another, reforms ought to be respectful of the initial conditions and by imposing the same pattern of adjustment to the different European social policy models, there is a high risk of jeopardising altogether reform efforts. Thirdly, interactions among different tiers of Government may drive decisions and the actual implementation of policies far away from the theoretical fiction of a benevolent planner.

Finally, the case for harmonisation on pure equity grounds is rather weak. In presence of large differences in productivity levels, harmonisation of policies does not imply harmonisation of outcomes. The experience of the Italian Mezzogiorno and the German unification episodes vividly testify this.

*Overall, there is a strong case for maintaining prerogatives over social policies to national Governments, and preserving the unanimity rule in EU-level decision-making in this area. Majority voting on these issues may just end up providing the worse of each welfare system with the countries with the best social policies in place being always in minority.*

1 *See Bertola and Boeri (2002) for a discussion of institutional interactions within the various "Social Europe(s)".*

## 3 Rules for Competition

Does the above mean that there should be only "negative integration" or veto-bargaining (Cameron, 1999) in the field of social policy? A number of arguments can be made to reduce the scope of competition across European welfare systems, which are very much in the spirit of "positive integration".

A quite popular argument in favour of policy co-ordination at the EU-level in this field is that closer integration and more intense competition may induce "social dumping" and set in motion a "race to the bottom" in social welfare provision (Sinn, 2002). Evidence in support of the view that the European welfare state is threatened by such type of pressures is weak to say the least (Bertola and Boeri, 2002) and the discussion in section 1 after all suggests that cross-country differences in social welfare systems are far from being "arbitraged" away by competitive pressures.

Yet, there may be other arguments for limiting competition among welfare systems and imposing some co-ordination of social policies at the EU level. An issue which is often overlooked is that differences in welfare state provision may distort the allocation of migrants. The EU enlargement process provides a one-time and unique opportunity to reduce the wide differences in productivity levels across the old continent. This means growing faster after the enlargement and having less undesirable redistributive effects of accession, provided that migrants do indeed go to the countries and regions with the tightest labour markets and highest labour productivity levels. Migrants tend to play this spatial arbitrage function (Borjas, 2002). Those from Eastern European countries to Germany jumped over the eastern Länder to find a residence in the western part of the country, which offers better chances to find a job and higher wages. Similarly, migrants from North Africa moved so far to the north-east regions of Italy, where there is virtually full employment, "jumping over" the depressed labour markets of the Mezzogiorno. It is just because of this spatial arbitrage that migration prevents overheating in local labour markets, contributing to contain inflationary pressures.

Migrants play an even more important role in allowing for non-inflationary and productivity enhancing employment growth in presence of wage compressing institutions as those characterising the European landscape (Boeri, 2002b). Migration flows, in this context, play two useful functions. On the one hand, they increase employment and reduce wages in the high productivity markets by increasing labour supply. On the other hand, migration, by acting on centralised wages, reduces labour costs also in the poor regions allowing to partially absorb unemployment in these areas.

Yet, to the extent that differences in the generosity of welfare states do not replicate the differences in the strength of local labour markets, this important function of migration in promoting non-inflationary growth in Europe may be jeopardised. There is some evidence that "welfare shopping" may be occurring within the migrant population, if not among the European population at large. Immigrants to the EU from non-EU countries tend to receive proportionally more social transfers than the native population (Sapir, 2000). Moreover not all the differences in access to welfare can be explained by observable characteristics of migrants (i.e., the number of dependent children, their marital status and skill level). In some of the European countries with the most generous welfare systems (Denmark, Belgium, the Netherlands, Austria and France) there are indeed indications that a rather mild form "residual dependency" is present thereby non-EU citizens receive social transfers more than what can be predicted on the basis of their characteristics (McCormick et al., 2002).

Against this background, the adoption of a common EU-wide safety net, adjusted to reflect cross-country and cross-regional differences in the cost-of-living, can be envisaged as a way to avoid distorting the distribution of enlargement-related migration over Europe.[1]) It is a one time opportunity to receive migrants who, because of cultural and historical ties, can be readily assimilated within Europe. This opportunity should not be lost by inducing migrants to choose the country or region of destination based on criteria – such as access to relatively generous safety nets – which are unrelated to labour market fundamentals.

An additional reason for having a mild form of positive integration is that social policy is a domain of ongoing policy experimentation. Supra-national bodies can be in a better position than national Governments to assess pros and cons of the various models, are not subject to pressures of local lobbies in benchmarking schemes which better serve specific interests and have typically longer horizons than national governments (and horizons are crucial in areas like pension reforms). Open co-ordination[2]) mechanisms, as those devised at the EU level in fields like labour policies and social protection (mainly social inclusion) can play an important role in drawing lessons from these experiments and identifying best practices.

This type of co-ordination could be strengthened by assigning more relevance to quantitative targets like those established in terms of employment rates at the 2000 EU Summit in Lisbon. The idea of New Maastricht for Labour is very much in this vein. It would also require a different timing and organisation of the review process. Under the so-called "Luxembourg process", supra-national institutions set employment guidelines which offer the basis for the development of National Action Plans by the Governments of the Member States. The plans and the achievements are subsequently verified by the means of an institutionalised procedure, selecting the "best practices" (so-called "benchmarking") and drawing up country specific recommendations. Stronger co-ordination along these lines should be explicitly directed to the Structural Spring Summits of the Council.

Another direction in which co-ordination could be extended is in assigning powers to the European supranational authorities in imposing improvements in the administration of welfare policies in the various countries, e.g. in conditioning cash transfers to able-bodied individuals in working age to stringent work-tests.

Finally, co-ordination needs to be supported by imposing more transparency in social policy expenditure accounts. Common standards may be adopted to estimate the debt of pub-

1 *There are also arguments for imposing minimum standards to the accession candidates (see Boeri et al., 2002, for a discussion).*

2 *Although not explicitly stated, open co-ordination is sometimes considered as a kind of preparatory stage for the "enhanced co-operation", already mentioned in the Treaty of Amsterdam and now explicitly called for by the Nice Treaty: after a breaking-in period, a certain number of countries more interested and open to the idea of a federal Europe could move on from open co-ordination to enhanced co-operation – that is greater integration as concerns substance and decision-making instruments.*

lic pension systems, develop social policy expenditure projections and provide generational accounts which can best isolate the various (often improper) functions played by public pension in the EU countries. Some progress has already been made in this direction, for instance imposing to all countries the provision of long-term (lasting at least 50 years) projections of pension expenditure and making sure that these projections are based on explicit and internally consistent hypotheses, jointly agreed upon by a working group of the EU Economic Policy Committee (Boeri et al., 2001). But more ground has to be covered in this context. ❧

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# Comments on Tito Boeri, "Does Europe Need a Harmonised Social Policy?"

Professor Boeri has presented an excellent paper. I am nearly convinced by all his arguments. Nevertheless a discussant's job is to develop some complementary or alternative ideas. In respect thereof I will discuss the paper in four parts:

- first, I will question Boeri's story of four European social policy models;
- second, I will briefly sketch the history of the development towards a "European Social Policy";
- third, I will discuss the possible constraints for social policy in view of the Stability and Growth Pact;
- fourth, I will point to some possible implications EU enlargement might have on social policy.

## 1 Four or Only One European Social Model?

Although Boeri rightly points to the fact that it is customary to divide Europe into four social policy models (grouping the Nordic, the Anglo-Saxon, the Continental European and the Mediterranean countries), the presidency conclusions of the Lisbon European Council of March 2000 speak only of "the European social model." Looking at the data on public social expenditures and GDP per capita it is easy to categorize the 29 OECD countries into three groups (see chart 1).

There is one group of rich European countries (11 EU countries plus Switzerland) which can afford and also prefer to spend more on social security measures (may be also because they believe in market failures in the field of social policy) than other countries. This group – following the wording of the Lisbon European Council – one can call the *"European Social Model."*

Then we see a group of rich countries in Europe and in non-European OECD countries – like the EU countries Luxembourg and Ireland and the U.S.A., Japan and Canada – where the governments prefer not to spend too much on social security. This group of countries forms the so-called *"American Social Model."* Either because they feel that market failures are not present in the field of social policy or simply because they believe that in a capitalist society each person can and should care by herself or himself (neo-liberal attitude).

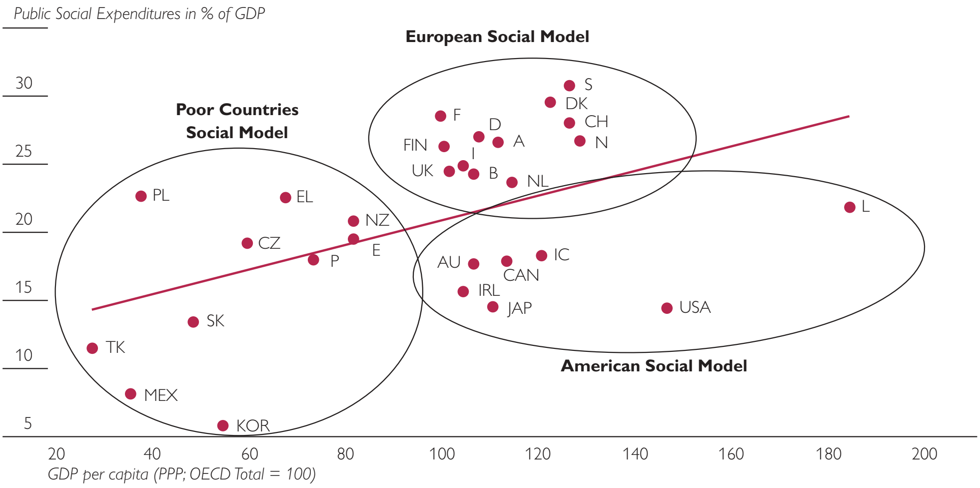
Then there are countries which are not rich enough to afford too much public spending on social security. This group forms a model, called the *"Poor Countries Social Model."* Within the EU Greece, Portugal and Spain are members of this group. Additionally the candidate countries in Central and Eastern Europe also belong to this category.

## 2 A Brief History of European Social Policy

In the field of social policy the European Union has gone a long way from a situation of pure Member States competence to a mixed or shared competence nowadays with primarily ruling minimum requirements and maintaining the country-specific specialties. From the Rome Treaty of 1957 to the Nice

Chart 1

**Social Expenditures and Economic Development in 1998**




Source: OECD.

Treaty of 2000 social policy in Europe changed gradually from a mere national to a more and more European agenda. We still do not have a real "European Social Policy" but a mixture of national and EU legislature in this field.

– 1957: In the Rome Treaty social policy was an exclusive competence of the – at that time – six Member States. At the beginning there was a debate similar to that of today whether the Social Policy should be centralized (harmonized) or remain in the competence of the Member States. At the Messina conference 1956 preparing the EC Treaty France demanded a wide harmonization of the social security systems (centralist position), arguing that its high social costs would hamper their competitiveness in the common market. Germany on the other hand argued that social costs were "natural costs" which would result of the different conditions of locations, which in its diversity would not be able to be harmonized (de-centralist position). Cost equality would be alien to a modern economy based on the division of labor. In the end the claim for a social harmonization had been canceled. Only in Article 119 (equal pay for men and women) and Article 120 (equality of paid work) entered into the EC Treaty (Schulz, 1996, p. 16).
– 1960: Already set up by the Treaty of Rome (1957), the European Social Fund (ESF) came into force in 1960 and was and still is the main financial tool of EU social policy. Today it translates the European Employment Strategy into action. The ESF is the longest established Structural Fund financing actions in the areas of objective 1 through 3 as well as in the special action EQUAL. It finances around one third of total EU's structural policy actions. The ESF contributes to reach the target laid down in Article 2 EC Treaty ("the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States").
– 1974: The EC started its first social policy action programs in 1974. Due to the bad timing – the first oil price shock resulted in a world-wide recession – this program was condemned to fail.

– 1993: With the Maastricht Treaty for the first time it was tried to integrate social policy into Community policy. Due to the hostile attitude of the conservative U.K. government of that time only a protocol on Social Policy entered into the Treaty.
– 1999: With the Amsterdam Treaty – in the meantime the government in the U.K. switched from Conservative to Labor – for the first time social policy entered into the EC Treaty (Article 136; ex Article 117). Together with the introduction of a new title on employment (Title VIII) as a reaction to the start of Stage Three of Economic and Monetary Union (EMU), encouraged by both the French and Swedish Presidencies, combined with a common employment strategy with specific targets being transposed annually into

National Action Plans for Employment (NAPs) by the EU Member States, the nexus social policy and employment got a high profile within the EU. This plans coincided with plans to modernize the European social model. Now – in the words of the secretariat of the European Convention – Social Policy is a "concurrent/shared competence" between the EU and its Member States (Convention, 2002). The major principles of a "European Social Policy" are:

(i) according to Article 137 EC Treaty (ex Article 118) the EU Council legislates with qualified majority (by means of directives) on minimum requirements/standards in the EU in the fields of improvement of the working environment to protect workers' health and safety, working conditions, the information and consultation of workers, the integration of persons excluded from the labor market, equality between men and women with regard to labor market opportunities and treatment at work; however unanimity is still required in the areas of social security and social protection, protection of workers where their employment contract is terminated, representation and collective defense of the interests of workers and employers etc.;

(ii) modernizing the European social model is a strong case for subsidiary (Adnett, 2001, p. 360) – a notion normally difficult to fill with life. But social policy is the proper area to apply this notion in practice.

– 2000: After several social action programs (1995 to 1997; 1998 to 2000) the Nice Treaty started a new attempt with the "Social Policy Agenda." The EU's social policy agenda is the EU's roadmap for modernizing and improving the European social model by investing in people and building an active welfare state. It should contribute to achieving the strategic objective defined at the Lisbon European Council in March 2000 ("to become the most competitive and dynamic knowledge-base economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion").

The so-called Lisbon process with its "new open method of co-ordination" – based on benchmarks and best practice annual controlling mechanism – is a good instrument of mutual learning and improving social policy in EU Member States, sometimes also called the "Soft Economic Policy Co-ordination" (Hodson and Maher, 2001) without denying national differences in preferences and financial potential for public social expenditures. The new provisions of the EC Treaty (Article 138) favor a strong dialogue between European social partners.

## 3 Is the Stability and Growth Pact a New Constraint or an Assistance for a European Social Policy?

One might argue that the emergence of new production technologies, the growth of the knowledge-driven economy ("new economy") and globalization, together with the adoption of EMU, have fundamentally changed the trade-off between the EU's economic and social objectives. The lost of one policy instrument (exchange rate) imposes more weight to national wage policy as a buffer to absorb asymmetric shocks. A greater labor cost variability between and, within, EU labor markets are needed in EMU. Further more, the specific co-ordination set-up for economic policy in case of the EMU in the form of the Stability and Growth Pact has constraint not only national public finance but also the quality thereof. As a consequence, the Lisbon European Council demanded a modernization of Social Europe (Adnett, 2001).

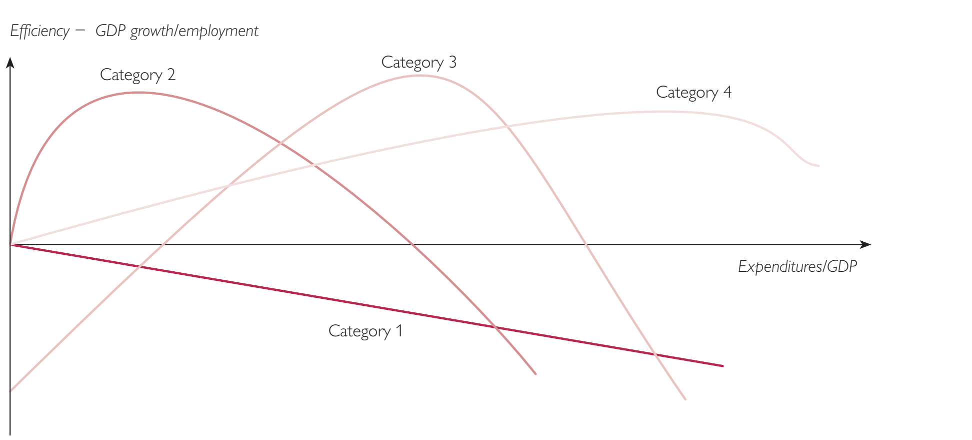
Since the start of EMU the rules-based framework for budgetary surveillance (annual presentation of stability and convergence programs by the EU Member States within the framework of the Stability and Growth Pact procedure) has undergone a considerable change. Starting with only budgetary balance targets ("close to balance or in surplus") in July 2001, the ECOFIN Council revised the Code of Conduct on the content and presentation of stability and convergence programs. Besides a more coherent statistical definition of the targets, it extended the coverage of programs to include sections on the quality and sustainability of public finance in line with the so-called Lisbon process. Under this new rules the European Commission undertook for the first time (EU, 2002a, pp. 80 ff) an analysis on the quality (composition) of public expenditures, including social expenditures which amount to around half of total public expenditures in most EU countries.

The components of public expenditures (see chart 2) can be classified according to their contribute to growth and employment (efficiency) in four categories (see EU, 2002a, pp. 85–86):

– *category 1:* Spending on *interest payments* always negatively affects growth and employment as these resources crowd out spending for more productive purposes;
– *category 2:* This consist of old *age and survivor expenditures, collective consumption and compensation of public employees.* Some public spending may be efficiency-enhancing, the decreasing effects, however, arise beyond a certain level of spending. High levels of spending may crowd out other efficiency-enhancing expenditures. Very high levels of spending on pensions have a negative impact on savings and capital accumulation;

Chart 2

**Efficiency of Public Spending**




Source: EU (2002a), p. 85.

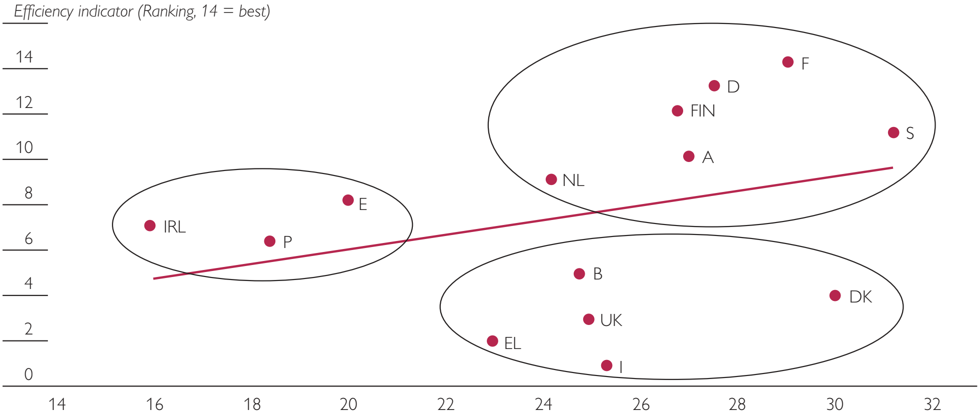
– *category 3:* This includes *social expenditures on disability, social exclusion, housing, family/children allowances and unemployment transfers.* Public spending on these items has a positive impact on efficiency provided it is kept within certain limits. Very high expenditures are likely to have a negative impact on efficiency due to moral hazard problems and benefit dependency;
– *category 4:* Here are included *expenditures in education, active labor market policies (ALMP), health, R&D and gross fixed capital formation.* These expenditures are considered to have a positive effect on economic efficiency (see the insights of the literature on endogenous growth theory) up to a certain limit, beyond which additional spending may have negative effects. These limits seem not yet been reached in EU countries.

With the help of a synthetic indicator of expenditure composition (see EU, 2002a, pp. 89 ff) the European Commission quantified the "quality" of EU Member States public finance at the end of the 1990s. In chart 3 the ranking of the efficiency indicator is correlated with the public social expenditures. France, Germany, Finland, Sweden, Austria and the Netherlands rank at the top according to efficiency of their expenditures. This group also spends most on social expenditures. A second group – spending also a considerable amount on social expenditures – ranks at the bottom: Belgium, Denmark, United Kingdom, Greece and Italy. The third group consists of Spain, Ireland and Portugal which spend very little for social affairs and ranks in the middle as far as efficiency of total public expenditures are concerned.

Not only the new attitude towards fiscal policy in EMU in the short- and medium-run may constraint social policy or lead to a more European coherent expenditure pattern on the lines described above (efficiency considerations) but the long-term challenges posed by ageing populations require considerations of sustainability of public finances in general and social policy in particular. Many studies point to the problems of ageing populations. A recent study by the Economic Policy Committee (EU, 2001) studied the impact of ageing populations on the long-term (over the next 50 years) sustainability of public finances. As a results of

Chart 3

**Efficiency of Public Expenditures, End of the 1990s**




Source: EU (2002a), p. 88, and OECD.

an assumed decline of population between 2000 and 2050 by 3% on EU average (with extreme cases of –17% in Italy; +29% in Luxembourg and +26% in Ireland) the public pension expenditures will increase by around three percentage points in EU average, with the highest increases in Greece (over +12 percentage points) and Spain (+8 percentage points). In an average EU debt country – starting with a balanced budget – the budget balance would turn into a deficit of around 6% of GDP in the baseline case and public debt would increase from 60% to 80%. Again category pension expenditures have to be slowed down. Otherwise other social expenditures would be in danger in the future.

Overall, the European Social Model – so called by the European Councils – could be more and more realized on the one hand because of a more sound legal basis in the EC Treaty as well as the specific attention which is given to it in the "Social Policy Agenda" in conjunction with a deliberate concentration on improving employment conditions (NAPs) and on the other hand because of the constraints exerted by the surveillance and co-operation procedure within the Stability and Growth Pact.

## 4 EU Enlargement – Possible Impact on Social Policy?

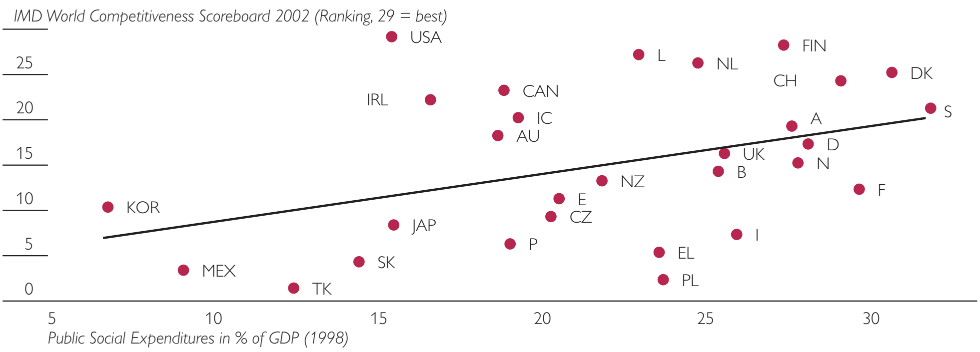
With the Enlargement of the EU by 10 (in 2004) or later more new countries, most of which are "poor" – GDP per capita in PPP of the Central and Eastern European Countries (CEECs) on average amounts to around 40% of EU average – the Union seems to start anew with a European social policy. Enlargement is an economic unification of "rich" and "poor" countries. As we have seen from chart 1, public expenditures for social policy are positively correlated with GDP per capita. Comparable data for OECD member countries Czech Republic, Slovakia and Poland show that these CEECs belong to the "Poor Countries Social Model."

The difference to the start with the EC in 1957 is that the new member countries have to take over the acquis communautaire in general and of course those for social and employment policies in particular. In the negotiations for enlargement Social Policy and Employment is dealt with under chapter 13. This chapter covers areas where there exists substantial secondary legal acquis at EU level, such as health and safety issues, labor law and equality of treatment between women and men, as well as areas such as social dialogue, employment and social protection where convergent policies are being developed, on the basis of the EC Treaty. In these areas there are no legal obligations to implement precise policy measures but a very important general obligation to co-ordinate the respective policies in order to develop a homogenous social framework in line with the principle and rules of the EU Treaty. Chapter 13 has been closed with all 12 candidate countries; however, half of them have negotiated for transitional arrangements to implement EC directives for minimum social standards (EU, 2002b).

Although at first sight low levels of social expenditures mean low labor costs and hence a competitive advantage of these countries, a look at "The World Competitiveness Scoreboard 2002" of IMD Lausanne shows that there seems to be a positive correlation between GDP per capita and the rank-

Chart 4

**World Competitiveness and Public Social Expenditures**




Source: IMD, The World Competitiveness 2002, Lausanne.

ing of world competitiveness. And because public social expenditures are positively correlated with GDP per capita (see chart 1) there is also a weak positive correlation between competitiveness and social expenditures (see chart 4).

Most of the countries grouped into the "European Social Model" (see chart 1) are ranked high in the IMD World Competitiveness Scoreboard 2002, those countries belonging to the "Poor Countries Social Model" rank low as far as international competitiveness is concerned. Hence, competitiveness is more than just a matter of (labor) costs. Entrepreneurs evaluate competitiveness in a broader sense and expect from richer countries also more non-cost competitiveness components (factors!).

Taking the relationships between social expenditures and competitiveness as given, the new Member States from Eastern Europe are no menace for the old EU Member States in the Single Market. Therefore one must not urge for more harmonization in social policy affairs when the EU is enlarged. A convergence of the level of social policy expenditures is only possible insofar as GDP per capita converges. With the great exception of Ireland, the EU cohesion countries did not converge despite the considerable efforts of EU structural and cohesion policy in the last decade. A harmonization of social standards is only necessary insofar as the functioning of the Single Market is at risk.

However, the big question remains whether the huge income differential between the old EU Member States and the candidate countries in the East may – if full freedom of labor movement is allowed in the enlarged EU Single Market – lead to a migration wave. Many studies on possible migration flows indicate a high potential of migration of labor (e.g., see Boeri and Brücker, 2000). However, on the one hand the countries where most of the potential migrants are expected to enter (Germany and Austria) have opted for a seven year transitional arrangement in the field of "Freedom of movement for persons" (chapter 2 in the enlargement negotiations – which covers also co-ordination of social security schemes; see EU, 2002b) on the other hand past experiences of enlargements with Greece (1981) as well as with Portugal and Spain (1986) have seen no big migrant flows.

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# The New Systems Competition[1])

## The New Systems Competition

The unbridled economic strength of capitalist economies brought communism to its knees. Centrally planned economies took their leave from the stage of history in disgrace. Who would deny that this systems competition produced beneficial results?

This was of course a form of systems competition that has lost most of its importance today and that has given way to a new systems competition. The goal of the old systems competition between communism and capitalism was economic, cultural and military dominance, and it took place amidst closed borders in the form of mutual observation, imitation and innovation. The new systems competition, however, is a competition for locational advantage that is primarily driven by the international migration of people and production factors. In the words of Albert Hirschman (1970), *exit,* or voting with one's feet, characterises the

1 *This lecture synthesises material the author presented at the occasion of his Yrjö Jahnsson lectures, Helsinki 1999, at the annual meeting of the Verein für Socialpolitik, Magdeburg 2001, and a Conference at the occasion of the 50th anniversary of the Department of Economics of Norges Handelshoyskole organised in co-operation with the Nobel Prize Centennial.*

new systems competition. *Voice* and *loyalty* were forces that used to play the more important roles in the competitive processes of the past.

All national economies today are confronted with the forces of globalisation. Goods and capital have been able to cross borders unrestricted for some time, and international direct investment is gaining importance. A growing number of firms are shifting their locations to low-wage and low-tax countries in order to prevail in increasingly intense international competition. At the same time, poverty refugees from all over the world are pressing into the richer industrial countries to participate in the blessings of the welfare state.

Globalisation is not a completely new phenomenon.[1]) Under the old colonial system, international trade and capital flows as a percentage of the national product reached significant levels. At the end of the nineteenth century one can even speak of a world labour market. This is at least the impression left by the enormous migration flows at the time. Nevertheless, with multinational corporations, the problem has now taken on new dimensions that were hardly conceivable not too long ago.

The mobility of people, goods and production factors places great competitive pressures on the countries of this world. They create a systems competition that is entirely different from the already concluded competition between communist and market-economy systems or also from the competition that the European nation states faced during the past two centuries. It is no longer a matter of implementing wise, internal policies to guide a largely autarkic economy to a position of economic strength, social peace or military dominance. The strategies of Bismarck, Stalin or Roosevelt are no longer called for. Governments today must be aware of the effects that national institutions have on the cross-border transfer of economic activities. Taxes, social transfers, public goods, regulatory systems, laws and many other factors are just as influential in motivating the movement of people and production factors as wages and other economic fundamentals that are not directly influenced by government. No state can afford to frighten off mobile capital as a result of grossly inefficient institutions, just as no state can afford to be a magnet for the poor of this world. Similar to a private company, a state competes for good customers and tries to ward off the freeloaders.

## The Euro, Capital Markets and Systems Competition

Understanding the new systems competition is especially important for Europe, since what has been said about the world applies in particular measure for Europe. The mobility of economic factors, the driving force of systems competition, will have a much greater impact on inner-European relations than brought about by the previous imitation and innovation competition of systems.

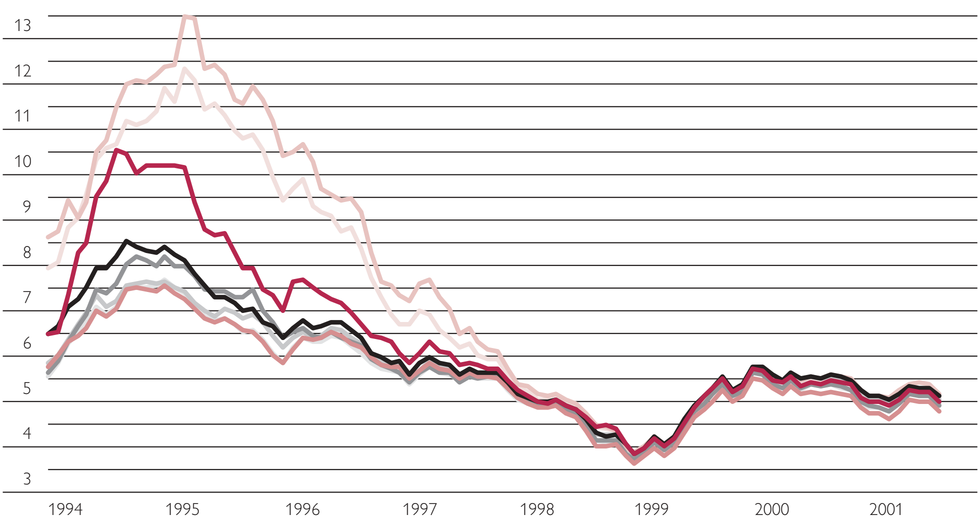
The introduction of the euro is a particularly important step in this connection because the euro is a symbol of a new liberalism and enhanced economic integration in Europe. People, goods, services and capital can pass borders without restrictions. The four basic

1 See Borchardt (2001).

Chart 1

**Convergence of Long-Term Interest Rates**

*Ten-Year Government Bonds in % p.a.*




*Source: Deutsche Bundesbank, Database.*

freedoms, guaranteed in the Treaty of Rome already in 1957, have finally been implemented.

The euro has not only helped to open doors in Europe politically. It is also directly increasing the inner-European mobility of production factors and goods. In the past, the uncertainty of exchange-rate movements has burdened cross-border trade with not inconsiderable risks and hedging costs. For Germany, the Netherlands and Austria, which were protected by the German mark, this brought the advantage of unmatched, low interest rates. All this no longer applies. Interest rate convergence, as shown in chart 1, is nearly complete. The euro has created a nearly perfect inner-European capital and goods market and thus the prerequisite for a free unfolding of the forces of systems competition.

The German tax reform of 2000 can be seen as a reaction to this development since it was explicitly justified – as was the so-called locational-safeguarding law (Standortsicherungsgesetz) of 1993 – by the locational competition that Germany is engaged in. Germany has come in last among EU countries in recent years in terms of economic growth. The lowering of the corporation tax rate to only 25% is meant to bring a trend reversal and to prevent capital from leaving the country.

Sweden and Austria have also had extensive debates on their attractiveness as investment locations which have led to courageous tax reduction measures. Sweden and Austria have even eliminated the synthetic income tax by taxing interest income at a lump sum rate of only 30% and 25% respectively.

Capital reacts particularly sensitively to the taxation of interest income. After the German government announced the introduction of a 10% source tax on interest income in autumn 1987, considerable amounts of capital left the country during the following six quarters. Long-term capital imports of DEM 3 billion in the year before the announcement turned into long-term capital exports of DEM 95 billion in the year after the announcement.[1]) The evasive reactions were so great that Germany was forced to rescind the law only four months after its introduction. The second attempt made in 1992 to tax interest income at source was only apparently successful since evasive reactions failed to materialise only because the government this time did not tax interest income earned in Germany by foreigners.

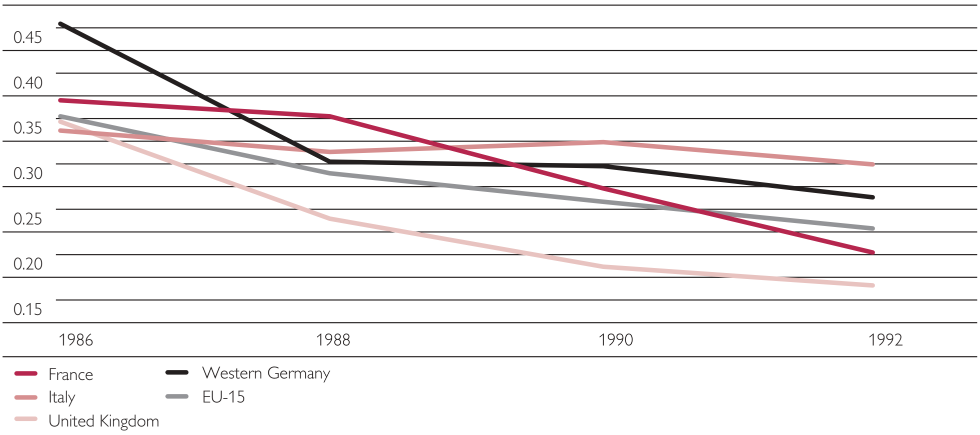
The erosive effects were not limited to the tax on interest income. Corporation income tax is also having a difficult time in systems competition. Since the dramatic income tax rate reduction from 46% to 34% that the United States introduced in 1986, many countries responded with similar tax reforms and also lowered their rates. As a result, the average effective tax burden that the present 15 EU countries impose on U.S. companies that operate in the EU fell by more than 12 percentage points between 1986 and 1992 (see chart 2). Germany was merely a follower in implementing these reforms.

Ireland has pursued a particularly aggressive locational-safeguarding policy by sufficing itself with a corporation income tax rate of only 10% for an increasing number of sectors. In 1987 Ireland extended this regulation, which was originally limited to manufacturing and special service industries, also to financial services within the International Financial Service Centres in Dublin and Shannon Airport. This led to considerable capital flows to Ireland. Other governments reacted by changing legislation on external tax relations of domestic firms which allowed the revenue authorities to tax income from borrowing transactions.

The Netherlands and Belgium have also followed the Irish example by granting special conditions to the financial and service industries that locate in

Chart 2

**Average Tax Burden for Subsidiaries of U.S. Companies in Europe: Reaction to U.S. Tax Reforms of 1986[1])**



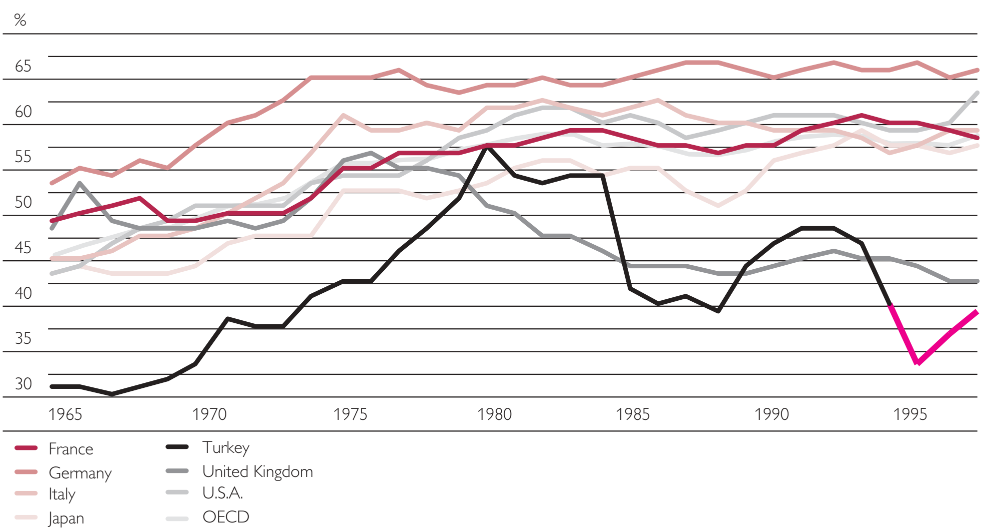

*Source: Altshuler, Grubert, and Newlon (1998).*

*1) The average tax burden was calculated from information from U.S. companies on income and taxes paid for companies they control in Europe, i.e. firms of which they earn least 50% of the shares. The average tax burden is defined as the ratio of paid taxes to profits, the latter being determined by U.S. accounting procedures. Changes in the valuation principles for determining profits are also reflected in this way in the average tax rates. The EU-15 average is calculated using GDP shares as weights.*

1 *See Nöhrbaß and Raab (1990).*

Chart 3

**The Growing Share of Taxes on the Factor Labour in the OECD[1])**




*Source: OECD Revenue Statistics 1999, OECD National Accounts 1999, own calculations.*

*[1]) Taxes on labour income as a percentage of total tax revenue, weighted by share of GDP. Taxes on labour income consist of taxes on labour income, social insurance contributions for wage earners and salaried employees based on payroll, and municipal payroll tax.*
*Data is lacking for Mexico, Iceland, South Korea, Poland, Czech Republic and Hungary.*

special areas. In nominal terms they tax income at the normal corporate income tax rate, but they permit a very generous way of calculating lump sum profits which effectively reduces the corporate income tax rate to 7% (Netherlands).

There is no doubt that capital is the most mobile of all production factors. It is more mobile than labour and of course more mobile than land. For this reason it is not surprising that taxes have shifted to other factors. The factor land is not lucrative enough because of insufficient income mass. Accordingly, more and more taxes have been placed on the factor labour.

Chart 3 shows a clear time trend of the percentage of wage tax on total tax revenue in the OECD countries, which despite the exceptions of Turkey and the U.K., is evident for most of the OECD countries. Over the past fifty years the share of wage taxes has risen from 45% to nearly 60%. The factor labour is the victim of globalisation.

## Migration in Europe

Despite this trend we must not ignore the actual mobility of the labour force in Europe. Today the percentage of German residents born abroad is 8.9% of the total population. This is not much less than the 9.8% of the United States, a country of traditionally large immigration.[1])

Migration will increase with the eastward enlargement of the EU. No fewer than 106 million Eastern Europeans are seeking entry into the EU, and the first wave of accession will include eight countries and about 75 million people. The wage of these people is currently between one fifth and one tenth of that in West Germany, compared to about half in Spain and Portugal when they joined the EU. According to estimates by the Ifo Institute for Economic Research between three and four million people will migrate to Western Europe over a period of 15 years.[2]) What comes on

1 *OECD (2001). Annex 1.*

2 *See Sinn et al. (2001).*

top of this is the immigration from other parts of the world.

The immigration from very poor countries to Western Europe could touch off considerable competitive pressure in the labour market. A person who decides to leave his home country to seek his fortune in the West will be guided above all by economic criteria in his choice of countries and will react to even the slightest differences. Even though considerable income differences are necessary to set off migration, the differential migration between the European countries is nevertheless extremely high. The theoretical ideal of perfect mobility is very close to being realised in this area.

Under these circumstances, the countries of Western Europe will be forced to engage in a warding-off competition so as not to attract too many people that the state would have to support. Immigrants in Germany are net recipients of government benefits during their first ten years of residence, according to a study by the Ifo Institute for Economic Research. Per capita and year they receive about EUR 2,300 more in terms of public goods and transfers than they pay in taxes and fees. It is foreseeable that this condition will not continue. The Western European countries will scrutinise their social welfare systems and try to avoid becoming welfare magnets. A successive dismantling of the European social welfare state is the likely outcome.[1])

This process will, of course, be much slower than the competition for capital. It took fourteen years for Germany to adopt the American tax-cut cum base-broadening. The warding-off competition among the welfare states will be much slower. It will certainly stretch out over decades and can only be gauged in an historical perspective.

An impression of the importance of labour-force migration on the behaviour of countries can be seen in the U.S. example. In America, labour force mobility has always been very high and at the same time the system of government is decentrally organised. Under these circumstances it was impossible to establish a European-type welfare state, and attempts that pointed in this direction failed miserably. When New York City expanded its welfare benefits under Mayor John Lindsay at the end of the 1960s as a means of combating poverty, it attracted the poor from all over America. The result was rapidly mounting debt that led to near bankruptcy in 1975, forcing a turnaround in anti-poverty policies.[2])

## The Invisible Hand and the Selection Principle

The major trends of systems competition are obvious and can be observed empirically. Economists also know full well what individual countries must do in the competition to attract investment. The recommendations of the various councils of economic advi-

1 *Network effects have little influence on this. To be sure, wherever a network already exists, the economic incentives for migration decisions are no longer so important. Then competition has already occurred. However, the expectation of future networks that may result from current migration will induce states all the more to cut back their welfare benefits. Ex ante, the competition is then all the stronger. See Thum (2000).*

2 *During the Lindsay's first term of office, social welfare expenses rose from 12.5% to 23% of the budget (Glaeser and Kahn, 1999, p. 124; Shefter, 1985, p. 86).*

sors and the economic research institutes are quite unanimous in matters of tax policies and regulations. This is no wonder: economists are the "managers" of their countries. They help their respective countries optimise their collective policy decisions. They help them survive in systems competition.

What is less clear is the result that systems competition produces on the whole and especially how this result should be assessed. Can we trust this competition as an organisational process? Is there an "invisible hand," as there is for private competition, that regulates everything for the better from the viewpoint of the community of nations? Do the main theorems of welfare economics also hold for systems competition, or is pessimism called for? Are central government solutions needed to correct the market failures in systems competition? Should policies in a variety of areas be harmonised to reduce competition? How much Brussels does Europe need? These are the fascinating questions that the theory of systems competition deals with.

It is certainly possible to construct models of systems competition whose assumptions in analogy to market competition are adjusted to producing a functional competition among states.[1]) But it is not clear whether such models can capture the essence of systems competition.

The reason for doubt lies in what I once termed the Selection Principle (Sinn, 1997a, 1997b). This principle maintains that states take over those economic activities that the private market is unable to carry out. Since the state acts as a stopgap, replacing lacking markets and correcting the failings of existing markets, we cannot hope that the reintroduction of the market through the backdoor of systems competition will lead to sensible allocation results. It is more likely that the failings that led the state to act will reappear on the higher level of competition between states.

According to the Selection Principle, drawing analogies between competition in the private sphere and competition between states is completely inadmissible because the states admin-

ister the exceptions in the competitive allocation processes. Precisely because competition functions well in the private sphere it must be feared that it will fail in the public sphere.

## Three Examples of the Selection Principle

To show how the Selection Principle works in reality, three examples will be briefly presented, without looking at the underlying, formal models.[2])

### The Erosion of the Social Welfare State

Among the reasons for government redistribution, the insurance motive is probably the most important. Behind a veil of ignorance, wise constitutional fathers – or also median voters – have agreed on the social welfare state to cover the life and career risks of their children. Those who suffer misfortunes in life are net recipients of state resour-

1 *See, for example, Sinn (1992), Richter (1994), Wellisch (1995) or Oates and Schwab (1988) and Oates (2001).*

2 *For the underlying models, see Sinn (2002), Chapters 3, 2 and 7, in this order.*

ces, the more fortunate are net payers. From an ex-ante perspective the expected utility of risk-averse citizens increases.

In establishing the redistribution measures, attention must be paid of course to the behaviour changes that they induce. Ex ante, as in all insurance contracts, the efforts to reduce the insured danger decrease, but, and this is a good thing, the willingness to take more risks in the choice of occupation and other decisions in life is greater than would otherwise be the case. Moreover, ex post, the incentive is lacing of acquiring more income through one's own efforts, which is, of course, a disadvantage.

Assumed the case that a national redistribution system is optimally designed by having found the best possible mixture of these various advantages and disadvantages. Would this redistribution system survive in systems competition or was it even brought into being by this competition?

The answer is surely negative since the free migration of net payers and net recipients of state benefits would induce precisely the effect that was described in the previous two sections. Every state would have an incentive to treat the net recipients a bit worse and the net payers a bit better that their neighbours do in order to ward off the latter and attract the former and in so doing create a budget surplus.

From the position of the individual country, given the behaviour of other countries, the utility effect for those who are induced to migrate because of this marginal decision is a negligible, second-order effect. However, the budget effect, as a first-order effect, is strictly positive. On balance with the scaling back of the social welfare state, national welfare in the sense of expected utility of the citizens increases since the budget surplus can be used to the advantage of all. From the position of all countries, however, nothing can be gained by such actions since no migration takes place when all act in this way. What happens is only that the redistribution is reduced and the expected utility of the citizens declines.

The result can also be understood by using the theory of externalities. The social welfare state creates positive external effects for other social welfare states by means of the international migraion that it induces. It drives away the rich, increases the supply of factors offered by them in other countries and in this way lowers their factor payments abroad. And it attracts the poor, whereby their factor payments rise elsewhere. In this way the income distribution in other countries becomes more even and the degree of goal performance of social policy in these countries rises. Since the positive external effects are not taken into consideration in national social policies, systems competition brings about an underprovision of social policy.

The underlying cause for this flaw in systems competition can be seen in the Selection Principle since the protection against inequality in lifetime income that the social welfare state offers cannot be provided by private enterprise. Private insurance contracts presuppose that the signers are of age and can only be concluded with adults. For an adult, however, the dice of fate have already been cast, the veil of ignorance has been lifted.[1]) Redistribution con-

1 *In theory it is conceivable that parents conclude such contracts for their children, but no civilised country gives parents the right to obligate their successful children to pay for the unsuccessful children of other people. Only contracts that involve a resource transfer from parents to children are allowed.*

tracts do not come into being on a private enterprise basis since the mobile net payers would not participate. Adverse selection prevents the private insurance market from coming into existence.

The migration processes that create a failure in the competition among social welfare states can also be interpreted as adverse selection. The migration of the successful and the unsuccessful is a choice that takes place ex post, that is after the veil of ignorance has already been lifted. Since the successful net payers do not participate, the social welfare state cannot survive.

A possible policy implication of this lies in the harmonisation of redistribution rules, but this is not easily achievable between countries with differing average incomes. What is better is a delayed integration of migrants in the national social system, as has been recommended by the Advisory Council to the German Ministry of Finance or recently by the Ifo Institute.[1])

**Infrastructure Goods and the Race to the Bottom**

It is often maintained that there is no need to fear the erosive forces of systems competition. There is no race to the bottom since the net payers do not orient themselves on the taxes that they pay but on the public goods that are placed at their disposal. There is especially no need to fear a race to the bottom in the competition to attract mobile capital since companies are prepared to pay an appropriate price for good infrastructure. This argument is true on the surface, but it is only half the truth.

First, it would be bad enough for the social welfare state if the taxes that are paid on the factor capital would only suffice to pay for the infrastructure made available to this factor. They would lose their fiscal character and become pure benefit taxes, because this would mean foregoing redistribution and insurance protection.

Second, it is not even certain that the taxes on mobile capital generate enough revenue to pay for the infrastructure. In systems competition, countries behave like competing firms that demand marginal cost prices, or to be more precise, tax rates that reflect the marginal congestion costs for a given infrastructure. It is not to be expected that these tax rates will provide enough income to cover the costs of providing the infrastructure.

The reason for this lies in the Selection Principle. When states are designed in accordance with this principle, they offer those goods which because of sufficiently strongly increasing returns to scale in production and use cannot be offered by the private sector, since private competition would be ruinous and would not achieve equilibrium. For such goods, tax rates or prices as high as the marginal congestion costs are not enough to finance the infrastructure. A chronic deficit arises that must be covered by other means. The private market failure that led to state intervention has renewed problematic implications at the higher level of competition between countries.

When the immobile production factors are sufficiently important this does not automatically mean that there is no equilibrium in systems competi-

1 *Sinn et al. (2001) and Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (2000).*

tion. Also competition is not inefficient. It is in the interest of the owners of immobile factors, which are complementary to mobile factors, to co-finance the infrastructure used by the mobile factors. Moreover, the individual state has the incentive of providing the right quantity and quality of infrastructure. Nevertheless, the result for the social welfare state is still worse than if only benefit taxes can be levied. The owners of immobile factors, which include very many infirm, weak, or those who offer simple labour, receive no money from the rich capital owners but subsidise these capital owners in systems competition. This is not a race to the bottom but in a certain sense a race below the bottom.

The policy implications of this observation are similar to those that can be derived from the erosion of the social welfare state. In addition, locational competition can be limited if cross-border profit flows are taxed according to the residence principle instead of the source country principle. The U.S. Internal Revenue Service with its world-wide income concept and its regulations for taxing passive foreign income has gone quite far in this direction.

A harmonisation of corporate income tax in the European context does not follow from this because such a step would likely lead countries to conduct locational competition with infrastructure goods which would lead to an oversupply of such goods. When there is harmonisation it must also be assured that the infrastructure used by the mobile factors is completely paid by them. This could be achieved by an extension of the EU subsidy bans to include indirect assistance from infrastructure gifts. Given that the EU is just now considering new proposals for a harmonisation of company taxes, this is a timely issue.

**Lemon Banks and Bank Regulation**

The third and last example to be considered deals with bank regulation.[1]) The Asia crises, the U.S. Savings and Loan crisis and various bank failures have shown that regulation of the banking sector is an important task for the state and that there are possibly problems with a free regulatory competition. Not least as a result of these crises, the Bank for International Settlements is currently improving its rules for bank regulation (Basel II) to promote, on this basis, a further harmonisation of national rules.

The purchaser of a bank bond does not receive a guaranteed redemption claim. Instead, the likelihood of the agreed redemption depends on whether the bank has not gone bankrupt before the repayment date, and the amount of repayment in case of bankruptcy depends on how much capital reserves the bank has, to service their creditors even in a worst-case scenario. Banks are not able to completely avoid bankruptcy because the companies to whom the banks pass on the funds they received from the purchasers of bonds are also not immune to bankruptcy. The expected redemption value is the key quality feature of a bank bond. If the true expected value cannot be determined by the bank's creditors because the creditors cannot effectively monitor the bank's

1 *For the formal model underlying the analysis of this section see Sinn (2001).*

actions, the bank bond is a lemon good whose quality is exposed to erosive forces similar to those that effect physical lemon goods.

In the case of asymmetric information between a bank and its creditors there is the danger of excessively negligent bank behaviour. The bank may have an incentive to conduct its business with excessively low capital reserves and to finance particularly risky enterprises. In the choice between an extended loan that has a high probability of a modest return and one with a low probability of a high return, it can be worthwhile to choose the second alternative even if a smaller expected rate of return is associated with it. The reason lies in what I once called the BLOOS rule which states that you cannot get blood out of a stone.[1]) Since a bank cannot lose more than its capital reserves, the acceptance of a smaller chance of success and thus a larger risk of bankruptcy has the advantage that the expected redemption value that the bank must give its own creditors is reduced. The expected profit of the bank can be enlarged in a similar way as the profit of a lemon supplier can be enlarged by a quality deterioration of the sold product.

If all banks in a market behave this way, then the buyers of bank bonds can conclude from observing the occasional bank failure that they are buying lemon bonds and they will demand appropriate risk premia on top of the agreed interest rate. To this extent they are not cheated in the final analysis and to this extent banks as a whole do not succeed in putting themselves in a better position by increasing the risk of bank failure. On the contrary, because they choose excessively risky and unprofitable financing projects the lessening of expected loan repayments from these projects will be expressed in a reduction of expected bank profits. The welfare loss that results from the lemon bonds will be borne entirely by the banks themselves.

It is in the interest of the banks to prevent the development of such a lemon equilibrium by means of collectively agreed or government ordered rules on capital reserves. Strict bank supervision, as is carried out in Western industrial countries, solves the allocation problem.


Unfortunately, the Selection Principle again indicates dangers if bank supervision itself is exposed to international competition. Assuming that bank customers are neither able to reliably assess the risk situation of the individual bank nor the importance of national rules on bank reserves, the national regulatory agency has an incentive to be generous in controlling the banks under its supervision if foreigners are among the holders of bank bonds. The loosening of the regulatory restrictions behind the backs of the creditors leads to redistribution from these creditors to the national banks, and the larger the percentage of foreigners among the creditors, the larger the national welfare gain that arises. National market failure translates into a competition of laxity of the regulatory agencies and thus to a failure of systems competition.

Noted economists have attributed the Asian crisis of 1997 and 1998 to an excessively lax regulation of Asian banks, and there are many indications

*1 See Sinn (1980, 1982).*

that systems competition resulted in overly lax regulation. In this regard, the efforts of the Bank for International Settlements to achieve a better de facto harmonisation of bank regulation with the Basel II accord is a step in the right direction.

## Concluding Remarks

Similar examples could be added from environmental policy, health care or other areas. They would confirm that because of the Selection Principle

the more likely outcome is a failure rather than a smooth functioning of systems competition.

The implications for the necessity of international agreements and harmonisation measures including the development of a new level of government in Europe are obvious and must be taken seriously. Of course, we know all too well that market failure is not a sufficient reason for government intervention or, for that matter, that a failure of the competition among the European nation states is not a sufficient reason for Brussels to step in. The danger that the central authority will do an even poorer job than the market participants is too great. We should be careful, however, not to throw out the baby with the bath water. The proof of failure in systems competition is the necessary prerequisite for considering international regulations in the first place. In this respect the Selection Principle is important for a new design of Europe and the world. It destroys the wishful thinking that some economists, enamoured by their firm belief in competitive processes, engage in.

A counter-thesis to the pessimism that follows from the Selection Principle is that systems competition is desirable because it forces inefficient countries to become more efficient. This thesis follows the same logic as the view that private competition eliminates inefficient companies or forces them to act efficiently. Indeed, much can be said for this thesis under ideal market conditions. Inefficiently managed firms have high average costs and are forced to mimic efficiently managed firms with lower costs, if they do not want to perish. The main theorems of welfare economics probably also apply, if the managers selected by the market process are too stupid to actively implement the conditions for a profit maximum, but clever enough to mimic successful competitors who by chance picked the right policies.

The problem, however, is the assumption of ideal market conditions. If such conditions are not present, it is not easy to talk about the efficiency promoting effects of competition. Consider the example of environmental pollution to clarify the point. Without competition, a management with a romantic, nature-loving orientation could survive but under competition it has no chance. Businesses that maximise their profits and minimise their operating costs will prevail, and these are the environmental polluters.

The Selection Principle states that ideal market conditions tend to exist in private competition but not in competition between states, and this raises doubts as to the efficiency of systems competition even if national governments are too ignorant to actively pursue a policy of national welfare maximisation. For a similar reason as in the case of private firms, competition will force even the badly functioning governments to mimic their successful neighbours which managed to find better policy mixes with regard to the mobile factors of production, but, as explained, such policy mixes need not be better from an international welfare perspective. In the above-mentioned examples a maximum of nation state efficiency was assumed. The behaviour of individual countries served the goal of maximising national welfare. Despite, or better, because of the perfect achievement of this goal, systems competition turned out to be defective. As correct as the thesis that systems competition forces the nation state to seek national efficiency is, it does not follow from this that systems competition itself is efficient.

The Selection Principle is in accord with the positive view of the state that stems from traditional public sector economics as represented by Schäffle (1880), Sax (1887), Wagner (1876), Wicksell (1901), Lindahl (1939), Musgrave (1959), Timm (1961) and others. For this tradition the modern state is a necessary accompanying feature of industrialisation and urbanisation touched off by the Industrial Revolution. It arose above all to correct the deplorable conditions that were characteristic of the late nineteenth century. Cities choked in filth, the pitiable living conditions of the proletariat, poverty among the elderly, catastrophic hygienic conditions, and many other evils gave rise to a general need for government intervention in the market process. The modern European state is not a ruling instrument of feudal powers. Despite all its weakness and problems, it must be seen as an instrument for the fulfilment of collective tasks that cannot be accomplished by the private market. It is not the result of an error of history but its logical consequence. In systems competition, however, its chances are no longer all too great.

The historical selection of government tasks came about in part by competitive processes. But this was not a systems competition forced by the international mobility of production factors, but the innovation and imitation competition described at the outset, which among other things was guided by the objective of economic, cultural and military dominance and which took place within largely sealed borders. Such competition follows completely different laws than competition induced by the mobility of production factors. Indeed, in the light of the Selection Principle it is conceivable, or even likely, that the new systems competition will destroy the results of the old if we do not succeed in drastically limiting its scope. ❧

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# Comments on Hans-Werner Sinn, "The New Systems Competition"

## 1 Introduction

Professor Sinn has provided a stimulating and provocative talk. It describes a scenario in which the new systems competition leads to a crisis for some of our most cherished public sector institutions. Perhaps to provide a rallying call to action, it promotes this outcome as inevitable. The purpose of this discussion is not to dispute the forces at work, but instead to review mechanisms through which they may be moderated or even beneficial.

It should be recalled that these issues of systems competition are not new. The 1944 Bretton Woods Agreement can be seen as a milestone in providing a transnational agreement that, although liberal in some respects, prevented a race to the bottom through the use of capital controls. Keynes, the chief British negotiator commented "Not merely as a feature of the transition but as a permanent arrangement, the plan accords every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodoxy."[1]) Then, as now, transnational institutions were seen as the natural solution to the problem of externalities in inter-regional competition.

## 2 Observations and Consequences

To provide a basis for my discussion, I draw from Sinn's paper a simplified statement of the main thesis and the consequences that follow from it.

The central thesis is that competition between economic systems (capitalism versus democracy) has been replaced by competition between large trading blocs and between countries within those trading blocs. This competition involves attracting mobile factors of production by inducements such as lower tax rates. The degree of competition is enhanced by the increased mobility of capital and labor, both of which can now more easily move to exploit economic advantage. For the European Union countries, this is especially true since the completion of the Single Market.

Sinn notes that governments are designed to intervene to offset market failure within countries. Consequently, when the market failure arises in interactions between countries, there is no natural authority to make the necessary corrections. The unregulated competitive process may therefore fail at this level of interaction and hence not deliver what is efficient.

Two major consequences follow from this:

*Firstly,* tax competition will occur as jurisdictions compete for the mobile factors of production. This is seen as applying particularly to capital and to be reflected in the process of decreasing capital tax rates that have recently been witnessed in several countries.

*Secondly,* the movement of labor is expected to overwhelm welfare systems as people engage in benefit shopping. This is especially important for the European Union with its enlargement to the East.

Both these consequences can be summarized as having the nature of a "race to the bottom" as governments cut taxes and public good provision in order to compete. Such ideas have received much attention in areas of the economic literature as diverse as environmental management and financial regulation. At the heart of all of this analysis is the general idea that the policy choices of countries impose negative externalities upon others. Unless regulated, an advantage accrues to those who cut their standards and this pressurizes others to do likewise. Consequently, all will cut standards (degree of regulation, rate of tax, benefits paid etc.) to the general detriment. This is just a reflection of the usual conflict between private and social benefits that always arises in the presence of externalities.

The outcomes described in Sinn's paper are perfectly possible and may well happen. However, this is by no means certain and a range of policy options is available to mitigate the consequences. After a brief review of some salient data, the following sections will

1 *Gardner (1980).*

suggest reasons why some of the effects may be beneficial, describe theoretical results that provide cause for hope, and discuss some policy proposals.

## 3 Basic Data

This section provides some data to illustrate the extent to which taxes on capital have declined and the potential for labor mobility within an enlarged European Union.

### 3.1 Capital Taxation

A review of the statutory tax rates leaves no doubt that they have fallen steadily in a number of countries in the last few years. Care must be exercised though before it is concluded that this indicates a reduction in the effective tax upon capital since the statutory burden and the actual burden can be quite different.

There is no doubt that the revenue raised from capital taxes has been low relative to the potential tax base. This is probably due to the difficulty of defining liability in a way that prevents widespread avoidance (and probably some evasion). What matters for the effect of a tax change is the elasticity of revenue with respect to the statutory rate, and this may well be greater than one. If it is, with lower rates reducing the incentive to avoid, revenue may rise as the tax rate falls.

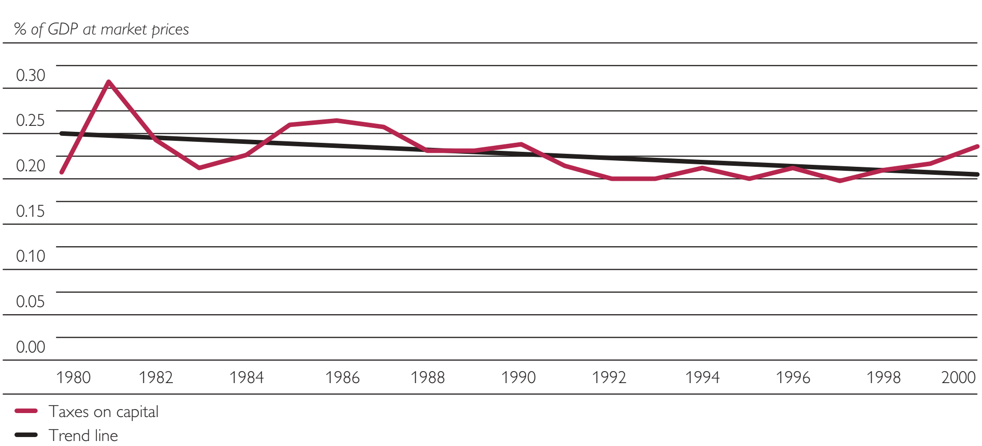
To provide some insight into this, chart 1 plots United Kingdom revenue from capital taxes as a percentage of GDP over the period from 1982 to 2001. The trend line in the chart shows that there has been a general decline in these revenues over the period. So over this twenty year period the hypothesis is supported and capital taxes decline both statutorily and effectively.

It might be expected that if tax competition is driving down capital tax rates, the process would have accelerated since the completion of the Single Market in December 1992. To test this idea, consider the data in chart 1 since 1993. It can be seen in the chart, and easily confirmed by plotting the data, that the effective burden on capital has actually risen since 1993 – the converse of what the tax competition argument would suggest.

This discussion just illustrates a very standard observation: considering statutory rates of tax never tells the full story of tax incidence. What is really relevant for economic analysis is the

Chart 1

**U.K. Revenue from Taxes on Capital**




*Source: Economic Trend 2001 (National Statistics).*

actual incidence and burden of the tax. A cursory glance at statutory rates may support the tax competition argument but it requires a comprehensive analysis of the actual burden to convincingly prove the point. As the chart above suggests, there may be some surprises when the latter is undertaken.

### 3.2 Potential Migration

One of the most disturbing claims of the paper is that migrants will overwhelm the welfare systems of the existing European Union countries once the Union is extended to the East. As a first step in establishing this argument, it has to be shown that sufficient incentives exist for such migration to take place.

The standard representation of migration in economics is that it will be driven by a combination of pure economic factors and an attachment to homeland. These ties to homeland rule out a situation of perfect mobility in which movements of labor occur in response to even the smallest of economic advantages. Although it is difficult to directly evaluate the value of these ties, so that a complete picture of potential migration cannot be obtained, at least the size of the economic factors can be detailed.

Table 1

**GDP per Capita and Population**

| | GDP per Capita GBP | Population million |
|---|---|---|
| Austria | 18,392 | 8.14 |
| Belgium | 17,397 | 10.14 |
| France | 16,596 | 58.68 |
| Germany | 18,212 | 82.13 |
| Spain | 9,665 | 39.63 |
| United Kingdom | 14,676 | 58.65 |
| Czech Republic | 3,530 | 10.28 |
| Hungary | 3,092 | 10.12 |
| Latvia | 1,659 | 2.42 |
| Lithuania | 1,741 | 3.69 |
| Slovakia | 2,536 | 5.38 |
| Turkey | 2,166 | 64.48 |
| Bulgaria | 836 | 8.34 |
| Romania | 932 | 22.47 |

*Source: The Economist.*

Table 1 provides data on average incomes (measured by GDP per capita) in some existing European Union members (top group), some of the potential "first-wave" of Eastern European new members (centre group) and some of the potential "second-wave" new members (bottom group). One point is strikingly clear from this table. Average incomes in the existing member countries are several magnitudes higher than those of potential members. In fact the United Kingdom, which is fairly representative of the European Union in this respect, has average income seven times that of Turkey and fifteen times that of Romania. It is clear that these simple figures support the contention that migration will be a very significant issue if the European Union does extend to the East. The financial incentives exist and are substantial. Significant migration is therefore a distinct possibility.

## 4 Grounds for Optimism?

The previous section has detailed some facts that are in broad agreement with the general hypothesis of the effects of systems competition. The consequences, though, need not be as bad as suggested. Two reasons why are now described.

### 4.1 Tax Differentials

One of the effects of the race to the bottom is that tax rates are reduced through tax competition and that tax differentials will not be maintained in the long-term. This is especially true when there is mobility and a single market.

In addressing whether these claims are correct, the United States makes an interesting case study. There is clearly mobility of labor (though not the income differentials identified between European Union countries and potential members shown in table 1) and a single market. Individual states are able to set their own income and sales taxes, and cities and counties can add their local taxes on top of the sales taxes.

Table 2 provides data on tax rates in ten U.S. states (actually the first ten in alphabetical order). These clearly illustrate substantial differences between the rates of both income taxes and sales taxes. If a suitable metric were adopted, these differences are likely to exceed the differences observed across the European Union countries. In fact, there are five states with a sales tax of 0% (Alaska, Delaware, Montana, New Hampshire and Oregon), although the highest city tax was 7% in Wrangell, Alaska. The highest combined sales tax rate was 11% in the city of Arab in Cullman County, Alabama, and the highest state tax was 7.25% in California.

To these observations should be added the fact that, rather than declining, the sales taxes have had a tendency to rise. Bell (2001) notes that there were 18 consecutive years of increase in the average combined rate (state plus local) until an all-time high of 8.251% was reached in 1998. The average combined rate fell to 8.231% in 1999 but increased again to 8.235% in 2000. Furthermore, the rates have been sustained even with the advent of Internet shopping that effectively allows tax-free shopping in all locations (see Goolsbee, 2000).

What conclusions can be drawn from this? Overall, this evidence seems difficult to dismiss easily. What it appears to show is an outcome in which tax competition has not resulted in a race to the bottom but instead one it which an equilibrium has been established with diversity in rates reflecting local preferences. One might even be tempted to argue that this reflects the efficiency claimed by the Tiebout hypothesis (see 5.2 below). If so, then the damaging effects of tax competition will only apply in Europe if there is something significantly different between Europe and the United States. It is not immediately clear what this difference might be. One argument could be that factors are less mobile in the U.S., though this does seem unlikely. Applied to sales taxes, such an argument makes no sense since the Internet makes cross-border shopping potentially available to all consumers which should have further reduced the differentials.

Table 2

**U.S. State Income and Sales Taxes**

| State | Income tax rates | | Income brackets[1] | | | Personal exemption | | | State sales tax[3] |
|---|---|---|---|---|---|---|---|---|---|
| | Low | High | Number | Low | High | Single | Married | Child | |
| | % | | number | USD | | | | | % |
| Alabama | 2.0 | 5.0 | 3 | 500 | 3,000 | 1,500 | 3,000 | 300 | 4 |
| Alaska | | | no state income tax | | | | | | none |
| Arizona | 2.87 | 5.04 | 5 | 10,000 | 150,000 | 2,100 | 4,200 | 2,300 | 5.6 |
| Arkansas | 1.0 | 7.0 | 6 | 2,999 | 25,900 | 20*tc*[2] | 40*tc*[2] | 20*tc*[2] | 5.125 |
| California | 1.0 | 9.3 | 6 | 5,454 | 35,792 | 72*tc*[2] | 142*tc*[2] | 227*tc*[2] | 7.25 |
| Colorado | 4.63 | Same | 1 | flat rate | | | none | | 2.9 |
| Connecticut | 3.0 | 4.5 | 2 | 10,000 | 10,000 | 12,000 | 24,000 | 0 | 6 |
| Delaware | 2.2 | 5.95 | 7 | 5,000 | 60,000 | 110*tc*[2] | 220*tc*[2] | 110*tc*[2] | none |
| Florida | | | no state income tax | | | | | | 6 |
| Georgia | 1.0 | 6.0 | 6 | 750 | 7,000 | 2,700 | 5,400 | 2,700 | 4 |

*Source: www.bankrate.com.*

[1]) *Income bracket ranges generally are for single taxpayers.*

[2]) *tc = tax credit.*

[3]) *In some states, local sales taxes are levied on top of state rate.*

### 4.2 Welfare Systems

The paper under discussion noted that most new immigrants are net recipients of benefits for the first ten years of residence. The question then, is whether the benefit system will survive the possible influx.

For some time it has been acknowledged that one of the major difficulties facing the welfare systems of Western countries is the increase in the dependency ratio facing state pension schemes (see Miles, 1999). This is due to both increased longevity and the decrease in the birth rate. It is predicted that the relatively smaller working population will face increased difficulties in supporting pension payments to the retired. This trend is illustrated in chart 2.

Given this observation, the potential benefit of inward migration becomes clear. If the inward migrants are working-age individuals then the dependency ratio will be reduced. This may allow the continued functioning of the existing pension schemes until reforms can be introduced that remove the long-term difficulties. Hence, rather than immigration being the end of the benefit system, it might actually be its savior.

## 5 Theory

The practical observations of the previous section can be supported by some theoretical observations. These are not briefly described.

### 5.1 Optimal Capital Taxation

Optimal tax theory attempts to determine the "best" tax structure according to some given measure of economic welfare. One of the most important recent results in this area is that of Chamley (1986) and its extension in Lucas (1990).

In an infinite-horizon model with optimizing agents, Chamley shows that a zero rate of tax on capital will be the optimal policy in the long run. It may initially be positive but will then decline along the equilibrium growth path. The tax burden trans-

Chart 2

**Population Structure of the Western Europe**


Source: United Nations; Miles (1999).

fers gradually to labor. If this does characterize the optimal policy, then the reductions that have been seen may just be movement along the equilibrium path to the long-run optimum. If they are, then the decrease in rate is to be approved rather than criticized.

Care, of course, must be exercised in putting too much faith in a result of this kind. The economy in which it is derived is very stylized and requires intertemporal optimization by the single consumer and the government. In addition, there is no natural way in which to interpret the long run, and even less to believe that we are currently converging to it.

**5.2 The Tiebout Hypothesis**

The seminal contribution of Tiebout (1956) established the hypothesis that competition between regions (in their choice of taxes and government provision) would lead to an efficient outcome. In essence, by voting with their feet between competing jurisdictions individuals would simultaneously reveal their preferences and join a jurisdiction that was optimal for them. This process leaves no scope for inefficiencies to arise or for a race to the bottom to take place.

A particular version of the Tiebout hypothesis can be found in Myers' (1990) work on tax competition. If labor is perfectly mobile, then it can move to benefit from the smallest differences in regional incomes. Whatever one region does is then to the advantage of all consumers. Hence any inter-regional externality is eliminated. This simple mechanism can allow efficient taxes to be sustained even if regions are competing. Although Myers phrases the analysis in terms of labor mobility, it clearly also applies to perfectly mobile capital.

How important are these results for rescuing the efficiency of the new systems competition? Tiebout's hypothesis has been subject to considerable criticism (see, for example, Bewley, 1981) and has proved a difficult hypothesis to formalize. What is clear is that it relies on fairly extreme assumptions on mobility and the availability of potential jurisdictions in order to generate the efficiency argument. However, even if reality does not conform to the required conditions

of the theory, this does not say that the forces identified by Tiebout are not at work in an imperfect world.

**5.3 Inter-Regional Transfers**

The fundamental problem of systems competition has already been identified as one of externalities. The standard response to solve such market failure is to institute a system of Pigouvian transfers between regions that precisely offset the external effects. An active center, such as the EU or the U.S. federal government, can undertake such transfers between member countries or states in order to internalize the tax competition externalities.

On the surface, these transfers would seem to be unlikely to be implemented since although socially desirable they seem not to be individually rational. If this is the case, it would therefore seem difficult to obtain consensus on their implementation. However, the argument in Hindriks and Myles (2002) demonstrates that regions may find it in their own interests to voluntarily provide such transfers. This finding is representative of the general class of observations that mutually beneficial (though individually damaging behavior) can be sustained in equilibrium when decisions are taken in separate stages.

Taken at a very literal level, it is in the nature of the European Unions that regions pay to the center and receive transfers back from the center. The two need not balance, however, thus generating transfers between regions. This process can be interpreted as having some of the features of a system that can internalize the externalities of tax competition.

## 6 Policy

The arguments so far have attempted to limit the potential damage of the new systems competition by appealing to the U.S. situation, the potential benefits of immigration and to theoretical results. These can provide some hope that the outcome may not be as bad as predicted but they are not entirely compelling. Attention now turns to possible policies that can be implemented.

The basic requirement of policy is to internalize the externalities wherever this is possible and to protect welfare systems against excessive demands. Tax externalities can be internalized by the inter-regional transfers already discussed. Within a trading bloc such as the European Union these can be made an explicit response to reduce the consequences of tax competition. To do this successfully, the center has to understand its role and to make its objectives clear.

An alternative solution is the harmonization of taxes. This was a key policy of the European Union in the 1980s (see Keen, 1993) which went some way to lessening differentials in commodity taxes. However, it no longer seems to be actively pursued. Harmonization has its problems in that it is perceived to lessen the degree of domestic control over taxation and the freedom to run independent tax policy. If it is to work though, these political difficulties may have to be put aside in order to achieve the benefits of higher levels of taxation.

If competition is across trading blocs, it becomes more difficult to achieve a solution. The obvious solution is to introduce some transnational body to oversee and coordinate policy or else hope that a solution will emerge naturally. Sandler (1997) describes the many global problems that have been confronted and solved by either formal agreement or through voluntary cooperation. Not all such agreements have been successful; the recent decision of the U.S. and Australia not to ratify the Kyoto agreement shows some of the difficulties that can arise.

The problem of immigration and welfare payments can be responded to in several ways, even accepting the principle of the free migration of labor. It is possible to restrict some benefits to only existing residents, or at least phase in entitlement so that there is no immediate major effect of immigration. A more expensive, and longer term, option would be to discourage migration by raising average incomes in the eastern countries. This is the role that regional development has already played within the European Union. The difficulty facing this policy is that the income differentials it is confronting are so much larger than anything challenged in the past. For example, even if income in the U.K. were to remain constant, it would take Latvia 23 years at 10% per annum growth to catch up.

Mention has already been made several times of the role of inter-regional transfers. The European Union could engage explicitly in such transfers in order to fund welfare payments in the lower income members. Effectively, this would involve paying the poor to stay at home rather then migrate and consume benefit payments elsewhere. The providers of the funds would benefit since its removes from them the burden of immigration. The recipients would also benefit as they would not lose their working age population and therefore retain a basis for development.

## 7 Conclusions

The challenges presented by the new systems competition are daunting and the worst-case scenario brings significant consequences. However, the outcomes do not seem to be entirely inevitable. This discussion has touched upon a range of reasons, both practical and theoretical, why this is so. There is also a range of countervailing policies that can be introduced. Some of these are protectionist, but protectionist of social security systems and benefits rather than industries. Others appeal to the role of transnational authorities to provide cover for the inefficiencies that emerge between governments. ❧

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# Podiumsdiskussion Finanzpolitik:

# Spielraum

# für regionale Finanzinstitutionen?

# Financial Policy Panel:

# The Scope

# for Regional Financial Institutions

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# Introductory Remarks

The role of regional financial institutions was until very recently clearly limited by national borders and narrow legal constraints. Fifteen years ago the questions we will discuss today would have been posed differently. This has indeed changed quite dramatically.

The successful establishment of EMU and the introduction of the euro created a new situation for the European and international financial system. Its indirect effects on the structure of European financial markets and financial institutions, in particular the European banking industry, are far reaching, but have materialized to a limited extent only today. There is little doubt that the role of regional financial institutions is and will be strongly affected by this process over the coming years.

A trend most clearly visible is a strong tendency for mergers and the creation of bigger units. In Austria the five biggest banking groups of today are the result mergers at the beginning of the 1990s. In the banking industry activities such as asset management and investment banking have grown more important at the cost of the more traditional banking business. To remain competitive at the international capital markets banks tend to merge and form bigger units. Though the empirical evidence for overall economies of scale in banking is rather limited, we cannot exclude a bigger role of those economies of scale in the future, in particular in specialized areas of the banking industry. Restructuring of banking activities as a consequence of financial market integration might take place at the cost of regional financial institutions and diminish their role and scope of business.

On the other hand we know from the modern theory of banking and financial intermediation that financial institutions often fulfill functions that financial and capital markets cannot provide by themselves. Much of these functions are related to problems of asymmetric information. This is a recurring topic in current academic research on banking and financial intermediation. Allen and Gale in their well known book "Comparing Financial Systems" write for instance "… (sometimes financial) markets are not viable because of asymmetric information, moral hazard, or something else. … Financial Institutions can overcome these problems by offering made-to-measure risk sharing contracts." (p. 17). In this context client specific relations play an important role. The very business of financial intermediation therefore partially relies on functions that are to a certain extent dependent on regional or even local knowledge. There might thus exist limits to centralization and creating bigger units. One should not underestimate the essential asset of local knowledge held by regional institutions which is of utmost importance in the business of financial intermediation. Those assets might be devalued or get lost in the course of the creation of units beyond a certain size.

I think it is necessary to enter into a deeper discussion of these issues to get a clear idea of future developments and to assess the role of regional financial institutions. A couple of questions to be addressed in this context come to mind immediately. Let me just name a few of them:

– Do only large financial conglomerates have a viable future or can regional institutions survive?
– Is there an optimal degree of concentration?
– What is the role of financial and capital markets in this context?
– Should policy interfere to avoid monopolization or should it promote the concentration process?

DIRK BRUNEEL
MEMBER OF THE EXECUTIVE COMMITTEE OF DEXIA

# The International Strategy of Dexia

## Introduction

Dexia belongs to the restricted group of European credit institutions with a market capitalisation in excess of EUR 21.3 billion (as of 30 April 2002) and is now 19th of the 25 largest publicly-quoted banking institutions in Europe and the 11th largest in the euro area. In the Euronext 100 index Dexia ranks as number 24 (as of 22 May 2002).

The data given in table 1 will allow you to locate the Dexia Group in the European financial landscape.

Few European banks have undergone such a change during the last few years as Dexia Bank. The creation of Dexia must be seen within the general and worldwide tendency towards larger entities in the financial sector since the beginning of the 1990s. At the end of 1996 Dexia was formed as a combination of Dexia Bank, known until May 2000 as Crédit Communal de Belgique and Crédit Local de France, meanwhile transformed into Dexia Crédit Local.

Established in 1860 as a public credit institution in order to finance the investments of the Belgian local authorities, Crédit Communal developed as the second largest Belgian bank, offering a full financial service to private individuals, self employed people and small companies next to its initial tasks.

This strategic choice was an answer to the challenges the banking sector was confronted with and allowed the former Crédit Communal to take control of its own future, since the original shareholders, being the Belgian municipalities and provinces, could not con-

Table 1

**The Dexia Group in the European Financial Landscape**

**Principal balance-sheet aggregates**

| | 2001 | Evolution 2001/2002 |
|---|---|---|
| | *EUR million* | *annual change in %* |
| Total assets | 351,355 | +36.3 |
| Customer deposits | 84,007 | +60.5 |
| Debt securities | 140,861 | + 4.8 |
| Customer loans | 156,379 | +16.4 |

**Ratios**

| | 2000 | 2001 |
|---|---|---|
| | % | |
| Return on equity | 17.7 | 18.7 |
| Tier 1 ratio | 9.3 | 9.3 |
| Capital adequacy ratio | 9.8 | 11.5 |
| Cost/income ratio | 55.1 | 59.5 |

**Ratings (long term)**

| | Dexia | FSA | Dexia Municipal Agency |
|---|---|---|---|
| Moody's | Aa2 | Aaa | Aaa |
| Standard & Poor's | AA | AAA | AAA |
| Fitch | AA+ | AAA | AAA |

*Source: Dexia.*

tinue to provide the necessary financial means for its further expansion.

Currently, the Dexia Group, employing some 25,000 people, has organised its activities around four business lines:

– public/project finance and credit enhancement
– retail financial services
– investment management services
– capital markets and treasury activities

For each of these four business lines a specific strategy has been worked out, that I will describe briefly later on.

The main shareholders with more than 5% of the capital are at present:

| | |
|---|---|
| Arcofin | 15.34% |
| Holding Communal | 15.04% |
| Groupe CDC | 6.99% |
| SMAP (Insurance) | 5.17% |
| | 42.54% |

In many regards Dexia differs from its European sector companions, while it was playing a pioneering role in the European integration and concentration trend.

Let us illustrate this by commenting following three items:

– Dexia as an answer to the creation of Economic and Monetary Union (EMU) and the euro
– Dexia as one of the few cross-border mergers in the euro area and as a truly European bank
– Dexia's low risk profile as a guarantee for stable revenue streams

## 1 Dexia as a Clear Answer to the Creation of EMU and Euro

There is more than one answer or valid strategy in response to the changing environment of the financial world and the challenges of the rapid developments in the information technology. Next to consolidation and large-scale entities there is certainly room for small institutions and pure local or regional players. It is difficult to say how much concentration is needed or, in other words, there is not one optimal size for a bank. Indeed, banking consists of a lot of activities, products and services and most of them certainly require a certain minimum size, but mostly a different one and it is difficult to say which is the optimal size. A lot has to do with the degree of specialisation and the choice of a targeted customer base.

Many people were convinced that the disappearance of the protection from the national currencies required to look for a larger scale, since a critical size is necessary to face the results of integrated, more transparent and competitive European financial markets. This was also the basic reason for the alliance with Crédit Local in 1996 but also for the acquisition of Artesia Banking Corporation in March 2001, securing Dexia's leading position in the Belgian market.

But Dexia was also fully aware that a financial institution couldn't be everything to everyone at the same time. Clear choices had to be made. Dexia has chosen for a limited number of business lines, but in each of these lines a full service and product range is provided and mostly at a European level or sometimes even broader. Furthermore special attention has been paid in order to have activities developed in each business line that could possibly support or reinforce the products and services in other business lines. For example the business line "capital markets" concentrates on those financial products and structures that can support or be used by the other business lines.

But in the same logic, Dexia has no ambitions in a lot of activities, such as investment banking and only small ambitions in corporate finance.

This European dimension of our activities is in line with the globalisation of the financial markets. Let us illustrate this globalisation by three examples:

– The broader and deeper euro market allowed also other issuers than central governments and banks to come to the capital markets at attractive conditions. According to figures published by the European Central Bank (ECB), the issuance activity by non-monetary financial corporations (including the special-purpose vehicles for the financing of specific assets) was very strong in 2001. Their outstanding euro-denominated debt securities increased much more (+34.5%) than for the banks (+6.8%). In the same way, the growth of the central government issuance was rather low (+5.2%) while the issuance of other authorities was high (+28.9%). This has probably to do with the pan-European budget restrictions and a growing delegation of competences from central governments. It means that financial institutions that are specialised in public finance and securitisation structuring are well positioned to benefit from these tendencies.
– Derivatives: For the year 2001 as a whole, the aggregate value of turnover in financial derivative products rose by 55% to USD 594 trillion, according to BIS-data. This was by far the largest yearly increase in activity since 1993 (the year the BIS began to compute value-based statistics for financial contracts). This upsurge reflected the nervous state of financial markets during much of the year, but also the continuing globalisation. Business in interest rate contracts grew the most rapidly (by 60%) to USD 543 trillion, with money market instruments driving the expansion (rising by 71% to USD 475 trillion). Money market business was fuelled by monetary easing as well as by broad changes in risk management practices. Overall activity in equity index contracts expanded by 10% to USD 12.8 trillion.
– The creation of Euronext (stock exchange of Paris, Amsterdam, Brussels, and Lisbon) is a first step in a European consolidation of stock exchanges that until now was hindered by differing legislation, regulations, clearing and settlement systems. Such larger scale European stock exchanges are a natural result of the integration process with many advantages to most participants and they do not exclude local or regional exchanges for smaller or mid caps.
The efforts of Euroclear's approach, involving a process of "horizontal integration" of the clearing and settlement through partnerships with other clearers, decreased the obstacles to a European-wide exchange (cf. the already estab-

lished links with Euronext and Nasdaq Europe).

## 2 Dexia as One of the Few Cross-Border Mergers in the Euro Area

The existence of different national legal, regulatory and fiscal structures and the reluctance of the national authorities have made cross-border mergers less straightforward until now. But for the Dexia project these differences were not insurmountable, thanks to a practical and decentralised organisation of the group and pragmatic solutions to enter the markets in the different core activities in which Dexia proved its experience and competence.

Initially Dexia was a French and Belgian financial institution, also present in Luxembourg through its subsidiary Dexia Banque Internationale à Luxembourg (BIL) that is specialised in private banking, asset management and fund services. In 1999 the binational holding structure was replaced by one single Dexia holding. Now a truly European character dominates the management structure of the different core activities.

This European character of the Dexia Group is a key factor in its successful acquisition policy. The reasons for the rapid external expansion of Dexia are twofold:

– to tap a bigger growth potential for each of the four business lines. The acquisitions have been in line with the strategy and activities of the business lines;
– to increase our market capitalisation in order to remain attractive for important international institutional investors, which should secure the financing capacity for further growth in the future.

## 3 Dexia's Low Risk Profile as a Guarantee for a Stable Revenue Flow

It is important to notice the continuous care that Dexia devoted to secure a steady growing revenue flow by actively monitoring a low and manageable risk profile.

Three of our core business lines, namely public finance, private banking/asset management and retail, have basically a low risk profile. Public finance credits are in general of outstanding credit quality (perennial nature of local authorities); whereas the rate of credit defaults in retail banking is very low because of the kind of credits (mortgage loans) or the strict internal credit scoring systems. Private banking/asset management for the account of private and institutional clients is fee business, with only very exceptional indemnifications, thanks to the strict description of clients' risk profile and a meticulous investment process. The activities in "Financial Markets" are developed and monitored in such a way that the low risk profile of the bank is maintained. This is reflected in the excellent ratings Dexia and its operational entities received from the international rating agencies. It is also reflected in the low cost of risk amounting only to 0.14% (= write-downs and allowances for loan losses and off-balance sheet items over gross outstanding customer loans and off-balance sheet financing commitments). Although there was a certain increase of this ratio against 2000, due to the general economic downturn and decline in asset quality, it is still a very low ratio that compares

very well with respect to the sector as a whole.

Furthermore, Dexia is expanding its activities with particular attention to the equilibrium of the intermediation revenues resulting from balance sheet operations and fee income from off balance operations. In this way, fee-business revenues have supplemented interest revenues from traditional public finance operations in many European countries from securitisations, mainly in France and Germany, and from credit enhancements in the United States and from asset management.

These relatively stable revenue flows from well-diversified activities with a low risk profile are the basis of the regularly growing results of the group. On the other hand Dexia always followed a strict cost management that allowed achieving a cost to income ratio that is among the lowest in Europe.

With an average yearly growth of net profits per share of 13.6% from 1996 to 2001, Dexia not only qualifies among the best performing European banks, but it also showed a low volatility of its results. This good track record comforted investors and it was the basis for successful capital raisings during the last few years.

## 4 Presentation of the Business Lines

Let us now briefly describe the strategy that was worked out for each business line.

### Strategy in Public Finance

Public finance must be understood in a very broad sense, not only financing of public authorities but also encompassing structured finance (projects, infrastructure), credit enhancement and financial services to social or non-profit organisations and mid corporates.

The general aim is to be a world leader in financial services to the public sector.

In the European Union Dexia has a market share of 17%. Dexia wants to consolidate this position by

– diversifying its offer of financial services in these countries where it is well established since long;
– looking for equilibrium between profitability and market share in the other countries.

Dexia hopes to acquire in each EU country a market share of minimum 15%.

The acquisition of Financial Security Assurance (FSA) in the U.S. in March 2000 for EUR 2.7 billion secures Dexia a leading position in this field since

– it opens the U.S. market for financial services to local authorities;
– it provides Dexia with know-how in the field of "credit enhancement";
– it increases Dexia's potential in the area of "securitisation" (asset backed securities);
– it opens new perspectives for new products and services to be offered to the European local authorities.

Apart from the acquisition of FSA, concrete recent actions and steps in public finance have been:

– February 2000: a 60% participation in Crediop, the Italian banker of the local authorities (in December 2001 brought to 70%). The remaining capital is placed with three regional Italian banks (Banca Popolare), namely Milano, Verona and Emilia-Romagna.
– April 2000: together with Kommunalkredit Austria a participation of 30% was taken in Prvá Komunálna Banka (PKB), a bank specialised in financing local authorities in Slovakia.

- July 2000: merger of Dexia France, Dexia CLF and Dexia Project & Public Finance International Bank into Dexia Credit Local in order to strengthen the competitive position in the French and international market for public finance.
- November 2000: replacement of a participation in Spanish Banco de Credito Local (40%) by a participation of 60% in Dexia Sabadell Banco Local (a common subsidiary of Dexia and Banco Sabadell that is specialised in public finance).
- January 2001: the participation in Kommunalkredit Austria is increased from 26.7% to 49%.
- January 2001: the participation in the Israelian Otzar Hashilton Hamekomi (OSM) is increased to 41%. This bank specialised in public finance has a market share of 12%.
- March 2001: acquisition of Artesia Banking Corporation that, in addition to its important retail oriented business lines, is a recognised player in the Belgian non-profit sector (hospitals, schools, associations, etc.).
- October 2001: buyout of 75% of Global Structured Finance (GSF) from PricewaterhouseCoopers LLP. GSF is active in the area of advice and engineering for structured finance and completes the Dexia Group's offer of products and services in this sector.

This overview clearly shows that the Dexia Group is well positioned to benefit from

- a truly European presence in public finance;
- a tendency to decentralise competences to regions and local authorities;
- the implementation of synergies between the various entities and business lines in the Dexia Group allowing a complete range of products and services;
- the increasing outsourcing of the delivery and management of public projects to the private sector;
- the growth of the securitisation market in Europe (joint offers of FSA and Dexia).

As of 31 December 2001, the total long-term credit outstanding of this business line amounted to EUR 150 billion, a growth of 10% over a year. There was also a very satisfactory increase in the amount of income from commission in the advisory or underwriting business, which amounted to EUR 25.6 million for the year.

At present Dexia's ambitions in the area of public finance in Eastern Europe are very limited. The demand for public finance activities from the local authorities in these countries is not yet developed to the same extent as in Western Europe. Furthermore, Dexia has a certain, but in general very small presence in those regions. But most activities in public finance just require a certain minimum market share that is well above our present reach.

**Retail Financial Services**

With the acquisition of Artesia BC/BACOB in July 2001 (announced in March 2001), Dexia ranks among the top three providers of retail financial services in Belgium. Bank and insurance activities have been considerably enlarged (900.000 new clients). Dexia hopes to improve the economics of its retail business through the integration of the 543 BACOB branches in its network of 930 branches, grouped in 159 "hub and spoke" clusters.

As for Dexia Banque Internationale à Luxembourg, this bank has a leading position in the Grand Duchy of Luxembourg through 44 retail banking branches. A participation of 20% was taken in the French retail bank Crédit du Nord in September 1999. All these "brick" networks are supported by a "click" offer that provides direct access to a comprehensive range of services delivered through centrally-oriented IT platforms and call centres.

Another strategic step was the creation in January 2001 of Dexia Insurance & Pensions Services, that provides global solutions for problems related to setting up and funding local and international pension plans. It assists companies in selecting, introducing and managing appropriate staff pension vehicles.

Total customer deposits and investment products increased with 34.7% in 2001 to amount to EUR 79.7 billion at year-end. Total customer loans increased with 45.5% and reached EUR 20.7 billion at the end of 2001. This was due to the broader consolidation since this growth at constant scope was respectively 0.7% and 8.1%.

For the future one might expect that the Dexia Group would expand this business line in other European countries, using appropriate distribution channels.

Dexia is convinced that the retail bank of tomorrow will function as a navigator to accompany the client in his analysis and choice among an extensive and complex European offer of financial products and services. Financial expertise will allow Dexia to model financial products and services to the specific requirements of its customers and to use the most appreciated distribution channels.

**Investment Management Services**

In this business, Dexia provides a full range of products and services to a broad spectrum of clients, including institutional investors, fund promoters, high net worth individuals, etc. Dexia is active in four main lines of activities chiefly in Europe:

- private banking
- asset management
- fund administration
- equity-related activities

These businesses are set to grow in the future as the need for financial asset management products and expertise is bound to increase due to the changes in the demographic structure in Europe and the foreseeable future of pension schemes.

The development of these activities in the last years and the various acquisitions made (Artesia BC, Kempen & Co, Labouchere, Bancoval, Financière Opale, Linde Partners, Bikuben Girobank International S.A., transformed into Dexia Nordic Private Bank S.A.) have positioned Dexia as one of the important players in this field.

Private banking is undergoing a major shift in European countries and it is Dexia's ambition to develop its franchise in other European countries, more particularly in the neighbouring countries: France and the Benelux, which is the Group's "home base". Through the acquisition of Artesia BC and Kempen & Co, Dexia has now a recognised presence in equity-related banking services.

The asset management services to a broad range of customers are conducted under one structure, Dexia Asset Management that resulted from the merger on 31 January 2002 of Dexiam and Cordius Asset Management. (Assets under management amounted to EUR 82.8 billion at the end of 2001). This united structure allows the harmonisation of the management processes, a rationalisation of the product range and a specialisation in the seven management centres, the principal ones being Paris, Brussels and Luxembourg. Dexia's investment fund administration business consists of custody services, central administration services and transfer agent services and these are provided through Dexia Fund Services (DFS) and First European Transfer Agent (FETA) and available in Dublin, Paris, Brussels, Milan, Madrid, Singapore and the Cayman Islands.

DFS provided in 2001 services to 1,067 investment funds or compartments, an increase of 13% over the previous year. The total outstanding amount in these funds reached EUR 92.2 billion. FETA saw a 15% increase in its activity volume from EUR 185.8 billion to EUR 213.8 billion.

Dexia thinks it can preserve a competitive advantage in this challenging, active and growing market. Despite a difficult environment for the securities industry in 2001 Dexia has observed further growth of 28.6% in net commissions and other income in this total business line.

Under the Dexia Securities banner different operations have been grouped:

- equity sales and trading
- equity research (expertise in some pan-European sectors)
- derivatives (options market of Euronext)
- corporate finance (most of the clients are listed small and mid caps in the Netherlands)

This new development within the Investment Management Services sector is aimed at increasing the level of services to the Group's clientele, both institutional and individual, and is approached so as to comply fully with the Group's policy of maintaining a low risk profile.

#### Capital Markets and Treasury Activities

Under this heading Dexia conducts a number of activities either relating to the central treasury functions of the Group and/or giving the necessary support to the first three business lines so as to supply the most efficient services to their respective clients. The aims of this business line are

- to secure the long-term and the short-term funding of the Group and to manage its liquidity;
- to provide financial expertise and added-value products and services to the Group's first three business lines;
- to be instrumental in the Group's assets and liabilities management process;
- to contribute to the net income of the Group as a profit centre.

These functions are conducted in accordance with the Group's risk management policy: maintaining a low risk profile and ensuring that the revenue streams provide stable cash flow.

Overall, 2001 was a good year for the Group in these activities, despite volatile and difficult market conditions. It generated a total revenue stream of EUR 636 million, despite the exposure to market risks being kept at a very low level.

### Some Final Remarks

Keeping the confidence of private and institutional investors and the financial markets in general is the big challenge for Dexia in the years to come.

With regard to transparency to the market, Dexia has stated its medium-term objectives on three financial key indicators:

- reduction of the cost/income ratio below 50%
- achieving a stable level of return on equity in the region of 20% per year
- earnings per share: corporate target of EUR 1.95 to EUR 2.00 in 2005

Therefore Dexia has developed a value based management method, which is used to adjust the targets and measure the performance of the activities in the Group and to allocate the equity capital.

The rapid external growth through acquisitions during the last few years also necessitates now to examine whether all parts and activities of the acquired companies are still in line with the mapped out strategy and are still justified from a value based management point of view.

It proves that Dexia wants to remain well focussed and loyal to its chosen strategy. For the same reason, the Dexia Group, after a review of the global exposures to the corporate sector, narrowed its target customer segments.

Dexia attaches great importance to the liquidity and market perception of its share. That is why now, more than ever, Dexia intends to be at the cutting edge of international corporate governance and sustainable development, thereby guaranteeing investors top-quality monitoring of its activities and complete transparency in its reporting. ❧

Reinhard Ortner
Chief Financial Officer,
Erste Bank der oesterreichischen Sparkassen AG

# Erste Bank Group in Central Europe – The Background of an Austrian Success Story

## 1 The Political and Economic Conditions

### 1.1 Klondike in Europe?

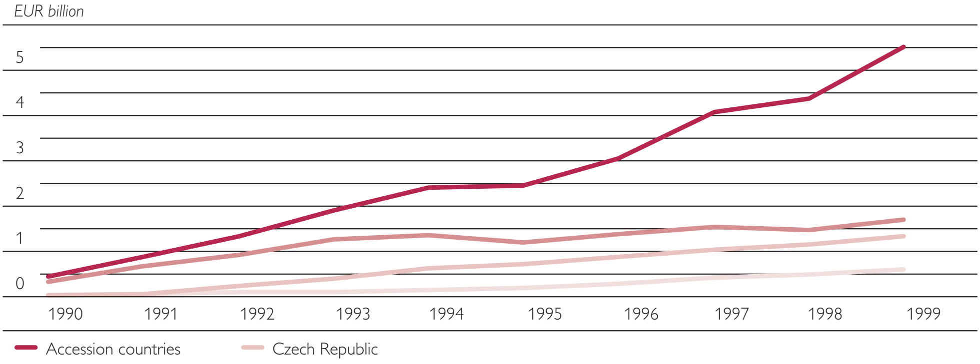
Five years ago, a bank pursuing a strategy of building up retail banking in Central Europe was regarded by many competitors with a mixture of pity and scorn. However, times have changed radically: nowadays, it is almost a requirement of good form within the banking sector to have a foothold in the Central and Eastern European countries, or to be at least on the point of acquiring such a foothold. The ignorance still prevailing only a few years ago with regard to the economic, political and cultural situation in the Czech Republic, Slovakia, Hungary, Croatia and Slovenia has given way to what almost amounts to a kind of "gold rush" euphoria. This applies not only to the banking sector, but may be observed equally within the automobile industry (e.g. Skoda or Audi), the beverage industry (Ricard Pernod and South African Breweries) or the telecommunications sector. Central Europe has unmistakably turned into a magnet for booming sectors of the economy. Numerically, this trend can be seen by studying exports and/or direct investments. Such exports/investments, coming from enterprises operating out of the EU countries and directed into the Central European states, have soared during the past few years.

On the other hand, the exports of the Eastern European EU candidate countries have increased five-fold since 1990, attaining EUR 92 billion. These two figures, even if taken alone, demonstrate very clearly how much the integration of the economies of the EU and its Central European neighbours has progressed since the break-down of the totalitarian regimes.

Not least so because, at present, the Central and Eastern European countries constitute the only real growth market in Europe, perhaps even across the globe, which, furthermore, lies

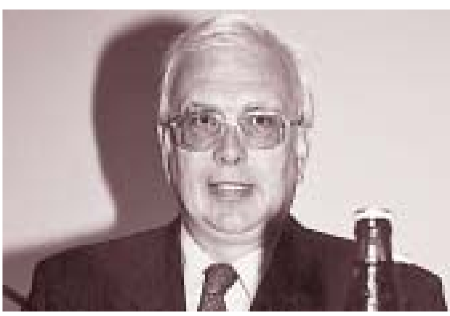
Chart 1

**Development of Austrian Direct Investments in the Years from 1990 to 1999**




*Source: OeNB, most recent figures available.*

right at the front door of the European Union. The growth potential inherent in these countries can be deduced from a comparison of the situation in Spain, Portugal or Greece before and a few years after their accession to the Union: not only the gross national product, but also prosperity in general, the investment activity in those countries and exports have markedly increased or improved. With regard to the most important economic indicators, such as the rate of inflation or the interest



rate, a convergence leading to stability within the region was noticeable even before accession.

Of course, the region with its approximately 40 million inhabitants is not the proverbial land of milk and honey. Some areas of the law are in need of reform, the infrastructure only partly satisfies Western standards and the willingness to give service in the tertiary sector has not kept pace with recent development and is still more or less at the level maintained throughout Communist times. However, on the whole, the people of all of the countries within the region show great readiness to quickly implement economic and political reforms, and, observing how swiftly and professionally privatisations are carried out and how fast leaps in technology are realized, it appears safe to assume that the implementation of the necessary reforms over the next few years will not present any serious problems. Moreover, the fact that the new policymakers in Central and Eastern Europe are often young business professionals who have gathered experience abroad and are unfettered by the political problems of the past provides additional momentum to a sustainable favourable development.

**1.2 Enlargement of the EU**

From the point of view of Erste Bank, the enlargement of the European Union is more than a contribution to the political stability of the region. It would of course have far-reaching economic consequences – mostly of an advantageous nature. For example: the integration of the economies of the candidate countries and the EU, which has been referred to above, is already more intense at this time than the economic integration among the candidate countries themselves, and it has extremely favourable effects. Numerous integration measures have already been taken in the areas of industry and financial services – though always supposing a quick accession to the EU. If the accession fails to take place or is materially deferred, there will, without any doubt, be negative effects for the economies of the candidate countries and thus for the dynamics of one of the most important economic regions in the neighbourhood of Austria.

However, from the viewpoint of Erste Bank and judging from our experience, the development of a successful regional bank is not seriously hindered by political frontiers. It is obvious that synergies cannot be exploited as fully across political frontiers as they can be within a unified economic area. But this does not mean that political decisions are an obstacle to expansion.

## 2 Success Factors and Trends in European Retail Banking

### 2.1 No Pan-European Retail Bank

Retail banking, as we understand it, means a close relationship with the customers in two respects: first, geographically, to be present locally near the customer by means of a network of branch offices and alternative distribution channels, and, secondly, a system of decisions made locally and guaranteeing quick and customer-oriented solutions, for instance as regards loans. Nobody can know the structures and requirements of the local industries better than the employees in the branch offices. There is no doubt that adequate control mechanisms are necessary, but decisions regarding loans that are taken in financial centres far away only lead to an alienation from the customer and his needs.

If this is regarded as a prerequisite for the successful implementation of a retail strategy, there will be no development towards a retail bank active throughout all European countries. On the contrary: local closeness to the customer requires an easy-to-survey radius of activity as well as a sufficient number of potential customers. A study of the development of banking throughout the European countries over the past ten years will confirm the above thesis. Several geographical regions in which profitable retail banking is carried on have evolved over the past few years: Scandinavia, the British Islands and Ireland. The Iberian Peninsula or Germany, taken by themselves, represent large enough markets, as does France. Central Europe, with its up to 40 million – depending on the geographical definition – inhabitants and, thus, potential customers, could also develop into such a region constituting a promising market for retail banking activities.

### 2.2 Erste Bank's Extended Home Market in the European Retail Banking Regions

An expansion of a bank into Central Europe, into a politically stable and economically booming region, leads, on the one hand, to a more favourable distribution of risk in markets showing different rates of economic development and, on the other hand, contributes to a heightened stability of the bank's economic development. With the economic development in Western Europe stagnating at present, and politicians spending their time in futile discussions about the exact starting point of a recession, the economic research specialists are predicting growth rates of about four percent for the Czech Republic, Slovakia, Poland, Hungary and Slovenia (see 2002/3 EU spring forecast of April 24, 2002 for EU candidate countries).

Table 1

**Selected Economic Data**

| | GDP growth | | C/A | | CPI | |
|---|---|---|---|---|---|---|
| | 2001e | 2002e | 2001e | 2002e | 2001e | 2002e |
| | *in %* | | *% of GDP* | | *in %* | |
| Czech Republic | 3.0 | 3.5 | (5.7) | (4.8) | 4.4 | 4.0 |
| Slovak Republic | 3.2 | 4.0 | (8.9) | (6.9) | 7.2 | 4.4 |
| Hungary | 4.5 | 4.8 | (3.5) | (3.2) | 7.8 | 5.5 |
| Croatia | 4.0 | 3.5 | (3.5) | (3.0) | 4.8 | 4.5 |
| Austria | 1.3 | 1.9 | (2.6) | (2.5) | 2.6 | 1.9 |

*Source: Erste Bank, EBDR.*

Chart 2

**Erste Bank's Extended Home Market**

**in the European Retail Banking Regions**


## 3 The Strategy of Erste Bank

### 3.1 Clear Focus in Terms of Geography and Content

The strategy of Erste Bank concentrates on business with the private customers and with small and medium-sized enterprises. From a geographical point of view, we limit ourselves to the region of Austria and the surrounding countries. These are the Czech Republic, Slovakia, Hungary, Croatia and Slovenia. These countries not only present us with a closed-in economic area with more than 40 million inhabitants, but are also a geographical entity of a size perfectly adapted to the structure of Erste Bank. Product-wise, our focus is on mortgage and infrastructure financing as well as investment and pension products.

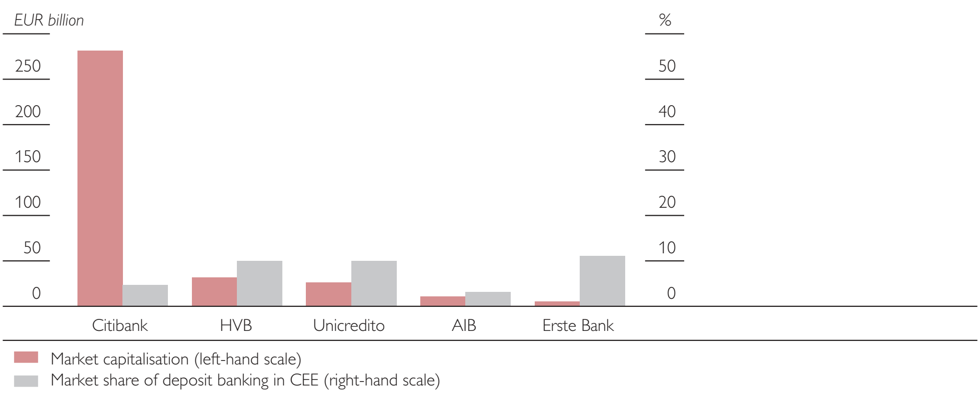
### 3.2 Customers as the Basis for Economic Success

Western European customers cannot, of course, be compared in any way to those in Central Europe. However, in this lies the attraction of the EU enlargement for the enterprises active in these markets, rendering them highly interesting to investors looking for values with a chance or potential of yielding high profits. Furthermore, in this area, the acquisition of the relevant customer structures is also more cost-advantageous. Erste Bank paid approximately EUR 400 for a customer in this area, as compared to – by now – EUR 4000 per customer in Western Europe.

It is our opinion that, within this strategy, the key to success is the number of customers attended by one institution. The larger the number of customers to which an institution has access, the stronger the latter's position within the distribution market of financial services. The more customers an

Chart 3

**The Market Strength of Erste Bank[1])**




*Source: Bankscope and GS Research.*
*[1]) Including Poland.*

institution can boast, the more attractive it will be as a partner for other suppliers of financial services who may not want to build up their own distribution network or for whom such an investment appears too expensive. An institution with a market share of between 15% and 20% will be a welcome partner for insurance companies and investment companies looking for access to this market. And, as in the food trade, any distributor whose portfolio includes an adequate number of customers will be able to fix the margins that he is prepared to pay for the products that he does not manufacture himself, but acquires by purchase.

With the acquisition of the two savings banks in the Czech Republic and in Slovakia, Česká spořitelna and Slovenská sporiteľňa, with their more than eight million customers, Erste Bank has acquired the most comprehensive basis of customer relations available within the region at present. This also brings an advantage that is almost as important for a retail bank, namely, access to inexpensive customers' money that will eventually lead to a favourable refinancing basis on the assets side.

### 3.3 Cross-Selling on the Highest Level Offers New Potential

Nowadays, retail banking in Central Europe is much less concerned with spreading basic banking services than it would have been only a few years ago. At that time, percentages were circulated that reflected the percentage of the population owning a bank account in a particular country and/or the number of enterprises that still handed out their employees' wages in envelopes. In this area, the Central European countries have caught up with amazing rapidity over the last few years,

Table 2

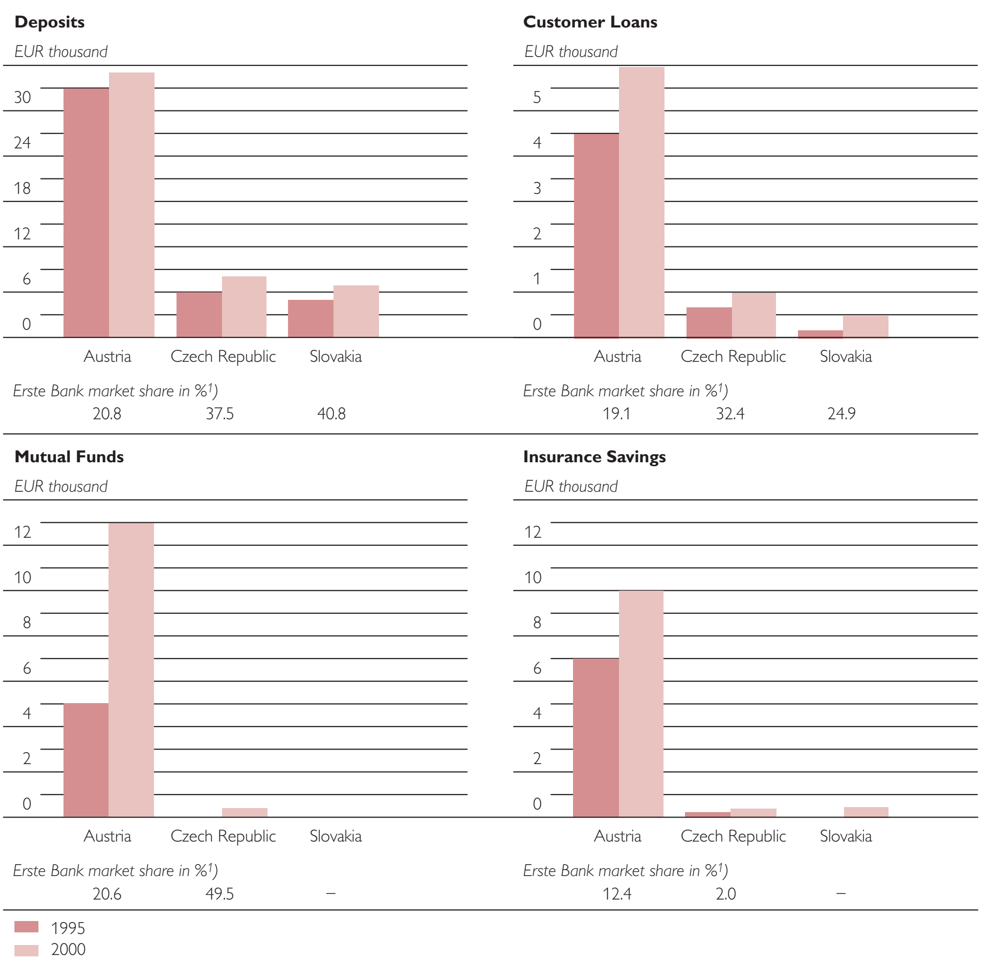
**Range of Products and Distribution Channels of Erste Bank**

| | Branch offices | Financial advisor | Callcentre | Internet |
|---|---|---|---|---|
| Austria | 1,125[1]) | ✓ | ✓ | ✓ |
| Czech Republic | 684 | ✓ | ✓ | ✓ |
| Slovak Republic | 441 | – | – | ✓ |
| Hungary | 66 | – | ✓ | – |
| Croatia | 107 | – | ✓ | ✓ |

*Source: Erste Bank, EBDR.*
*[1]) Including the 810 branch offices of the Sparkassen (savings banks) group.*

Chart 4

**Growth in Financial Assets per Household from 1995 to 2000**




*Source: Erste Bank, EBDR.*
*1) Based on 2000 Financials and market statistics.*

coming close to Western European standards almost everywhere. In the meantime, a new world is opening up in retail banking: nowadays, we are more concerned with the cross-selling of the various banking products that are (can be) offered in the relevant countries.

Comparing the current market shares of the two leading retail banks in the Czech Republic and Slovakia with the market shares held by Erste Bank in Austria, it is easy to see the enormous growth potential still present in these markets. The relation of the available incomes is approximately one to ten. While, for instance, each Austrian citizen invests approximately EUR 12,000 of his available income into funds, the corresponding value in the Czech Republic, where Česká spořitelna has a market share of almost 50% in this branch, is no more than approximately EUR 200. A comparison with the situation in Slovakia reveals similar potentials.

### 3.4 The Right Moment

In accessing an emerging market, the question of the right moment is, of course, always a fundamental one. In Central Europe, or so it seems, the most important markets – that is, from our point of view, the countries with the highest population figures – have already been divided among the various competitors. Most recently, a shifting of market shares could only be expected in Hungary and Croatia. The privatisation of the large banking firms has been completed in all countries. And, as in Western Europe, the three largest market participants in Poland, the Czech Republic and Slovakia with their subsidiaries dominate more than 50% of the market. In Hungary and Croatia, further consolidation steps are already under way or are to be expected that offer new opportunities of acquiring market shares. As recently as May 2002, this enabled Erste Bank to increase its market share in Croatia from 4% to 10% by acquiring 85.02% of Rijecka Banka, thereby expanding its customer base to 600,000 customers.

Many foreign investors are even abandoning some of their operations in this area because they are realizing that market shares of less than 10% do not constitute investments that will turn in long-term profits. Moreover, regional banks of varying financial soundness will continue to be for sale.

Experience shows that retail banking can only be carried on successfully in those economies that have reached a certain level of economic development regarding the average income or per-capita capital assets. In all other countries, investments are too risky and/or the chances of profit are insignificant owing to a lack of purchasing power.

Erste Bank has succeeded early on in quickly positioning itself as one of the leading retail banks within the region. This is true not only with regard to the market shares in important product segments, but also with regard to access to the customer groups that are important for retail banking. We are no "late comers", but "frontrunners" in retail banking, since there are just a few banks

Chart 5

**Number of Customers of Erste Bank in Central Europe**


¹) Including the 1.8 million customers of the Sparkassen (savings banks) group.

within the region that have succeeded in building up a customer base wide enough to enable them to recover their investments through the various distribution channels.

## 4 The Comparative Advantages of Erste Bank Group

### 4.1 Market Leadership Within Five Years

By concentrating on the economic area outlined above and the customer groups which have been mentioned, Erste Bank has succeeded in establishing itself as one of the most important participants in the Central European market since going public in 1997. Figurewise, the picture is as shown in table 3.

As a result, Erste Bank group and the Austrian savings banks taken together are currently handling more than ten million customers within their extended home market. This and its almost 30,000 employees make Erste Bank today's leading financial services group within the region.

Offering services ranging from capital-building to financing to insurance, Erste Bank group quite distinctly and uncompromisingly concentrates on private customers and small and medium-sized businesses. This is an essential characteristic and – as the success of the past few months has shown – a comparative strategic advantage over the competition.

The market leadership of Erste Bank group in Central Europe is not an end in itself, though. It affords the basis for increased profitability of the entire group and is grounded on a swift and effective integration of the Central European banking establishments and on regarding them to reach Erste Bank quality levels. We have demonstrated that we are able to make 1 + 1 add up to more than just 2, and to do so for the benefit of our customers, employees and shareholders.

### 4.2 Uniform Market for Customers and Employees

Tied up with the expansion of Erste Bank into Central Europe is the creation of a uniform geographical market for both customers and employees. This distinguishes our strategy from that of our competitors. As an example, Vienna is only about 50 minutes distant by car from the Slovakian capital, Bratislava, and Prague and Budapest are less than 4 hours away. Austria is a popular holiday region for Hungarians and Czechs, not only in winter, and the Croatian coast is also high up on the

Table 3

**Participation of Erste Bank Group in the Central European Market**

| | Austria | | Croatia | Slovakia | Czech Republic | Hungary |
|---|---|---|---|---|---|---|
| Bank | Erste Bank der oesterreichischen Sparkassen | Sparkassen | Erste & Steiermärkische Bank; Rijecka Banka | Slovenská sporiteľňa | Česká spořitelna | Erste Bank Hungary |
| Participation | | since 1995 | since 1998 and 2002, respectively | since 2001 | since 2000 | since 1997 |
| Balance sheet total | EUR 56.7 billion | EUR 3.5 billion | – | EUR 4.7 billion | EUR 13.9 billion | EUR 961 m |
| Branch offices | 315 | 810 | 107 | 441 | 684 | 66 |
| Employees | 4,750 | – | 2 | 6,300 | 14,500 | 950 |
| Customers | 600,000 | 1,800,000 | 600,000 | 2,300,000 | 4,900,000 | 400,000 |
| Market share | 5.50% | 45% | 10% | 41% | 32% | 3% |

*Source: Erste Bank, EBDR.*

list of favourite holiday destinations of the Central Europeans. A uniform IT-system enabling the (travelling) customer to print bank statements in the required language in all branch offices of a banking group active within the region in question and/or to carry out banking transactions in the branch offices, offers an enormous strategic advantage by comparison with those institutes whose markets are one or two thousand kilometres apart.

The employees also profit from the attractiveness of a uniform market. Leaving aside for the moment a possible language barrier, it should be no problem to change from one subsidiary of the group to another: an employee of the Slovakian investment company will be able to change over into a branch office in Austria or in the Czech Republic, just as a culturally interested Hungarian father of a family will be able to carry out his job as a customer advisor in festival towns like Salzburg, Vienna, Bregenz or Prague for a few years. These are no utopian ideas. We will still need a few years to implement them, but we are on our way.

**4.3 A Spirit of Partnership Based on a Cultural, Sociological and Geographical Advantage**

Although, from time to time, political obstacles may have to be overcome in our relations with our Central European neighbours, it is especially in the area of business that one can see how much the Central European region has grown together over the past few years. Here, Austrian businesses have an advantage – for instance over their Anglo-American competitors – not only in terms of geography but also where sociological aspects and (business) culture are concerned.

Erste Bank has succeeded in using and maintaining that advantage in its expansion strategy. It was, and still is, our goal to independently manage and expand an international group while operating from Austria. Today, the former Erste oesterreichische Sparkasse is the biggest Central European supplier of financial services with its corporate headquarters in Austria. The number of customers – which, as pointed out above, is one of the most important indicators of success for a supplier of financial services – had been increased more than tenfold, i.e. from 600,000 to more than 8 million, within 48 months of going public in 1997. What was decisive for the success of this transformation was not least the conviction of all policymakers that the independence of Erste Bank could best be maintained by upgrading it to become an important player within the Central European region. The concept behind this vision is that of partners of equal standing – meaning the countries concerned as well as the banking establishments concerned – growing together to form a new identity.

Our firm belief in the region of Central Europe and our strong orientation towards pursuing a dialogue with all the stakeholders from that region have always been present during the process of making Erste Bank the leading Central European supplier of financial services. Indeed, yet another essential comparative advantage of Erste Bank group seems to be the personal contacts and business relations throughout the region which have developed over many years. We have shown that, in an international group, personal roots not only have their place but are an invaluable asset. Openness and fairness as well as the practice of relating to shareholders, investors, analysts, customers, partners and employees in a spirit of partnership are essential aspects of our strategy and, therefore, of our success.

**4.4 "In Every Relationship, It's the People that Count" …**

… is more than a buzzword within Erste Bank group. For, in modern marketing, it is the people, i.e. the customers and employees, who are at the centre of attention. The central importance of this "human aspect" is particularly well exemplified and easily measurable in the Czech Republic, where, only a short time after its integration, Česká spořitelna has been voted the most customer-friendly bank and the third friendliest business of the country. Since the take-over, it has already won half a million new customers – and not quite by chance, it seems.

This example demonstrates clearly to what extent: the people behind the various ratios, quotations and yield figures matter, especially in the banking business. At the end of the day, it is the employees who are the most important success factors, in bringing a strategy and an idea to fruition. We at Erste Bank realized this early on, and it is of the utmost importance to us that the employees of our group, although their number may have multiplied, are familiar with our common concepts and have a clear view of the goal.

We set great store by personnel development because, if a team wants to make its way, everybody must know the direction and all must join forces. In the space of just a few years, we have managed to create a feeling among our employees that we all belong together. This feeling transcends the boundaries of individual banks and countries. The consciousness of contributing to the success of our young, Central European group and being rewarded by respect und recognition – not only in one's professional life but also in one's private environment – is a spur and motivation to many of our employees and doubtlessly quite an essential "USP" of Erste Bank group as compared to our competitors.

## Conclusion

Over the past five years, Erste Bank has proved that an Austrian business is capable of building up an international group by its own efforts, where all business policy decisions are taken in Austria. On the one hand, this success is based on the clear strategy which we have been pursuing with determination since going public, and on the other hand it is based on the motivation of our staff, who, in the main, are performing their work for the biggest supplier of financial services of Central Europe with pride and enthusiasm. ❧

Albrecht Schmidt
Spokesman for the Board of Managing Directors,
HVB Group

# Comments for the Panel Discussion on the Scope for Regional Financial Institutions

Business with regions has acquired such an appeal because the regions in Europe are experiencing a renaissance. This development began twelve years ago in Central and Eastern Europe with the downfall of an ideology and centrally planned economies which burst not only external but also internal borders. And through globalization and the competition for industrial locations, in Western Europe the same development which repelled the leveling force of the nation and welfare state is becoming perceptible so that long buried regional self-confidence is now reviving. In Britain, Scotland and Wales have already achieved more autonomy, and even in such centralist countries as France, Italy, and Spain, regions have won greater independence.

## Regional Market Anchoring

Regional financial institutions operate on the principle "all business is local." And they implement this principle by

(i) providing special proximity to the customer and regional expertise in order to respond adequately to the needs and the individuality of the regions;
(ii) decentralizing and delegating market responsibility and establishing local competence centers to keep decisions paths short;
(iii) building efficient corporate management systems which allow a top-down cascade of goals and control impulses to ensure that objectives are achieved and risk control is in place. On the other hand, these systems must also pass on bottom-up market signals to enable financial institutions to adjust flexibly to changing customer and market requirements.

Regional financial institutions have the advantage in business management terms of not having to dissipate their energy over a broad area. Instead, they focus on regional growth poles which usually hold trump cards in the form of specialization, close economic networks, and low transaction costs because they are geographically close to each other and have much in common. They profit from the competition of regions among each other which, according to Friedrich A. Hayek, is after all a process of discovery in the search for the best ideas, performances, and solutions. The attractiveness of the regions is enhanced by a sensible regional economic policy, moderate wage settlements, good public administration, good educational facilities, a pro-business climate, receptiveness to innovation and location of new business. In terms of the economy, strong financial institutions are of great advantage for the regions: Modern financial services increase their efficiency and promote their development by mobilizing savings, capital inflows and direct investments, and facilitate transactions and risk management in business. Central and Eastern Europe, the region of the future, still has much

catching up to do in this area if in addition to joining the EU these countries are also to equal Western performance and standard of living.

## Global Product Capability

Financial institutions operating in the European regions need a broad horizon and cannot ignore globalization and its demands.

(i) Global competition for risk capital as a scarce resource means that shareholders demand an adequate return. No company can afford to ignore this if it hopes to retain its independence and scope for action. Companies must thus be streamlined from top to bottom. They must concentrate on performance in the market and – as a reflection of this – reduce loss-making corporate activities, all the way down to the individual regional units.

(ii) The opening up of the markets, increasingly shorter product life cycles, and the Internet have lowered market thresholds and generated ever steeper international competition. As a result, companies must gear themselves to the market and their customers. Regional niches are tending to disappear.

(iii) One result of the liberalization and linking of capital markets is the revival of many old financing instruments such as shares and corporate bonds, but also the rise of innovative instruments like ABS and MBS and the development of increasingly complex financing solutions. This has consequences for financing structures: financings which tap the capital market are on the increase and are accompanied – in no small measure as a result of Basle II – by a re-dimensioning of credit funding. At present we are witnessing this development in the EU Member States. In the countries of Central and Eastern Europe, the still underdeveloped capital markets are profiting from the development of privately financed retirement pension systems which are further ahead than in the West. With this in mind, it is probably correct that these countries will make the transition directly to a market-oriented financing system instead of going the roundabout way through a bank-oriented financing system.

(iv) Globalization also brings larger market dimensions and makes our operations more international. This creates economies of scale and scope, in other words cost savings and new services demanded not only by global but also local customers. No longer content with traditional service, customers are demanding international product capabilities, global market links, speed, and convenience – and all this at a low price.

## The Bank of the Regions

The HVB Group which arose from the merger of two regional universal banks entitled to perform mortgage banking operations and the coalescence with Bank Austria, is meeting the challenges of both regionalization and globalization. With total assets of EUR 728 billion, shareholders' equity of EUR 25 billion, almost 70,000 employees and over 2,200 branches, it is one of the three largest banks in Europe. As a focused universal bank it no longer does everything for everyone like traditional universal banks, but instead concentrates on business segments in which it is or in the foreseeable future can become a market leader. In so doing, it pursues a distinct strategy between the two extremes of global player and niche specialist. This is the strategy of the Bank of the Regions based on its market anchoring, its resources, and its product capabilities. As such, the HVB Group is a leading bank in Germany, Austria, and Central and Eastern Europe, a market with altogether 160 million inhabitants.

At the beginning of this year, the Bank introduced a new management and control structure. Three alternatives were conceivable:

(i) A purely regional orientation. This would have meant ensuring customer proximity, regional expertise, short decision paths, but also the loss of economies of scale and global product capabilities.

(ii) A purely divisional, product-oriented stance with retention of the advantages of economies of scale and international product capability, but with the risk of losing contact to the customer and local anchoring.

(iii) Linking the regional and divisional strategies. In the past, the HVB Group had already had such a matrix organization which had proved itself to be far too complicated. It also absorbed too much energy and resources which then were lacking when it came to providing optimum customer service.

This explains why the HVB Group sought a fourth solution: a simple combination of regional and divisional management, entirely without a matrix. Here regional operations in the Bank of the Regions in Europe are linked with the global product capabilities of the Bank of the Capital Markets with which we have completed our new Group structure. The HVB Group now altogether consists of five business divisions.

## The New Management and Control Structures

In broad private customer business and in business with midsized corporate customers, what counts is regional expertise, individual advisory service, and short decision paths. For this reason we have grouped the Bank of the Regions into two regional business segments:

(i) One is the business segment Austria/Central and Eastern Europe. The leading company for our offices in this area is Bank Austria Creditanstalt. In Central and Eastern Europe, we focus especially on Poland, the Czech Republic, Hungary and Slovakia where we are in each case one of the top banks with a market share ranging from 4% to 10%.

(ii) The other regional business segment is Germany with HypoVereinsbank in the south and Vereins- und Westbank in the north.

We will continue enhancing our position through a regional brand and the cost advantages of a standardized range of products in our core markets while expanding our position in other regions of Europe as well.

The HVB Group has bundled the international product capabilities of our capital-market bank in three global business segments:

(i) We have HVB Real Estate which through the merging of three formerly independent mortgage banks has opened up opportunities for growth at home and in the international real estate business where margins are better. This segment serves professional customers in Europe and the U.S. and creates scope for new business through securitization and placing risks in the capital market.

(ii) Then there is HVB Corporates & Markets which is responsible for all activities in global capital markets for the HVB Group and for the multinationals and those which tap the capital market. It serves for product development and acts as service provider for the Bank of the Regions.

(iii) Next comes HVB Wealth Management which brings together the important growth areas, Private Banking and Asset Management. It delivers product and service solutions related to asset accumu-

lation and provision for the future for private and institutional customers. The HVB Group is a pioneer in the growth market of company retirement plans.

The goal of these global business segments is to offer topnotch advisory service to clients seeking capital market solutions and to provide them with global market capabilities.

The prerequisite for regional expertise and global product capability is consistently defined with clear management responsibility. In the newly formed management boards we have separated the operative responsibility for the individual business segments from strategic management and further development of the HVB Group, but at the same time forged a close link between strategic and operative responsibilities through the members of these boards. The Board of Directors for the HVB Group is responsible for strategic control, but in addition to the spokesman of the Board of Managing Directors, the Chief Financial Officer and Chief Risk Officer, the Board also includes the heads of the various business segments. They hold operative responsibility together with their chief operating officers at the division level in the individual business segments and member banks. In contrast, the Board of Directors for the HVB Group is responsible for the strategy of the entire HVB Group, in particular for the Group's business segment portfolio, for the allocation of resources and capital, and for controlling Group business segments. The aim of the new management structures is to enable the HVB Group to respond faster and more sensitively to changes in the market.

In short, it could be said that the concept of the HVB Group as a Bank of the Regions and global markets best fulfills the needs of customers, shareholders and employees for regionality and globality. This concept, coupled with our new management structure, constitutes a synthesis which combines customer and market proximity of a regional bank with the capabilities and cost advantages of an international bank. ❧

Axel A. Weber
Professor,
University of Cologne
Member of the German Council of Economic Experts

# Comments for the Panel Discussion on the Scope for Regional Financial Institutions

My task as the academic participant on the panel will be to put into perspective the strategies we have been hearing about and to relate them to the current economic debate. Before that, let me make two disclaimers: first, I should like to say that I speak here purely in a personal capacity. The views expressed are my own and do not necessarily reflect the views of German Council of Economic Experts. Second, I am not an expert on banking strategies. However, the organisers know that as a former Director of the Frankfurt-based Center for Financial Studies I have hosted many bankers talks and heard the entire spectrum of banking strategies and their adaptation over time, so based on that experience, I hope to have something interesting to add to this panel on the scope for regional financial institutions.

This topic is of interest because we observe two diametrically opposed trends in banking and finance today, namely globalisation/internationalisation/cross-border banking and regionalisation. Both strategies are interrelated and cannot be discussed in isolation, since they are the two possible choices for banks embarking on different avenues of geographic diversification. But why do banks diversify geographically? Two main arguments are typically referred to: first, cost synergies, usually achieved in connection with x-efficiency gains or economies of scale or scope, and second, revenue synergies, usually by moving into either less than fully competitive markets or into growing markets (which probably applies more to internationalisation than to regionalisation).

Given these two alternative strategies, which specific factors can be said to support the regionalisation of banking, that is, the strengthening local customer-client relationships? What is the key role of a regional/local bank? In the EU (and to a similar extent in the U.S., as Governor Santomero indicated over lunch) local banks typically provide credit to small businesses. Such small business loans are usually associated with a higher cost of project evaluation than loans to large firms with more established track records and reporting practices. Why is this the case? The key argument is that information access for such small businesses is typically more limited, and local banks have better access to intangible information, for example, they are aware of the reputation of the creditor in the local community. Therefore, local banks can do a better job at evaluating credit risks as they have a comparative advantage in solving the asymmetric information problems inherent in credit relationships, that is reducing adverse selection, moral hazard and the cost of the private production of information versus publicly available information, which is very limited for small enterprises. Furthermore, local banks' information advantage with respect to

small businesses is frequently given by the fact that they also simultaneously deal with their credit customers on the deposit and transaction side of the business. Such information is typically not available to non-regional credit competitors of regional banks.

So, why is regional banking not an undisputed strategy in the geographic diversification attempts of the banking industry? The answer is simple. The same factors that are behind the major advantages and opportunities offered by regional banking are responsible for the higher risks of regional banks as well, that is regional banks are more vulnerable to regional economic slow downs due to their regionally concentrated loans and deposit business. For example, in June 2001 roughly two thirds of the U.S. banks had more than 97% of their loans outstanding concentrated in a single county. Note that I said county and not state, since due to the institutional and legal set-up in the U.S. the latter would not be too much of a surprise. Local or regional shocks therefore simultaneously reduce the credit quality of many loans in a system of predominantly regional banks. The recent literature on the credit or banking channel of monetary policy transmission would suggest that this may amplify the differential regional impact of a common monetary policy if asymmetric negative shocks occur predominantly at the regional level. This is precisely why optimal currency area considerations would not favour a common monetary policy in such circumstances.

So, should we worry about banking systems with predominantly regionally concentrated banks from a systemic point of view? If regional banks are seriously exposed to regional shocks an optimal response to this would be to diversify the banks' exposures by branching out across regions, either nationally or even cross-border if necessary. In addition, this would have further benefits through exploiting economies of scale by being part of a large and strong financial group. But how pressing is the need to diversify against the adverse effects of regional shocks? Empirical evidence suggests that a considerable degree of regional diversity is present and will persist within the EU, but the occurrence of regional as opposed to national, EU-wide or even global shocks has been declining over the years. European integration and the impact of Economic and Monetary Union (EMU) are making European regions more synchronized in terms of their business cycle and inflation performance. However, empirical evidence also suggests that structural change in the European industrial landscape is causing very diverse and persistent differences in the regional employment impact of this process. Unemployment rates differ dramatically across European regions and show little tendency of convergence. Regional concentration of large business firms or even entire industries, such as coal or steel in Germany, is partly responsible for this. If regional shocks are likely to be less of a problem in the future, the exposure of regional banks to such shocks is likely to decline. At the same time the advantages of nation-wide banks in diversifying risks by operating across many regions will decline, since regions which show strong cyclical co-movements provide little diversification. Risk diversification motives therefore are likely to drive nation-wide banks to embark on pan-European or even global geographical diversification strategies, whilst regional banks are likely to focus more on their comparative advantage in credit risk evaluation at the regional and local level by providing credit to small and medium scale regional firms.

My previous remarks suggest a development in banking that may best be described by a hollowing-out scenario: large banks will grow bigger and more international, whilst regional banks will remain focussed on their core business, which is likely to remain locally contained. However regional banks are also likely to network with each other increasingly, owing to attempts to exploit scale effects. What are the policy implications from this? Let me focus on those issues that are of relevance to a central bank. Due to time constraints I will focus exclusively on supervisory issues here. Let me start with a question I asked Governor Santomero over lunch: Is supervision demand different for more (locally) concentrated regional banks? Differences in vulnerability to local developments make local information and data processing more important. Governor Santomero called this the grass-root perspective of supervision. National central banks in the Eurosystem and even regional branches of national central banks (such as the former Landeszentralbanken in Germany) will therefore have to continue to play a key role in safeguarding the soundness of the local and regional banks in the EU. Aggregating this information up through the system to the national and European level is the second, federal pillar of bank supervision that needs to be developed and strengthened quickly in Europe. Efficient and fast real time coordination across countries in the EU should be a key feature of the banking supervision system. The European System of Central Banks (ESCB) will have to play an important role in this process of understanding systematic risks locally and aggregating this information system-wide. But so far I only talked about banks, disregarding other financial institutions, such as insurance companies, asset management institutions, stock exchanges, near-banks, non-banks etc. The branching-out of financial institutions into the various lines of business and financial products complicates the coordination process considerably. This suggests that the ESCB is unlikely be the only agency involved in this financial supervision process at the European level. But institutional arrangements in this area need to be implemented soon, before the failure of a large pan-European financial institution highlights this need for action in a more obvious manner. Thus, if speed is of the essence, entrusting the ESCB with the task of building a pan-European coordination system for financial supervision seems like the natural thing to do in order to fill this vacuum quickly. ❧












Klaus Liebscher

Klaus Liebscher
Governor,
Oesterreichische Nationalbank

# The Role of National Central Banks Within the European System of Central Banks

## Introductory Statement

Welcome back to our conference. Today, we have quite a comprehensive and ambitious program on our agenda, which covers institutional matters, the issue of financial structures and of financial market surveillance in Economic and Monetary Union (EMU), as well as the question as to whether structural economic differences in EMU are a matter of concern.

I am happy and honored to welcome my esteemed colleagues and close personal friends, Jean-Claude Trichet and Arnout Wellink, both also members of the Governing Council of the European Central Bank (ECB), who have contributed substantially to shaping the European System of Central Banks (ESCB) as it exists and as it successfully operates today.

As you know, the ECB Governing Council usually takes its decisions by consensus. So, do not expect us to offer controversial views on the role of the national central banks (NCBs) within EMU simply to spark a lively debate at this conference. But we have made it a principle and good tradition to invite academics and advisors for an open exchange of views on all matters relevant in our quest for the best monetary policy for European citizens. It is thus a great pleasure for me to welcome David G. Mayes and Richard Portes, who will, as I expect and hope, help us tease out some of the more analytical issues at stake in the context of the role of NCBs within the ESCB.

The division of tasks within the ESCB is an old – and much discussed – issue. It was extensively considered in the Committee of Governors and in the Intergovernmental Conference for the Maastricht Treaty in the late 1980s, when the draft Statute of the ECB and the ESCB was being prepared. Also a considerable portion of the work of the European Monetary Institute between 1994 and 1998 concentrated on the allocation of precise responsibilities and the design of efficient procedures for deciding on, and implementing, the euro area's monetary policy.

The issue was also addressed in a previous OeNB Economics Conference in May 1998, i.e. shortly before the establishment of the ECB. On that occasion, I identified five areas of responsibility NCBs would have in EMU:

– *First,* the national central bank governors actively contribute to all central decision-making processes within the ESCB – today I have to be more specifically by saying "in the Eurosystem."
– *Second,* in this context the national central banks serve as intermediaries between the single monetary policy and national economic policies.
– *Third,* they act as the Eurosystem's operative entities in carrying out monetary and foreign exchange policies as well as policies relating to payment systems and in compiling monetary and balance-of-payments statistics.
– *Fourth,* the national central banks contribute the ECB's capital and, as "the owners" of the ECB, also receive their share of ECB income.
– *Fifth,* the national central banks, apart from being ESCB member banks, continue to exist as independent institutions and as such are free to perform additional functions on their own responsibility.

In the meantime, roughly four years later, we have gained a lot of experience in the practical functioning of the Eurosystem. What is my personal assessment of this experience in short?

– *First,* I think that the five areas of NCBs' responsibility I mentioned before, which in 1998 were still conceived to be somewhat programmatic, have very much turned out to become the reality in the Eurosystem.
– *Second,* once the rules of the game had been agreed upon – admittedly not always an easy process – the Eurosystem in its actual operation turned out to work very smoothly and efficiently.

Clearly, the operation of the Eurosystem will evolve further in the future, as the political and economic environment in which the euro area's monetary policy operates changes. There will be an evolutionary process in the course of time, and the exact direction of this evolution will be influenced by experience gained in the conduct of monetary policy and other areas of our business.

The very constructive and friendly climate within the group of personalities involved at all levels of the Eurosystem is, indeed, captured very well by the topic our first speaker this morning, Jean-Claude Trichet, Governor of the Banque de France, has chosen: "The Eurosystem: The European Monetary Team." The nature of good teamwork is that tasks and responsibilities are shared in a fair manner among the members of the team. ❧

Jean-Claude Trichet

Jean-Claude Trichet
Governor of the Banque de France

# The Eurosystem: The European Monetary Team

The Maastricht Treaty clearly defines the institutional and organisational framework of the European System of Central Banks (ESCB) and of the Eurosystem, which comprises the European Central Bank (ECB) and the 12 national central banks (NCBs) of the euro area. I am convinced that such a set-up, which combines both centralised decisions and decentralised implementation, is able to cope successfully with current and future challenges.

## The Unique and Original Set-Up of the Eurosystem Results in a Close-Knit Monetary Team

### The Unique Nature of the Eurosystem in the EU Construction

#### The Monetary Field Falls Within the Exclusive Competence of the Community

In the EU construction, the Eurosystem is a unique institutional structure, of a supranational (in a way: federal) nature. The first basic task of the Eurosystem is, according to the Treaty, "to define and implement the monetary policy of the community", in order to achieve the primary objective assigned to the Eurosystem: maintaining price stability.

The single monetary policy framework implies that:

– there are neither national nor "regional" monetary policies in European Monetary Union (EMU);
– the decisions of the ECB are binding on the entire EMU;
– monetary policy decisions are implemented in all Member States participating in EMU according to identical procedures.

Moreover, the probability of any inconsistency on *exchange rate matters* – a subject on which responsibility is shared with the EU Council – is ruled out by several provisions.

*First,* while the ultimate decision to participate in an exchange rate system in relation to non-Community currencies is to be made by the EU Council, the Treaty points out that the ECB shall be consulted "in an endeavour to reach a consensus consistent with the objective of price stability". Such a decision can indeed have important implications for monetary policy.

*Second,* the Luxembourg European Council in 1997 stated that the EU Council may formulate general orientations for exchange rate policy "only in exceptional circumstances", and that these general orientations must always be "consistent with the primary objective" of maintaining price stability and respecting the independence of the Eurosystem. This reinforces the credibility of the commitment to price stability and rules out the likelihood of any inconsistency between exchange rate policy and monetary policy.

**This Unique Institutional Setting is Enhanced by a Strong Independence Coupled with Transparency and Communication**

The *independence* of the ECB and NCBs is enshrined in the Treaty. When exercising their powers and carrying out their tasks and duties, neither the NCBs of the Eurosystem nor any member of its decision making bodies shall seek or take instructions from Community institutions, from any government of a Member State or from any other body. Independence means institutional, operational and financial independence. We consider this comprehensive definition as an essential contribution to the clarity and the credibility of the single monetary policy.

*Transparency* and *communication:* political institutions, opinion leaders of all sensitivities, enterprises, unions and public opinion at large must be fully informed on the conduct of the single monetary policy: an independent institution is in fact accountable before the public opinion. The ECB was one of the first central banks in the world to introduce, as of 1 January 1999, the concept of a regular, frequent, real-time display of the detailed diagnosis of the central bank. Indeed, once a month, immediately after the meeting of the Governing Council, the President of the ECB holds a press conference.

The independence of a central bank and its accountability are two sides of the same coin. In this respect, both public speeches and testimonies by the President of the ECB and by the governors of NCBs, to the attention of institutions as well as public opinion, are significant, and an important part of our collective duty consists in tirelessly explaining the reasons and the arguments that underpin the decisions of the Governing Council.

### The EMU Set-Up also Provides for a Permanent Dialogue with the European and National Authorities, as Well as an Operational Framework for the Co-ordination of Economic Policies

At the European level, the ECB maintains a permanent dialogue with the European Council and the European Parliament, as NCBs do with national institutions. As the Eurosystem operates with a plurality of languages, it is important that its message is conveyed by all the governors who are the natural contact point of the Eurosystem for their respective national public opinion, national media and national parliaments. This shared responsibility enables the Eurosystem to deliver a "single message" as regards monetary policy and the exchange rate.

Turning now to economic policy – that is to say fiscal and structural policies – there are sometimes questions on an alleged lack of co-ordination between Member States economic policies, in the absence of a political federation.

It is not disputable that for EMU to function well, Member States, especially the major ones in terms of GDP, must be aware of the spill-over effects of all their national budgetary policies. The existence of spill-over effects justifies the implementation of close co-ordination between national economic policies. This is contained in the Treaty itself, which obliges Member States to treat national economic policies "as a matter of common concern" and subjects them to a multilateral surveillance procedure.

Institutions and mechanisms have thus been set to promote the required level of co-ordination. A coherent operational framework has been provided for the co-ordination of economic policies through close mutual surveillance (under the responsibility of the *"Eurogroup"* and the *Ecofin Council*) and through the implementation of the *Stability and Growth Pact*. Moreover, the *Broad Economic Policy Guidelines,* discussed each year by the Heads of States and Governments, help monitor and guide macroeconomic and structural developments in the Member States.

## An Original Framework with Centralised Decisions and Decentralised Implementation

### Centralisation of the Decision Within the Eurosystem

The Treaty provides for a centralisation of the decision-making process within the Eurosystem. This contributes to strengthen confidence in the institution and credibility in its commitment to price stability.

The *Governing Council* of the ECB is the supreme decision-making body of the ECB. It consists of the six members of the Executive Board and the twelve governors of the NCBs of the Member States which have adopted the euro.

According to the Treaty and the Statute of the ESCB and the ECB, decisions relating to the objectives and tasks of the Eurosystem are taken centrally by the Governing Council which adopts the guidelines and takes the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem. In particular, the Governing Council formulates the monetary policy of the euro area and establishes the necessary guidelines for its implementation.

The *Executive Board* of the ECB is primarily the co-ordinating centre at the operational level. In accordance with the guidelines and decisions laid down by the Governing Council, it adopts implementing instructions addressed to the NCBs, which enables the Eurosystem to react and adapt to quickly changing conditions in the money and capital markets, to address specific cases and to deal with matters of urgency. To sum up, with its central co-ordinating position, the Executive Board, and thus the ECB, is the "coach" of the whole Eurosystem monetary team.

The ECB and NCBs co-operate tightly in the decision-making process through the *ESCB Committees.* Those ESCB Committees are composed of representatives of the Eurosystem central banks and, where appropriate, of other competent bodies, such as national supervisory authorities in the case of the Banking Supervision Committee. At the request of both the Governing Council and the Executive Board, they provide expertise in their fields of competence and thus facilitate the preparation of the Governing Council decisions.

#### Decentralisation of the Implementation of the Decisions: Decentralisation is Both Possible and Appropriate

In accordance with European tradition, the Eurosystem adheres to the principle of decentralisation, which stipulates that, to the extent deemed possible and appropriate, the ECB shall have recourse to the NCBs to carry out operations which form part of the tasks of the Eurosystem. This principle is the organisational reflection, within the Eurosystem, of the subsidiarity principle which underpins the whole European construction.

Given due account of the knowledge and operational experience accumulated by the staff of NCBs in the set-up of the Eurosystem, the system actually relies on the NCBs for the implementation of monetary policy, the management of foreign reserves, the collection of statistics, the issuance of banknotes, the management of large value payment systems, etc. As integral parts of the Eurosystem, NCBs comply with the internal legal instruments adopted by the Governing Council or the Executive Board. They act therefore as operative arms of the Eurosystem, carrying out on a decentralised basis the tasks conferred upon the Eurosystem in accordance with the rules established centrally by the Governing Council.

The experience accumulated since 1999 has proven that this framework is not only possible, as testified by the current practice, but is also appropriate.

- Each NCB remains the *natural contact and interlocutor* for credit institutions established in its country. They are the access points to central money in euros for national credit institutions, which have their accounts on the books of the NCBs This configuration ensures a *level playing field* for the different financial markets.
- Through the NCBs, the Eurosystem benefits from a direct access to *relevant national information*. NCBs can also channel the local needs to the European level and they are of course an important channel for communication of the Eurosystem stance to the credit institutions.

## The Cohesive Action of Each Component of the Eurosystem Monetary Team has Produced Effective Results and Concrete Benefits

### The Mutualised Assets of the Eurosystem Monetary Team

#### Common View and Culture Within the Governing Council

The Governing Council takes the most important and strategically significant decisions for the Eurosystem. Its composition represents a very fruitful ground for building a common Eurosystem identity and culture. As a matter of fact, it perpetuates a well established tradition of close relationships and co-operation, within the European Monetary Institute (EMI), and even before within the Committee of Governors of the European Economic Community (EEC), which was created in 1964 and greatly contributed to building the indispensable common approaches in the run up to EMU.

For all decisions relating to the definition and conduct of the single monetary policy, the Governing Council members vote according to the "one member, one vote" principle. NCBs' governors sit in a personal capacity, that is to say, they do not represent particular national interests; they take together the decisions best suited to the overall situation in EMU.

The smooth functioning of the Governing Council, inter alia through its bimonthly meetings, helped make the multi-cultural dimension of the Eurosystem strength. In this decision-making body, common views are formed not only on monetary policy, but also on many other issues of relevance for a central bank or linked to the additional tasks laid down by the Treaty. These common views established within the Council through frequent meetings, ultimately prove very useful for the credibility of the Eurosystem.

#### Close Co-operation and Team Spirit Between NCBs and the ECB

The Eurosystem is a team whose members work in close co-operation, and the team spirit is very strong. The organisation of the European monetary team according to the principle of decentralisation allows the system to take full advantage of the diversity of its components, by making use of existing knowledge and resources with a view to share competencies and experience and enhance the Eurosystem's identity and corporate culture.

The network of the ESCB Committees, which provide assistance to the decision-making bodies of the ECB, plays an important role in forming the co-operation spirit between the central banks of the Eurosystem. This original institutional feature has greatly contributed to the progressive constitution of a shared corporate culture.

As an example, within the International Relations Committee, issues scheduled for discussion by relevant international and European institutions or fora (International Monetary Fund – IMF, G-7, G-10, G-20, Financial Stability Forum – FSF, Economic and Financial Committee – EFC, etc.) are prepared with all Eurosystem participants. This allows the full body of the Eurosystem to build its positions on a comprehensive analysis and to show a great cohesiveness in international organisations and fora.

**The Concrete Benefits Resulting from This Original Set-Up**

Success in Terms of Credibility and Efficiency

The Eurosystem has inherited a legacy of credibility and expertise from its constitutive NCBs. The *introduction of euro banknotes and coins* on 1 January 2002 has been the last step of a now more-than-twenty-year process of monetary integration. This unique and highly symbolic event for Europe can be considered as an outstanding achievement. The way the cash change-over has been successfully handled, thanks in particular to the efficiency of the monetary team of Europe, had, for sure, a strong positive impact on the image of the Eurosystem as a whole.

As regard France, the early change-over of non-cash payments in 2001, and the rapid introduction of banknotes and coins in euro in early 2002, proved to be a success entirely in line with the scenarios devised by Banque de France in close consultation with all the involved parties (the banking sector, cash-in-transit companies, the Police and the Army, retailers, companies and consumers). It has been the same all over Europe.

The *internationalisation of the euro* also illustrates the success of the European monetary team in terms of credibility.

The euro has become a major currency in the world. As an official reserve currency, it is the second most widely used. As a bond issuance currency, according to the most recent statistics from the Bank for International Settlements (BIS), the euro has played a substantial role since the end of 1998 and accounted for around 35% of total issuance in 2001. The share of the euro in international bank assets has also increased significantly over the past two years.

Furthermore, the euro constitutes a major reference currency for exchange rate regimes adopted by third countries. Over 50 countries in the world, mainly in Europe and Africa, are managing exchange rate arrangements that include a reference to the euro. The intensive trade and financial links with the euro area are the main factors behind this choice. Of course, the adoption of a euro-based exchange rate arrangement by a non-EU country is a unilateral decision, and does not involve any commitment from the Eurosystem.

The internationalisation of the euro might develop further, thanks to an established track record of the Eurosystem with reference to its primary objective of price stability and continuing integration of financial markets in the euro area. But the Eurosystem does not pursue the internationalisation of the euro as an independent policy goal: this implies that it neither fosters nor hinders this process.

**A Successful Technical Framework, as Highlighted by the Smooth Functioning of the Monetary Policy Framework and the Operational Efficiency**

Prior to the launch of euro banknotes and coins in 2002, the launch of the euro on the financial markets, on 1 January 1999, has also been an indisputable success from a technical point of view. In this respect, three points are worth mentioning:

– the *monetary policy framework* contains a wide set of instruments chosen with a view to observing the principles of market orientation, equal treatment, simplicity, and transparency. The decentralisation of the operations has undoubtedly contributed to the smooth functioning of the framework.

Maintaining a close contact between commercial banks and their national central banks has helped the financial markets to quickly adopt the harmonised practices relating to open market operations, eligible collateral for credit operations and minimum reserve systems;

– *operational efficiency* is highlighted by the precise adjustment of banking liquidity and effective steering of short-term interest rates. The Eurosystem has demonstrated this efficiency, in the days after the tragic events of 11 September 2001, by acting quickly and by ensuring a smooth and orderly functioning of the European financial markets;
– *security* is provided by the procedures and systems implemented, both for the execution of interbank transactions, and vis-à-vis large-value payments. It is reinforced by the decentralised set-up. In particular, thanks to the setting up of the Target system for the real-time transfer of large-value payments throughout the euro area and in other EU countries, the inter-bank market became highly integrated.

The credibility of the European monetary team and of the single monetary policy, the successful changeover to the euro are major achievements. They certainly demonstrated the efficient functioning of EMU and of the European economic and financial institutional framework. Those are strong assets, which will help us to deal with two main challenges: financial stability and the accession of new Member States to the EU.

## The Flexibility of Its Set-Up Allows the European Monetary Team to Address Current and Future Challenges

### Financial Stability

#### A Growing Challenge

Like every modern and independent central bank, the European monetary team has to fulfil two main functions: firstly, ensuring price stability, a key condition for sustained growth, *and secondly, preserving financial stability,* a growing challenge in a context of globalisation of the world economy, of amplification of financial cycles, of instant access to information.

I insist on the highly complementary nature of these two objectives: price stability is the bedrock on which financial stability is built.

Maintaining financial stability might be considered as a fairly complex task nowadays. Indeed, globalisation and financial integration have significantly contributed to improving overall economic efficiency, by allowing a more optimal allocation of resources. However, experience over the last decade suggests that they also have tended to amplify financial cycles relative to business cycles, which may in some circumstances have led to somewhat erratic developments. I would also like to mention the rapid emergence of the "new economy" bubble in 1999 and early 2000, which was followed by a series of sharp corrections. As a result, financial authorities, and, among them, central banks, have been confronted with boom-bust episodes, which must be carefully monitored, since they could affect global monetary and financial stability.

The tragic events of 11 September 2001 and their impact on the financial markets have recently reinforced concerns over financial stability. The fight against the potential abuse of the financial system for the financing of terrorism has received top priority on international and European agendas. The international community is stepping up its efforts to hunt down money used by organised crime and terrorism.

To this end, all players on the financial markets should observe the rules of international legal co-operation.

#### The Adequacy of the European Monetary Team's Set-Up Enables it to Adapt Quickly to Current Financial Trends and to Contribute to Tackling Related Challenges

I would like to stress here the special responsibilities of central banks as regards financial stability, due to their position at the heart of financial systems:

– they contribute directly to supplying liquidity to the economy, via the banking sector, and might be called upon to play their role of lender of last resort in exceptional circumstances;
– because of their close and constant contact with credit institutions, their expertise in banking systems is indisputable;
– they contribute to prudential supervision and to the safe and efficient functioning of payment systems, and at least for some of them, to the safe and efficient functioning of securities clearing and settlement systems.

The present set-up of the European monetary team is appropriate to tackle the changes triggered by the current financial trends and the introduction of the euro. Their key position allows central banks to capitalise on the information-related synergies between supervisory tasks and core central banking functions. Coupled with extensive supervisory responsibilities of NCBs in domestic markets, and with reinforced co-operation at an area-wide level, their traditional focus on systemic risk puts them in a strong position to assess the potential impact of disturbances in domestic or international financial markets.

Beyond financial stability, the accession of new Member States to the EU and to EMU is the last challenge that I would like to mention, but certainly not the least.

### Accession of New Member States to the European Union and EMU

#### Attractiveness of the European Framework

Indeed, we are already working in the perspective of enlargement of the EU and, at a later stage, of the euro area.

Twelve countries from central, eastern and southern Europe are currently negotiating their accession to the EU. According to the very demanding calendar endorsed by the European Council, new accessions to the EU will take place as from 1 January 2004, that is to say in less than 19 months. This testifies again to the attractiveness of the EU framework, which has provided us with economic prosperity and political stability for half a century. When we negotiated the Maastricht Treaty, we did not think at all about enlargement. History has gone very fast. And after

27 members, we may go up further, up to 36 members or even more.

The accession countries have accomplished remarkable progress in stabilising and strengthening their economies and institutions. Observing their recent history shows the major improvements those countries have made, in hardly ten years, on the road towards convergence with the EU and the euro area.

However, we must not forget that the *nominal convergence,* which is requested in order to adopt the euro, *must be sustainable* and therefore constitutes a medium-term objective, rather than a short-term priority. Indeed, the EU Treaty calls, as a prerequisite for adopting the euro, for a high degree of sustainable convergence in the fields of price stability, government fiscal position, stability of the exchange rate, and long-term interest-rate levels. Therefore, nominal and real convergence should be pursued in parallel, and are not antagonistic, in the interest of both accessing countries and the euro area.

Moreover, *a sound and efficient banking and financial system is essential.* Significant progress has been made over the past few years in rehabilitating the banking sector and encouraging reorganisations and foreign ownership. Progress in corporate governance, the enhancement of the legal and supervisory frameworks that support the banking sector, and an efficient fight against money laundering, are also crucial. They are conducive to achieving the macroeconomic objectives of the accession countries.

### Role of the Eurosystem Monetary Team

The Eurosystem, and notably the Banque de France, is following the enlargement process with a great deal of attention. The European monetary team monitors the enlargement process, and particularly the following points, which are of particular relevance for the Eurosystem and for accession countries themselves:

– *Central bank independence is of the essence.* As I said earlier, it is an integral part of the acquis communautaire, which is laid down, not only in national legislation, but above all in the Maastricht Treaty. The effective implementation of the acquis communautaire is not only a legal prerequisite for accession to the EU. It also implies the effective transformation of accession countries' economic framework, which should facilitate their integration into the EU and, later, the euro area. In this context, it should be ensured that there is no discrepancy between the central banks' formal status in the legislation and the implementation of that legislation. Independence means institutional, operational and financial independence. We consider that comprehensive concept as an essential contribution to the clarity and the credibility of the single monetary policy. It is of utmost importance that all present and future Member States respect this economic and institutional ground rule of the European framework.
– I noted that many accession countries have already expressed their intention to join exchange rate mechanism II *(ERM II)* as soon as possible after EU entry. This intention is to be welcomed, as it facilitates nominal and structural convergence. However, it should be clear that ERM II membership needs neither to happen immediately after EU accession in all cases, nor to be limited to only two years, which is the minimum for adoption

of the euro. It would be misleading to consider ERM II as a mere "waiting room" before euro. On the very contrary, ERM II would allow countries to retain some limited exchange rate flexibility during the catching-up process. ERM II membership offers a meaningful, flexible but credible framework for increasing convergence with the euro area, for tackling the challenges faced by accession countries on the road towards the adoption of the euro, for contributing to macroeconomic and exchange rate stability, and for helping determine the appropriate level for the eventual irrevocable fixation of parities; and this, again, in the best interest of candidate countries themselves.

## Conclusion

First, the Eurosystem's track record so far illustrates that the centralised decision-making of the Eurosystem has provided a strong and coherent basis for the exercise of the missions imparted to the European monetary team by the Treaty, both in normal and in exceptional circumstances. Equally, the principle of decentralisation of operations, which is the second principle guiding the functioning of the Eurosystem, has also proved efficient. Both principles call for working out, developing and permanently improving a single team spirit, a single corporate culture within the ECB and the NCBs throughout the full body of the Eurosystem.

Second, the currency changeover has proved that the European citizens have confidence in the euro, confidence in its capacity to be a good store of value, confidence in its medium- and long-term solidity, and confidence in the capacity of the ECB and the Eurosystem as a whole to deliver price stability. This confidence is a very precious asset. It is a very important ingredient for fostering growth through consumer confidence and therefore consumer demand which is presently the main driving force behind the European economy. ❧

David G. Mayes

David G. Mayes
Advisor to the Board, Suomen Pankki[1])

# Comments on the Theme "The Eurosystem: The European Monetary Team"

The introduction of Economic and Monetary Union (EMU), the single currency, the European System of Central Banks (ESCB), the Eurosystem and the European Central Bank (ECB) has been a fascinating experience and the process continues as the EU is enlarged and the single market for financial services becomes more of a reality. It is rare to get the opportunity to be involved in the designing, moulding and implementation of monetary institutions on such a scale. Normally, even if the opportunity to "break the mould" occurs, as with the reform process in New Zealand, it is usually in the context of a specific national history and culture, not one that runs across a whole set of different experiences and traditional approaches. While the idea that EMU in Europe and the Eurosystem is in important senses "unique" can no doubt be overdone, the novelty of the enterprise is notable. The basic

1 *The views expressed here are purely personal and intended to stimulate discussion.*

ingredients of monetary policy, the provision of a currency and the efficiency and stability of the financial system are common across countries. However, beyond that, central banks can vary enormously in their requirements to regulate banks, operate cheque clearing and settlement systems etc. Nevertheless, having not merely to run across a variety of traditions and languages and bring together a set of institutions that are used to running policy in their own way is no mean task. The juxtaposition of the words "competition" and "integration" in the title of the conference is apt. Forging a new set of institutions and operating cultures involves both market and non-market forces. Sometimes these forces pull in the same direction and other occasions they contradict each other.

In these brief remarks I look at just three aspects of the evolution of the Eurosystem. In the first section I argue that much of the basis for assessment tends to be rather weak, as it relies for comparison on organisations and concepts that are superficially similar but fundamentally different. In the second I explore the implication of the core "national" element in the system for its structure and development. Finally, I briefly look forward to how the evolution may develop as we get beyond the phase of "completing" the internal market for financial services and expanding the system to admit new members.

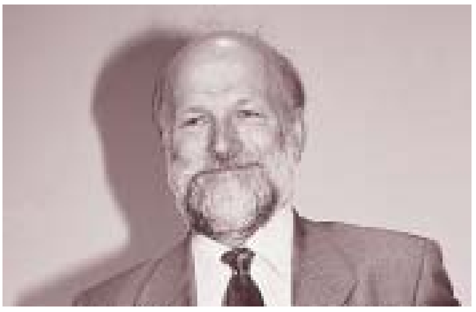
## 1 Labelling the Contents

There is a temptation to look towards parallels for what has been and can be achieved in order to make assessments of the ESCB and its components. The obvious places to look are at other central banks covering large and heterogeneous regions or at other European institutions that cover the same region but for different functions. In practice, the first comparison then focuses on the U.S., as the Peoples Republic of China, Russia and India, while in some cases larger in population, are rather too different in the services being undertaken to provide a useful basis. However, even the U.S. offers only limited comparability as the region as a whole has had a rather closer federation for over two hundred years and while the central bank itself did not get its present form for the first 140 years of the U.S. it has nevertheless been operating in a similar mode for over 70 years. Even though U.S. financial markets have remained relatively fragmented, given the regulatory role of the states, compared to the individual European countries, the common language, single currency and largely similar structure makes it much more homogeneous. European models for operating single policies are equally difficult to apply, ranging from competition policy operated by the Commission, through special agencies and the European Court of Justice, to joint action by the Council of Ministers.

Looking for a basis for comparison is thus likely to be a relatively fruitless task. If the Federal Reserve in the U.S. were being set up today it would no doubt look rather different. Technology has enormously altered the requirements for structures to say nothing of the movements in populations and economic activity over the period. The Federal Reserve Bank of San Francisco, for example, now covers 20% of the

U.S. population and 35% of the land area. It might therefore seem possible to operate with 5 districts rather than the current 12. The Federal Reserve Banks are much more similar in size than the Eurosystem banks, varying only by a factor of two despite much greater disparities in GDP and population – excluding the Federal Reserve Bank of New York, which has greater responsibilities. Even if we treat Luxembourg as an outlier, the remaining Eurosystem banks vary in size by a factor of 20. There are clearly overheads in running any central bank and anyone designing a system from a blank sheet of paper would be balancing up these initial costs against the disadvantages of great size, which may not be clearly expressed in terms of central bankers or dollar costs per head of population.

There has also been somewhat of a confusion of labels for the European monetary system. The U.S. seems to have a fairly neat and descriptive set of labels. The component banks in the system are labelled Federal Reserve Banks. The Board of Governors of the Federal Reserve System in Washington, which is responsible for the running of the system, has no further name beyond that. Thus the staff who work in Washington for the Board do not belong to some separate institution. Monetary policy is decided by a defined committee, the Federal Open Market Committee (FOMC), comprising the governors and Federal Reserve Bank presidents. The Eurosystem by contrast is not even a legal entity but a description. In part this has occurred because there is not an exact match between the members of the European System of Central Banks and those participating in the euro area. However, it has also occurred because of the creation of the ECB in Frankfurt. The Eurosystem is much less centralised than the Federal Reserve and the hierarchy of responsibility is inverted. It is the Governing Council that has the ultimate responsibility not the Executive Board of the ECB. Yet the organisation supporting the system has been labelled as a Bank. The Eurosystem has a Monetary Policy Committee but it is not the body that decides monetary policy. The confusion of labels extends to the head of the organisation, who is the Chairman of the Board in the U.S. but the President in the ECB.



These are of course only labels and once the tasks are described the position is clear. They do however provide implications for outsiders for what does happen or for what is intended to happen as time passes, which may turn out to be quite mistaken if assessments are based on the use of the same labels in their own countries.

## 2 The Core National Ingredient

While the execution of the requirements for the ESCB laid down in the Treaty is largely a technical matter, the EMU project remains at the heart of national policy-making, as it involves fiscal and monetary policy, which are two of the core activities of government. The Member States can be expected to guard their interests with considerable care. Thus while there may be no difficulty for governments (or indeed for the local electorate) with the ideas that monetary policy should be aimed a price stability for the euro area as a whole, that purely national concerns are not relevant to the discussion and that the national central bank governors participate in the decision-making in a personal capacity, not as a national representative, it would be a very difficult matter to persuade the Member States to give up a seat at the table.

One of the interesting features of the ESCB is that each Member State is treated equally, with the exception of issues relating to the capital subscribed on the basis of GDP and population. Clearly since many matters are purely technical and the members of the Governing Council do not act in a representative capacity this is not a prima facie problem. However, one could envisage circumstances where disagreement could prove awkward in a system where a simple majority can decide matters. It is therefore no surprise that the Governing Council tries to act by "consensus". Although consensus is a somewhat ill-defined word its practical definition is clearly that any minority decides not to pursue its claims. This provides a neat balance with everybody having their say and not overriding deeply held dissenting views. It is, however, an illusion to believe that monetary policy decisions cannot be taken with all necessary speed in this environment. An examination of FOMC voting records shows that most proposals are passed without dissent and that when not all parties agree, the number of dissenters is usually very small. Just because each individual has one vote it does not mean that each argument is equally persuasive.

Nevertheless, in many respects it might seem that trying to create a central banking institution with at least a dozen components and potentially around thirty would be a recipe for difficulty. It is essential to grasp such problems. The European Union is prone like any political entity to slogans, such as "strength through diversity". However, in practice diversity does indeed have a lot to offer, not least because each of the individual states have their own framework of laws, traditions of doing business, financial institutions and so on. Diversity in delivery sounds almost inevitable even with a single monetary policy and a single framework of European law applying to financial markets. This same diversity in behaviour and ideas provides important opportunities for more rapid learning in other areas of economic policy and is explicitly built into the Employment Guidelines for example. It is difficult to see why the same should not be true of monetary policy and experience in the committees of the Eurosystem tends to bear this out.

Perhaps one should not look at the central banking system as an entity but as set of functions that can be differently organised. The members of the Eurosystem, between them, have more than adequate expertise to tackle the problems that assail them at the leading edge of international skills. It is largely a matter of choice based on standard business principles as to how they should organise themselves to tackle any particular problem area. In an electronic world many activities can be undertaken without regard to location. Indeed there is no requirement for people to be stationary with respect to the ground in order to undertake many tasks including communication. The Eurosystem can thus act as a single organisation without having a single site. There is a natural assumption that increasing integration implies increasing concentration, however, in a network there is no such requirement.

Indeed, as people become more used to working with each other increased decentralisation is possible, as those working with the internet have readily discovered.

In very crude terms it is possible to divide central banks into their policy functions and their service activities. In the U.S. the Federal Reserve Banks are dominated (in personnel terms) by these service activities. These activities involve the provision of currency, payments systems and market operations, which in turn can be divided between reserves management and monetary policy implementation. Some central banks are also supervisors of the financial system and all have some responsibilities for the integrity of the financial system as a whole, including some form of lender of last resort function. Some of these service functions are location specific but the requirement of central banks to have branches to handle currency for example is negligible. There are none in New Zealand for instance. In particular, the South Island, which comprises the majority of the land area and is larger than most of Eurosystem Member States including Greece, has no branch of the central bank at all. Much of the process of issuing and returning currency can be efficiently contracted to the commercial banks. Similarly the private sector can run much of the payment system including operating the RTGS (Real-Time Gross Settlement) system. In practice much of the reserves management can be run by counterparties and central banks may in fact have little of the concept of a bank about them. There is certainly no necessity for them to be the government's bank. Hence there is no requirement to follow the U.S. model and see the national central banks in the Eurosystem concentrating on being service organisations.

On the contrary a route forward is for them to act as policy organisations. While substantial amounts of the provision of the information used in the policy-making process can be outsourced, the digesting and analysing of the implications of the information is inherently a core function. The responsibility for financial stability requires a close contact with the local financial system. Similarly the framework for monetary policy involves a close relationship with the national government, the media and the local population. The links with the population are particularly difficult to exercise across borders and indeed large countries find that they need a local presence in their regions. The Bank of Canada for example has reopened some provincial offices so that it can remain more in touch with local sentiments. An independent central bank inevitably faces an issue of legitimacy. Not only is its staff indirectly appointed but the route to affecting it if it does not appear to be fulfilling its mandate is also, deliberately, indirect. It is one thing to be independent but quite another to be "distant", where distance in this sense reflects stance and perceptions not locational separation. Many central banks make considerable efforts to be visible in local areas despite the absence of local offices, through participation in local events, direct communication in the local papers and radio. This local dialogue can be important in both directions as it helps the bank in the implementation of policy. Greater understanding of the bank can help reinforce expectations and hence reduce the "costs" of monetary policy.

It also helps in the detection of financial trends and misperceptions in advance of published statistics or more formal survey indicators.

However, this still implies that it is the local issues that are the driver of the policy as opposed to a variety of view and analysis contributing to better policy. It is this latter which is a particular strength of the Eurosystem. It is of course a coincidence that there are twelve Federal Reserve Banks and twelve national central

banks in the Eurosystem but quite a number of organisations are required to cover the range of plausible views in a varied area. Concentrating those views beforehand through a single route and then having a single "voice" present the range of views is much less effective than having the proponents promote their views in the decision-making body itself. However objective and professional the presenter, it is unlikely that second-hand views are as coherently argued. This is particularly true when a compromise has to be brokered. Even in a court of law, where the judge summarises the evidence and arguments for a jury, the jury has already heard the arguments put directly by the parties involved.

It is thus not surprising that the participating banks in the Eurosystem have been increasing rather than diminishing their policy and research functions. It is not simply that they each want their "day in court" but that they want to see the issues debated more widely by academic experts, market practitioners and of course through the media, parliaments and government. Central banks do not have a monopoly of knowledge and in an uncertain world want to see as much of the difficulties with policy strategies spelt out in advance.

There are some difficulties if national parliaments and governments are not matched by national central banks. The Finnish parliament debates the conduct of monetary policy on a regular basis and the Bank of Finland has to respond to that debate in person in parliament. It has to explain the impact of Eurosystem policy in the national context. The period since the start of Stage 3 of EMU in Finland has been characterised by less price stability than in the preceding years and clearly less than that previously required under the Bank of Finland's inflation target. The appropriate response requires not an appeal to the greater European good but to the context of the Finnish economy.

## 3 Characteristics of Maturity

One of the key features of the Eurosystem is that it is an evolving organisation. The first few years have been dominated by trying to work out how it should be organised, what systems to put in place and learning how to work with each other. Now with the system up and running and the notes and coin in circulation the pace will slow, although there is still the potential of enlargement to continue to complicate procedures. Elsewhere the process of financial integration, the impending need to implement some form of Basel II and respond to our increasing understanding of financial (in)stability and the consequential reorganisation of the regulatory and supervisory structure in Europe will continue to generate change for some time to come. It will therefore be a while yet before the system reaches even dynamic equilibrium. Over that period no doubt many of the national central banks will shrink in size as the activities become more efficient or are hived off. The Bank of Finland certainly expects to be markedly smaller five to eight years ahead. However this does not of itself imply any "centralisation" of activity, indeed the general experience of financial markets would suggest that while activities may become more concentrated or specialised, the trend is for the entire organisation to shrink including "head offices" as productivity improvements run ahead of output growth. An efficient network organisation is actually likely to be hollower.

It would be helpful to find a characterisation of the Eurosystem in this period of change that was apt, accurate and generally acceptable, particularly to those involved. Almost all analogies such as hubs and spokes are likely to be misdescriptions. Use of the word "centre" is likely to please almost nobody. The challenge is to come up with some more neutral description that makes it clear that the parts of the system are operating (harmoniously) together in a variety of interlocking roles towards a singly defined set of objectives. The word "team" is helpful in this regard, as long as it is associated with pulling together rather than with sporting events.

Even if the issue of labelling can be solved, a real challenge remains on many fronts for outsiders to understand the Eurosystem. The Eurosystem and the media are at last beginning to come to terms with the fact that disagreement over many issues including monetary policy is not only inevitable, it is the sign of a healthy and vibrant organisation, as is clear from the example of the U.S. Federal Reserve. The media has now learnt how to distinguish official statements and personal remarks. The academic policy debate has taken off and the rapid increase in research publications is helping our understanding of the choices available and of how to handle the uncertainty that inevitably faces the decisionmaker in monetary policy. The macroeconomic debate in the U.S. has been impressive for a long time. While it is not yet mirrored in Europe, the balance is changing. Ironically as the organisation matures and becomes one of the institutions of the European map its profile will tend to diminish as its reputation grows. Effective monetary and financial policy is not a talking point. In those circumstances central bankers only become a focus of attention when something goes wrong. ❧

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# Comments on Jean-Claude Trichet, "The Eurosystem: The European Monetary Team"

It is a pleasure and a challenge to discuss, perhaps more accurately to complement Jean-Claude Trichet's eloquent presentation of the European Central Bank (ECB) and the European System of Central Banks (ESCB). The difference between the two institutions is of course central to some of the issues we consider. As did Governor Trichet, I shall cover a wide range: general structural questions, the functions of the ECB, and the political context in which it operates.

Many academics who supported monetary union, myself included, voiced early concerns on two grounds related to the institutional structure of Economic and Monetary Union (EMU): the potential for conflict between the ECB and national central banks (NCBs) and the risk that the decentralised structure of financial supervision could not cope with an episode of serious financial distress.[1]) Fortunately, we were overly pessimistic.

1 *See, for example, several papers in the Special Issue of Economic Policy on EMU (Number 26, April 1998), and Monitoring the European Central Bank 1 ("Unsafe at any speed?"), CEPR, November 1998.*

On the first point, we were perhaps too influenced by the historical example of the Federal Reserve System – possibly the use of "System" in both names was misleading. It took decades for the Fed to work out a satisfactory, non-conflictual relationship between the Board in Washington and the regional Federal Reserve Banks. It has been a pleasant surprise to observe how well President Duisenberg and his colleagues on the Frankfurt-based Executive Board have defused the

natural tensions between the Eurotower and the NCBs. There has been an apparently high degree of consensus in decision-making as well as a creative use of the inbuilt, structural competitive relationships. Policies have demonstrably been set at the euro area level, rather than as a compromise among different national interests. And the NCBs have done rather well in justifying their continued existence (though perhaps not the maintenance of their previous staffing levels) as sources of local knowledge, research, and decentralised implementation of policies.

Nor have we seen any cases in which the ESCB has proved unable to deal with financial instability. The concern here was that in a crisis, one or more major financial institutions might require a lender-of-last-resort (LOLR) response, and that the unclear allocation of LOLR responsibilities might inhibit the system from reacting quickly enough.[1]) I do not agree that September 11 was a serious test, from this point of view. It did indeed require fast action to stabilise financial markets, but there was no need to make bailout decisions, no concern about systemic risk arising from illiquidity or insolvency of key financial institutions. September 11 did not raise the issues of cross-border coordination or the division of responsibility between the ECB and NCBs and fiscal authorities. In fact, we have not yet seen any serious threat to a bank with euro-area systemic significance.

One might like to believe that on both points, policy-makers just reacted effectively to the concerns we had expressed. That would be a welcome further justification for academic research and the free expression of critical academic views! An alternative or complementary explanation is that on neither point has the system really been stress-tested yet. We have not seen strong asymmetric shocks or an extended, deep recession, so monetary policy-making has been operating in a relatively benign environment. And we have not had a European LTCM or Continental Illinois, although that may indeed be a consequence of very effective financial supervision at the national level.

The underlying structural issues remain. There are well-known difficulties in managing a network structure, and here they are not compensated by any clear network externalities or economies of scale. Moreover, this is not a pure network of individual nodes, none with any special status. There is a hub, the ECB, and spokes, the NCBs; and some of the latter are "more equal than others". Theory is not much help here.

1 *See Portes, R. (2001). The European Contribution to International Financial Stability. CEPR Discussion Paper No. 2956, August.*

We do have a theory of teams, but it is based on the incentives that team members have to share information and use it effectively. Here the incentives are at best fuzzy and there are conflicts between the need to generate and use local knowledge (but distortions in aggregating it) and the desirability of centralising information and decision-making.

The NCBs themselves differ significantly. The obvious issue is that they come from countries of very widely differing economic weight and characteristics – from Germany to Luxembourg, a much wider range than across U.S. Federal Reserve regions. Yet the rule is one governor, one vote. In practice, of course, we can expect that discussion and consensus formation will incorporate informal weighting, just as the aggregate euro-area data on which decisions are based incorporate formal weighting. Still, there are other differences as well – in research capacities or specialisations, for example (an issue of great interest to academics), which affect the perspectives and authority that individual governors bring to the discussions. Yet there is more symmetry than in the Federal Reserve System, insofar as no euro-area NCB has a role analogous to the money market centre status of the New York Fed. There may be political constraints that preclude the emergence of any single NCB with this status in the euro area – although U.K. entry might lead unavoidably to a de facto role of this kind for London.

Structure is intimately related to function. Let me take up two points regarding the functions of the ECB. First, although current arrangements for setting monetary policy seem secure, they become an issue with enlargement.[1]) The composition and voting structure of the ECB could quickly become unwieldy and its flexibility overly constrained. The Nice outcome specified that the ECB should itself come forward with a proposal to deal with this, or failing that, the Commission should offer its proposal. Neither has spoken. Enlargement, we must hope, will proceed according to the agreed timetable and bring in new members in 2004. It would be unwise to delay the discussions and negotiations on ECB voting structures until then, or indeed until the ratification of the Nice Treaty or the outcome of the constitutional convention. Academics have of course put several options on the table, such as a monetary policy committee along the lines of the Bank of England Monetary Policy Committee – perhaps the presence of "independent" members, including academics, enhances its appeal. It is improbable, however, that any proposal transferring monetary policy authority away from NCB governors would emerge from the ECB. But would they prefer a rotation scheme, a constituency scheme, or what? They should tell us sooner rather than later.

Second, a key function of both the Frankfurt-based ECB staff and many of the NCBs is research. We should hear more open discussion of the justification for NCB research activities, except insofar as they might relate to national functions (financial system supervision and regulation, in particular). If there is a euro-area policy – as I believe there

1 *See Baldwin, R., et al. (2001). Preparing the ECB for Enlargement. CEPR Policy Paper No. 6, October.*

is – what is the need for national macroeconomic and monetary research, except possibly for a few of the largest countries? Even if one posits a case for competition – among NCBs and with the ECB – one might argue that three or four major competitors would suffice. In practice, some of the smaller central banks are important contributors to euro-area central bank research output – including, of course, our hosts at this conference – and it would be helpful to know more about how this work interfaces with that conducted at the ECB.

The two final issues I wish to raise both have significant political dimensions. First, I have criticised the ECB for its "neutral" stance on the international role of the euro, and more broadly for its reticence regarding unified euro-area representation in international financial institutions and discussions.[1]) Europe's influence is not in fact enhanced by having four members of the G-7 and several Executive Directors in the International Monetary Fund (IMF), especially since they seldom put common positions. It is encouraging that the International Relations Committee of the ESCB has finally agreed a European position on sovereign debt restructuring. That it does seem to have influenced the United States significantly, and this is reflected in the April 2002 G-7 Action Plan, shows that a common European view can have weight. The implications are clear.

Second, both proponents of enhanced EU political union (especially in Germany) and sceptics about EMU (especially of the "Anglo-American" variety) have maintained that greater political integration is essential to underpin a single monetary policy. The arguments range from the supposed need for a federal fiscal policy to the problems of ensuring democratic accountability and legitimacy for monetary policy decisions that can sometimes be politically divisive. I disagree on economic grounds, because national fiscal policies, when properly run, can provide the necessary complement to a centralised monetary policy. But on the political argument, there are concrete counterexamples. The European Commission has sole competence in both competition policy and trade policy – these are not domains in which the Member States or the Parliament have any authority. Of course the relevant Commissioners and their staffs do communicate closely with national authorities and Parliament, but the Commission has decision-making power. And these two domains are at least as politically sensitive as monetary policy. Greater federalism is not required to sustain their legitimacy. Nor is it required to buttress the ECB and EMU. ❧

1 *Portes, R. The euro and the international financial system. CEPR Discussion Paper No. 2955, forthcoming in: Buti, M., and A. Sapir (eds.). EMU: Early Challenges and Long-Run Perspectives.*


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# The Role of National Central Banks Within the European System of Central Banks

## Introductory Statement

As Governor Trichet has already outlined in his speech national central banks (NCBs) in the European System of Central Banks have to cover a very wide range of tasks. These tasks range from preparing the analytical basis for monetary policy decisions, the participation in the decision-making process itself over to its operational implementation at the national level. NCBs are responsible for producing reliable statistical data and concise economic analyses as well as for the provision of liquidity, banknotes and coins and the functioning of the payment system. And, above all, NCBs have to make sure that the monetary policy which is decided on the European level is well understood by national financial markets and the general public.

One task which is of utmost importance and on which I want to focus today is the contribution of NCBs in the field of financial stability and, more in particular, the institutional structure of banking supervision in Europe.

The current banking supervisory system in Europe is essentially based on three pillars:

(i) harmonization of regulations across Europe,
(ii) national regulatory powers, and
(iii) bilateral and multilateral cooperation.

In line with the principle of home country supervision, every bank has the right to offer its services throughout the European Union, the only legal requirement being a single license, the so-called European passport. In order to cover the cross-border activities, bilateral cooperation between home and host country supervisory authorities – within and outside the EU – is regulated by means of a variety of memoranda of understanding.

The above-mentioned arrangements are complemented by cooperation platforms at the multilateral level. Let me deal briefly with just a few of them:

The Eurosystem body responsible for banking supervisory cooperation is the Banking Supervision Committee (BSC), which was set up by the ECB and is composed of senior representatives of central banks and banking supervisory authorities of all 15 EU Member States. Another body on the level of the European Union involved in banking regulation is the Banking Advisory Committee (BAC), which is made up of representatives of the banking supervisory authorities, finance ministries and central banks.

Let me now turn to the European debate currently underway. Financial markets change a lot and the introduction of the euro certainly brought in a new structural element that has to be reflected in the institutional setup when it comes to financial market regulation and supervision.

The adequacy of the existing arrangements for prudential supervision and the safeguarding of financial stability in the European Union have recently been assessed in two reports produced under the outstanding chairmanship of Henk Brouwer from De Nederlandsche Bank. The outcome of the analysis was that the current institutional system based on national responsibility is appropriate, but that there is a need to strengthen cross-border and cross-sectoral cooperation between supervisors. This is to enhance convergence of supervisory practices and to reinforce collaboration between supervisors and central banks.

Only recently a new debate has been launched by a letter written jointly by the German and British Ministers of Finance. The aim of this letter is to streamline the Community financial regulatory process in analogy to the proposals made by the "group of wise men," led by Alexandre Lamfalussy, in the field of securities regulation. The burden of detailed and cumbersome regulation at the Community level shall be removed by delegating rule-making powers to a committee of regulators and by promoting consistent implementation at the national level through a committee of supervisors. Extending such a mechanism to banking and insurance would probably also produce tangible benefits, though differences existing between the three sectors should also be taken into account.

The Council of Ministers has decided to have the institutional structure of financial supervision reformed. A final report shall be delivered in September this year. My opinion in this regard is that an improvement in the decision making process is always welcome. However, by reforming the system two principles should be respected:

(i) The involvement of all those who play a role in preserving financial stability and improving financial regulation in the respective committees must be ensured: This means ministries of finance, central banks and supervisors shall all be represented in new institutional formats.

(ii) One should not re-invent the wheel, but rather start from existing structures and try to improve their functioning. As the Brouwer report concluded: what is needed is not the creation of new institutions, but rather an improvement of the cooperation between existing bodies.

The first drafts of the reform ideas that are circulated currently appear to go into the wrong direction: NCBs shall be excluded both from decision-making and from advisory bodies with respect to banking regulation and supervision. The only forum where NCBs shall be represented would be a very large forum on financial stability of no particular institutional or decisional importance.

We are still in the middle of the discussion process, but I would like to urge not to underestimate the importance of having central banks on board in the area of financial supervision. The reasons for this range from the profound central banks' knowledge of the national banking industry to the link between micro- and macro financial stability and the issue of crisis management. My warning would therefore be to very carefully analyze different possible options before rearranging the institutional framework of financial supervision in Europe – leaving NCBs aside can certainly not lead to an optimal solution. What is at stake is the stability of the European financial market – and this should not become

subject to short-sighted political war games.

The contribution of NCBs to the stability of financial markets is one of the most important tasks to be met in the future, but it is only one task of NCBs in the European System of Central Banks among others, as was already pointed out. De Nederlandsche Bank is certainly one of the leading NCBs with respect to the professional conduct of its supervisory functions in the banking sector. I am therefore very glad and honored to announce Arnout Wellink, the President of De Nederlandsche Bank, who is also member of the Governing Council of the ECB, as our next speaker. ❧

Arnout H. E. M. Wellink

Arnout H. E. M. Wellink
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# The Role of National Central Banks Within the European System of Central Banks: The Example of De Nederlandsche Bank

## Introduction

Monetary policy is one of the few areas of European integration where there is a genuinely supranational policy. In considering the role of central banks in general, the main focus of authors is typically on monetary policy (e.g. Fischer, 1995). The same focus is evident among those who have considered the role of national central banks (NCBs) within the European System of Central Banks (ESCB).[1]) Seen from this perspective, the transfer of monetary policy sovereignty from individual countries to the European level since 1999 has raised questions about the ongoing role of national central banks. However, central banks also have a number of other tasks. This paper takes

1 *See, for example, De Nederlandsche Bank (2000) and Goodfriend (1999). For convenience, and consistency with the Treaty, the paper refers to the ESCB (which includes all EU central banks), even though some EU countries have not adopted the euro.*

a broader perspective and considers the position of NCBs in the context of the ESCB with respect to the full range of tasks carried out.

We set out a number of criteria to evaluate the division of ESCB tasks, review the current assignment of tasks and consider how they are likely to change in the future. Moreover, NCBs also fulfil non-ESCB tasks. For De Nederlandsche Bank (DNB), these non-ESCB tasks span a wide range of policy areas that are indirectly related

to our ESCB responsibilities and occupy around 50% of staff.[1]) These tasks are not specified by the Maastricht Treaty, but are agreed upon with the respective national governments. The role of NCBs in carrying out these other tasks is discussed, using the example of DNB.

To preview the conclusions, our current system is likely to continue to evolve over coming years as we gain experience with monetary union and efficiency gains are exploited. As long as nation states remain in existence, it seems unlikely, for various reasons, that the role of national central banks will alter completely.[2]) Although major changes in the way in which the system is organised can be expected, most of them are only likely in the long term, by which we mean more than a generation.

The paper continues in section 2 with a discussion of the criteria proposed for evaluating the distribution of central banking tasks within the European context. Section 3 discusses the current role of NCBs within the ESCB and the possible future evolution of these tasks. Section 4 discusses the non-ESCB tasks that DNB is responsible for and section 5 summarises the main findings.

## 2 A Framework to Analyse the Division of Tasks

Ideally, a "normative literature" on central banking would provide guidance on what central banks should be doing, including

(i) the tasks the Eurosystem should be fulfilling and
(ii) an optimal division of these tasks between a centre (the ECB) and national central banks. Such a normative literature on central banking is, however, lacking. Instead, we establish some criteria against which the current division of tasks can be assessed. In the European context, the Maastricht Treaty forms the basis for the current assignment of tasks. It is based on the idea that the ESCB as a system shares a number of tasks. Given this common responsibility, all participating central banks – be it the ECB or NCBs – have to be involved in all relevant policy areas. In addition, all participating central banks have

1 *In this regard, we also count tasks such as banking supervision as "indirectly related" to monetary policy, as is explained below in section 4.2. Note, however, that not all NCBs perform this task.*

2 *The conference theme concerns a Europe of regions. Regions can obviously be defined in different ways. Regions which are economically integrated need not necessarily correspond to the geographic boundaries of nation states (which form political regions). However, NCBs are linked to nation states. Given that, the regional analysis in this paper is linked to political regions.*

to have the means to fulfil these tasks for which they are collectively responsible. Within this overriding framework, the Treaty refers to two broad principles: first, the idea of subsidiarity, i.e. the current system was created out of respect for national sovereignty within some basic rules set by the EU, and not on the basis of better coordination or centralisation per se. This also reflects the heterogeneity of the Member States. Consequently, any task should be performed at the lowest regional level possible and there are limits on the extent to which national tasks can be centralised. Second, the Treaty emphasises the idea of efficiency, i.e. where can the task be effectively undertaken at the least cost?[1]) There is a relationship between both principles, in that subsidiarity (and the benefits that come with it – see below) should prevail, but gross inefficiencies should be prevented or eliminated.

The Maastricht Treaty specifies the tasks to be carried out by the system, but in most cases is not specific about which part of the system should undertake them. The following sections consider the extent to which the allocation of tasks conforms with the subsidiarity and efficiency criteria proposed. The concept of effectiveness subsumed in the efficiency principle includes, inter alia, the following aspects:[2])

– A system of checks and balances form part of ensuring the accountability of independent central banks. Because the ESCB independence is contained in an international treaty, unlike other central banks where independence can be overturned by a parliamentary majority, accountability arrangements are particularly important as a counterpart to this independence. The lack of credible accountability arrangements could undermine public and political confidence in the monetary union and therefore the effectiveness of monetary policy.
– One of the key "ingredients" for monetary policy is the accurate assessment of market sentiment and expectations, and of economic developments. A system of NCBs spread across Europe can potentially provide a better picture of sentiment within the entire euro area than a single, centralised body.
– NCBs are important channels for ESCB communication, as they are more closely linked to their national audiences. They are more aware of national traditions, cultures and histories, and can therefore potentially better tailor communication to the needs of the local population. Moreover, it may be particularly "reassuring" for the public in countries where economic developments diverge from the euro area average if "their" NCB governor is seen to participate in the formulation of the single monetary policy, even though the governor's decisions are based on euro-wide considerations. These national governors are then better able to explain the consequences of European monetary policy.

The above-mentioned framework can be used to assess the allocation

1 *This principle has also been stressed by the ECB. See European Central Bank (1999), p. 57. A framework based on similar considerations has also been proposed for the re-organisation of the Bundesbank after the adoption of the single monetary policy. See Kösters et al. (2001) and Deutsche Bundesbank (1999).*

2 *Note that not all of the aspects of effectiveness discussed here are relevant for every task carried out by NCBs.*

of Treaty tasks between the ECB and NCBs. Throughout the analysis we first examine the current situation and then consider likely changes in the future.

## 3 The Division of ESCB Tasks Between ECB and NCBs

### 3.1 Monetary Policy Decisions

Monetary policy-making covers a number of aspects. This sub-section discusses the role of NCBs in decision-making, in research activities underpinning those decisions and in the communication of decisions.

The Treaty provides that the meetings of the ECB Governing Council (which formulates monetary policy) are to be prepared by the Executive Board of the ECB. The main task of the ECB in this respect is to lay the groundwork for the monetary policy decisions of the Governing Council. NCB governors (together with ECB Executive Board members) decide on monetary policy, requiring the NCBs to brief their governors (and this briefing has to be an interactive process) so that they can carry out this joint responsibility. NCBs are therefore involved in research and the preparation of monetary policy decisions.[1]) That is, the need to conduct independent research inter alia arises from the obligation NCBs have to fulfil their role in carrying out the tasks the ESCB as a system has been assigned. Certainly for NCBs such as DNB, which prior to Economic and Monetary Union (EMU) had maintained a fixed exchange rate vis-à-vis the German mark, monetary policy preparation has become more complex. It now requires the analysis of economic variables and monetary indicators for the euro area as a whole.[2])

These current arrangements are explicitly set out in the Treaty, so are fixed for the time being. However, the composition of the Governing Council has been the subject of debate, with some arguing for limits on the number of NCB governors. It has been argued that decreasing the numbers of national governors may increase effectiveness, since having twelve NCB governors participating may exceed the optimal "club size" for monetary policy decisions.[3]) This could make it difficult for the Council to engage in effective debates over policy decisions and hamper the development of a cohesive decision-making body. A further argument against including all NCB governors is that the Eurosystem has to guard against the perception that European monetary policy could be sub-optimal for the following reasons (e.g. Baldwin et al., 2001):

– National interests could dominate decision-making.[4]) This could be the case if NCBs governors regard themselves as representing the monetary policy requirements of their home country, rather than basing their decisions on the euro area as a whole.[5])

*1 NCBs are also involved in the preparation of monetary policy via their participation in the ESCB Monetary Policy Committee, which inter alia prepares the economic projections of the euro area.*

*2 See also De Nederlandsche Bank (2000), p. 26.*

*3 This holds all the more in an enlarged EMU with more than 20 Member States.*

*4 Berger and de Haan (2002) and Meade and Sheets (1999).*

*5 In fact, small, open countries have a natural inclination to make decisions on the basis of the euro area as a whole – possibly more so than large countries. A strong and successful European economy is of particular importance for smaller members of the euro area. For example, if euro area decisions were based only on Dutch circumstances, this would eventually have negative consequences for the euro area as a whole and therefore for the Netherlands.*

– If euro area countries are very heterogeneous, competing national interests could offset one another and result in a bias against changing interest rates. This could make it difficult to reach a decision to change interest rates in the Governing Council.[1])

Despite the above arguments, we consider a Governing Council without adequate representation of NCB governors as unwarranted for a number of reasons. First of all, NCB members of the Governing Council do not consider themselves to be representatives of their home country. Second, their removal runs counter to the criteria set out in section 2. In particular, it conflicts with the notion that all NCBs must contribute to the maintenance of price stability and the other tasks of the ESCB. Broad participation in decision-making is a part of the checks and balances that are a necessary counterpart to the independence of the ESCB. Third, the quality of policy debates in the Governing Council could be adversely affected if the number of NCB governors was to be reduced. The argument runs as follows: economic theory suggests that competition typically leads to higher efficiency. Competitive pressure on the centre (ECB) regarding research and the preparation of monetary policy decisions is provided by the NCBs to ensure that monetary policy remains innovative and e.g. incorporates the latest academic insights. It also ensures that decision-makers are exposed to alternative academic paradigms: "Every research department ... is at risk of developing a dominant 'in-house' view that is intolerant of challenges to the local orthodoxy. It would be unfortunate for the citizens of Euroland if all ... Council members drank only from the same fount of economic wisdom."[2]) Finally, as noted above, monetary policy requires the accurate assessment of market sentiments and expectations. Here NCB members of the Governing Council play a vital role, as

they have a "regional information advantage" and can – helped by the fact that they have at their disposal established organisations – typically provide a better assessment of the situation in their home country.[3]) This local knowledge is also important in the communication of monetary policy decisions to the public. Here there is a role to be played by national central banks, as communication is facilitated by a better knowledge of languages, regional institutions and particular circumstances.

In summary, monetary policy decision-making within the ECB Governing Council should therefore be characterised by a team effort with a strong, but not dominant centre. Interest rate decisions are based on input provided by both the ECB and NCBs. At the same time, to ensure that the public understands that monetary policy is based on

1 *See Aksoy et al. (2002).*
2 *See Buiter (1999).*
3 *See Goodfriend (1999).*

the entire euro area, NCBs must be careful not to overemphasise country-specific needs.

It is possible that in the long run, integration and trade links within the enlarged EU will reduce diversity and reduce the argument for NCB input in decision-making based on their regional information advantage. However, even if this were to occur, in our view, the argument for reducing NCB input so as to improve efficiency is outweighed by the benefits provided via competition, the contribution to the checks and balances of the ESCB and their role in communication.[1]) Also, to a large extent it resembles the setting in the U.S., which indicates that in other monetary unions regional participants also play an important role.[2])

**3.2 Monetary Policy Implementation**

The Treaty requires the ECB's Executive Board to "implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council."[3]) Consistent with the subsidiarity principle, monetary policy operations are co-ordinated by the ECB and the transactions are normally carried out by the NCBs (European Central Bank, 2001a). The decentralised operation also reflects a philosophy of allowing broad participation in monetary policy operations: all financial institutions subject to minimum reserve requirements in the euro area are able to participate in standard open market operations and access our standing facilities.[4]) For the Netherlands, this means that around 85 institutions can participate in tenders, and around 5 to 10 regularly do so. Within the euro area as a whole, between 300 and 400 banks currently participate. This contrasts with the system operated in other countries (such as the U.S.), where participation in open market operations is limited to a few large players. In the latter systems, the transmission of monetary policy to a broad range of financial institutions occurs mainly via the money market. Both systems are possible. Perhaps the most important difference is that the system used by the Eurosystem differentiates less between types of market participants. Financial institutions are able to decide for themselves whether or not to access funds from the central bank or the market. This also allows monetary policy to more directly influence a greater number of financial market participants, without being completely dependent on the interbank market.

At the same time, the decentralised implementation ensures an element of continuity for counterparties to the operations in that they continue to hold accounts at their national central banks. The decentralised approach also embodies an element of insurance against disasters, by ensuring that the system has the ability to implement policy from locations across the monetary union. Finally, the approach fosters ongoing contact between NCBs and market participants which is useful in the formulation of monetary policy and, in the case of some NCBs (including DNB), can assist in the exercise of the supervisory responsibilities.

1 *This does not exclude the possibility that, for practical reasons, the number of NCB governors in the Governing Council may be limited at any point in time (e.g. subject to some form of rotating scheme) following euro area enlargement. Nevertheless, were this to occur, it would be important for NCBs to continue to participate in the Council to the fullest extent possible in order to be able to effectively contribute to the tasks of the ESCB.*

2 *See, for example, Goodfriend (1999).*

3 *Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 12 (1).*

4 *See European Central Bank (2000).*

Given the philosophy underlying the system, we do not see any scope for significant changes here in the short-term. This would also run counter to some of the criteria set out previously, notably the need to accurately assess market sentiment and the relevance of NCBs for communication. In the long term, if there is increasing consolidation within the banking sector that reduces the total number of banks, as well as an increase in cross-border mergers, the usefulness of implementing policy from every central bank may diminish. If that occurs, it is possible that operations might be centralised in one or a few locations.

**3.3 International Co-Operation**

With regard to international co-operation, it is necessary to distinguish between "European" and "national" responsibilities: European responsibilities relate to matters that are of importance to the entire Eurosystem, whereas national responsibilities are linked to national institutions or governments. The Treaty states that the ECB should be the system's representative vis-à-vis third parties. The Governing Council, as the key decision-making body of the ECB, decides how this is arranged in practice. For most European issues, the ECB president would normally fulfil this role. But, the Council can decide that others should also act as the representative where this is desirable, or that national representation is more appropriate.

However, not all external representation involves European issues. National central banks are the agents of governments, and to the extent that international responsibilities are linked to national sovereignty, these responsibilities remain at the respective NCB. An example is IMF membership: nations are members of the International Monetary Fund (IMF), represented by their central banks and/or ministries of finance, so NCBs are often involved in the preparation of IMF-related activities. The international network that NCBs have can in turn be beneficial for other tasks. Given the fact that national interests can diverge across EMU members, this set-up can be regarded as appropriate. NCBs are also represented directly at (and are shareholders in) the Bank

for International Settlements (BIS). The BIS is not only a bank, but also provides a forum to discuss a range of issues, including those relating to financial stability. As is discussed below, this is a national responsibility. Given that we are a shareholder in the BIS, and that the topics discussed in BIS forums relate to our areas of responsibility, it is logical for NCBs to remain actively involved in BIS forums.

In the long run, as European integration proceeds, European interests will increasingly replace national interests. There will be less need to pursue purely national policies vis-à-vis the outside world in some areas. The speed at which this internationalisation occurs will probably vary across issues. If European integration also moves towards political union, it makes sense to de-couple representation of the Member States from the nations and to transfer it to an European institution. That is likely to mean that the ECB, and therefore its president, would have an increasing role as the public face of the ESCB. If national representation were to be centralised at the European level, governance arrangements of some international organisations may need to be adjusted to reflect this. A single European representative in the IMF, for example, would imply that both the European and the U.S. representatives have blocking votes. Such an arrangement could hamper the effective working of the IMF.

### 3.4 Foreign Exchange Operations and Reserves Management

The Treaty provides that the ESCB is responsible for conducting foreign exchange operations and managing the official foreign reserves of Member States. To avoid conflicting policy messages, the Treaty also provides that foreign exchange transactions should take place within a common framework.

Key reasons for central banks to hold foreign reserves are to ensure that they have the ability to intervene in foreign exchange markets if necessary – e.g. to smooth exchange rate fluctuations or in reaction to financial crises. All members of the ESCB own foreign reserves. Those of the ECB are managed on its behalf by NCBs.

Foreign reserves and a central bank's net worth represent a part of the wealth of a nation and are therefore owned by the nation. Accordingly, there is no particular need to transfer the ownership of these assets. However, the question of who should manage these funds on behalf of a country is open to debate. Currently NCBs are responsible for managing these funds and do so according to their own risk preferences. Nevertheless, these reserves could in principle be centralised and managed by the ECB (or a private sector asset manager). The ECB (or a private sector manager) would then effectively be acting as an agent for NCBs.

However, there are economic arguments against the complete centralisation of reserves management: given the substantial value of these reserves, a common reserves management is not necessarily optimal. The risks of pooling such a large fund can be spread if each NCB manages its own reserves. The potential benefits from the reduction in risk may therefore outweigh the additional costs of the decentralised reserves management (consistent with the concept of effectiveness set out in section 2). Moreover, managing reserves deepens our knowledge of financial market developments, which assists in carrying out our other tasks. However, this argument should not preclude co-operation with another NCB or the ECB where an NCB lacks sufficient economies of scale to carry out the task efficiently. NCBs currently also manage the reserves of the ECB – this involves only marginal additional costs for NCBs and means that the ECB does not need to duplicate the reserves management expertise that already exists in the system. However, at some point, it is likely that the ECB will manage its own reserves, thereby gaining the benefits of additional market contacts. In making decisions on this issue, the Governing Council will consider the costs and benefits for the system as a whole.

In the long run, the arguments against centralisation of all reserves are likely to remain valid. Scope for complete centralisation therefore seems small.

**3.5 Statistics**

According to the Maastricht Treaty the ECB "… shall collect the necessary statistical information" to fulfil its tasks, but the Treaty stipulates that the tasks should be decentralised "… to the extent possible"[1]). Monetary statistics are collected by NCBs, as the collection of data typically involves close contacts with commercial banks. In a situation where NCBs are responsible for both the implementation of monetary policy and prudential supervision, the efficiency criterion of section 2 implies that it is clearly more efficient for the NCB to collect monetary statistics. Otherwise, another statistical agency would also have to establish and maintain contacts with commercial banks. To the extent that NCBs collect statistics on national data, it seems reasonable that this should remain a national task.[2]) There seems little scope for gain from centralisation.

Some NCBs also collect or compile non-monetary national statistics. DNB does this for balance of payment statistics as most of these data are also obtained from commercial banks. Although this task could in principle be transferred to the national statistics institution, there is no indication that they would be any more cost-efficient than DNB, given the natural links we have with commercial banks.

Over the long term, if national borders become less important from an economic perspective, the arguments for national collection of data diminish. It seems, however, unlikely that all statistics collection activities could be efficiently centralised in one location (given the size of the bureaucracy implied), but some clustering into regional groupings could occur. Closer political union would also presumably result in some clustering or centralisation of statistics gathering, as some countries might wish to centralise their statistical activities.

**3.6 Operational Tasks: Payment Systems and Banknotes**

Operational tasks remain within the domain of the NCBs. As the banker to banks, central banks have typically provided facilities whereby banks can settle debts amongst themselves. Payments to and from the government are also often channelled through the central bank (as banker to the government). A further reason why central banks provide services in this area is to ensure financial stability. Because payment systems form a link between financial institutions, there is a risk that instability can be transmitted via these systems. By providing payment systems, central banks minimise that risk.

Payment systems differ across the euro area. In this context, it is useful to make a distinction between wholesale and retail systems. An integrated wholesale system was necessary for

1 *See Article 5 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.*

2 *Language differences also play a role here.*

the introduction of the common monetary policy. To meet this requirement, the Eurosystem has developed the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system. Each NCB has its own wholesale payment system, based on their existing technologies, and the European payment system TARGET provides a common interface. TARGET works effectively as one pan-European system, but national differences remain. There is also a link in this area to monetary policy implementation. Institutions subject to reserve requirements are required to hold reserves at the NCB in the country in which they are established. Similarly, they participate in monetary policy operations via that NCB. This necessitates the provision of some form of payment systems by NCBs.

Looking ahead, further harmonisation of the TARGET system is likely in coming years, although the exact form that this will take is not yet clear. In this respect, there are three important factors that will determine how payment systems are organised in the long term: (i) the desires of customers (i.e. commercial banks), (ii) competition and (iii) technology.

(i) Customers' wishes differ somewhat. Some large banks that operate across Europe are keen to see the introduction of a completely centralised system. That reduces their need to deal with different national central banks and different payment systems. On the other hand, those banks which focus mainly on national markets are less interested in seeing greater European harmonisation that would entail (potentially costly) changes.

(ii) Competition is less of an issue with wholesale payments, given the need for systems that ensure financial stability (implying a continued role for central banks). However, we do need to ensure that the services we offer to banks do not take advantage of any monopoly power that we have.

(iii) Although we cannot be precisely sure how the wholesale payment systems will develop, it is clear that technology provides us with increasing options. For example, it is possible to envisage a system that is more harmonised than the current system, but nevertheless allows for some national variation to reflect the different desires of customers in different countries.

Using the criteria of section 2, it seems likely that, in the long term, the efficiency argument would imply a further consolidation in the area of wholesale payment systems. An important determinant of the speed of this process is trends in the banking and finance system. To the extent that there is a significant consolidation of banks, and increasing numbers of banks operating across the euro area, there may be less demand for national differences in payment systems. Integration of stock markets and other exchanges also increases the demand for harmonisation. These factors could eventually lead to some or all NCBs ceasing to offer payment systems.[1])

In contrast, central banks are often not directly involved in the provision of retail payment systems. Instead, they

1 *That could also have implications for the decentralised implementation of monetary policy.*

typically act to promote market solutions. Cross-border retail payments in the form of credit transfers are made via correspondents (sometimes in a multilateral context in the form of "club" arrangements), or the commercial banks' own networks. These payments are relatively expensive, especially for small amounts.

For the future of retail systems, the role of central banks is less relevant as they do not provide the systems here. On the other hand, competition may play more of a role. That is already evident in the Netherlands where currently a single provider of clearing services operates between banks, although another provider is considering entering the market. There is clearly more scope for cross-border services to develop. That is beginning to occur. The EU has recently decided that cross-border payments within the euro area must be provided for the same price as payments within a country. This decision is likely to stimulate the provision of cross-border services. Here commercial banks need to consider how to balance the competing demands of those customers predominantly interested in making payments within a country and the costs that are incurred to accommodate those wanting cross-border payments. To be cost-efficient, a completely integrated clearing system would require countries' payment systems to be more harmonised (e.g. with regard to the use of instruments such as cheques and giro payments). Reaching agreement on how to proceed will take time and the ESCB has a role to play in encouraging and supporting further progress.

Finally, it is also important to consider the more physical side of the operational tasks, i.e. the production and distribution of banknotes. It is clearly not efficient to centralise all operations in one location, for instance with regard to the sorting of banknotes. On the other hand, the production of banknotes is an area where further rationalisation is possible and where considerable efficiency gains can clearly be achieved for the system as a whole, as can be seen by a comparison between the number of staff involved in this task in Europe and the number involved in the U.S. In addition, the introduction of a common currency suggests that the distribution of banknotes can be rationalised across the monetary union as a whole, rather than being based within individual countries. Market participants are already calling for discussions on this issue and we need to continue to work with them to arrive at sensible solutions.

## 4 National Tasks – Responsibilities of DNB Outside the ESCB

As is the case for other national central banks within the ESCB, DNB carries out a number of tasks that do not fall under the provisions of the Treaty of Maastricht. Cross-country differences between NCB activities in this area reflect different preferences and traditions regarding the organisation of these tasks and whether they have been allocated to the central bank or not. Although emanating from a national responsibility, these other tasks are generally related to monetary policy and allow synergies between the various tasks to be exploited.

In this section we use DNB as an example to illustrate national duties. The key non-ESCB tasks of DNB cover financial stability, prudential supervision and our role as an independent economic advisor to the Dutch government.[1]) As noted above, some of our statistical functions and parts of our role in international co-operation also fall outside the framework of the ESCB.

For these non-ESCB tasks, the relevant question to consider is whether these national tasks can best be carried out by a (national) central bank or by another national and/or international institution. This section will focus on financial stability, banking supervision and our role as an independent advisor.

**4.1 Financial Stability**

The Treaty specifies that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities related to the … stability of the financial system."[2]) Financial stability is a responsibility that brings together a number of the key tasks of central banks – including monetary policy, banking supervision and payment systems.[3]) Because monetary policy is implemented via financial markets, financial stability is required for the effective implementation of monetary policy. Payment systems also have an important link with financial stability in that they can be a transmission channel for financial instability. For those NCBs with an involvement in banking supervision, there is a further link, as the soundness of individual financial institutions is obviously relevant for the stability of the entire financial system. Given these links, all NCBs have a competence in the area of financial stability – even where that is not explicitly set out in national legislation. In fact, central banks are unique in that they are entrusted with an array of interrelated tasks that gives them a broad oversight of the financial system from these various perspectives. That implies that they have a competitive advantage in ensuring the stability of the financial system.

In some countries, authorities other than central banks also have a responsibility for financial stability. Given the Treaty requirement that the ESCB is also involved, those non-central bank institutions have a responsibility to work together with the ESCB to ensure that we can fulfil the task allocated to us. The increasing integration between financial systems (both cross-sector and cross-border) requires close co-operation and information exchanges between all institutions with a responsibility for financial stability.

At present the financial stability task is mainly national in character, with countries taking responsibility for markets in their jurisdiction. At the same time, international meetings and ESCB networks provide the opportunity to exchange information and views. Where necessary, international co-operation can be readily arranged to ensure the stability of the financial system, as was evident in September 2001. But, as globalisation of financial markets and financial institutions continues, the international character of this task will become increasingly apparent. As internationalisation continues, we will have to consider whether some form of European financial stability forum,

1 *Additionally, together with the Minister of Finance, DNB provides reinsurance of foreign payment risks for exporters and importers.*

2 *Protocol on the Statute of the European System of Central Banks and the European Central Bank, Article 3 (3).*

3 *These issues are discussed in more detail below. Note that although not all central banks have explicit banking supervision tasks, their involvement in financial stability means that they have to take a close interest in it.*

or a broader co-ordination mechanism such as a world-wide forum, is the most effective way forward. At the moment, such international forums provide for the exchange of information, but they respect national responsibilities in this area. Whether and how that might change in the future is unclear.

### 4.2 Banking Supervision

As with financial stability, the Treaty provides that the ESCB shall contribute to the conduct of policies pursued by the competent authorities relating to prudential supervision.[1]) In contrast to the situation for financial stability, not all NCBs are the leading authority for prudential supervision in their countries. But, by explicitly assigning a role to the ESCB, rather than to the ECB, the Treaty gives all parts of the system a role in contributing to prudential supervision. This institutional set-up requires a creative solution to allow the various players to each fulfil their role.

This sub-section briefly reviews two issues: (i) the arguments surrounding whether supervision should be a task for a central bank, and (ii) the issue of the integration of supervision across Europe. Clearly, countries have made different decisions regarding their choice of the lead banking system supervisor. Moreover, those choices have recently been reviewed in a number of countries, including the Netherlands, where the decision was made that the central bank should continue to be the prudential supervisor.[2]) To evaluate the potential long-term development of banking supervision, we briefly review the factors that determined the decision to retain the supervision function for the Netherlands within the central bank: first, the function was already in place in the central bank. In order to justify a change, there need to be clear efficiency gains from moving to another allocation of tasks. That was not judged to be the case. Second, there is a close link to our role in financial sector over-

sight, meaning that we can exploit synergies between the two functions. Third, there is a link to our role as lender of last resort. Having the supervisor in-house makes the communication channels shorter in the event of a crisis where it is necessary to judge whether problems relate to only one institution or to the system more broadly, and to assess whether they reflect solvency or liquidity difficulties. For small countries, the need to ensure a strong and viable institution (including its ability to attract high-quality staff) is an additional argument in favour of combining supervision with monetary policy.

1 *Again, the Treaty does not give the ESCB primary responsibility in this field. Article 105 (6) does provide that, in the event of unanimous agreement by the European Council, acting on a proposal from the Commission and after consulting the ECB, could confer on the ECB specific tasks relating to prudential supervision. There is no indication that this is likely to happen in the foreseeable future.*

2 *The recent changes have resulted in a division of tasks of along functional, rather than sectoral, lines. Organisational links between DNB and the insurance supervisor have been strengthened. This facilitates an integrated approach with respect to the prudential supervision of financial conglomerates who may be active across a range of financial products. These prudential supervision tasks have been separated from tasks associated with overseeing the conduct of business of these companies and consumer protection.*

There are also arguments against combining supervision and monetary policy in the same institution. Prominent among these is the argument of a conflict of interest: for example, monetary policy may not be tightened sufficiently to offset an inflation risk for fear of undermining the position of parts of the banking system (see Sinclair, 2000). In practice, however, the risk of a conflict of interest is rather limited (see Goodhart, 2000, and European Central Bank, 2001b, regarding the relevance of this point).[1]) Advocates of removing the supervisory function from central banks also argue that agreements to exchange information can ensure that there are sufficient information flows between the central bank and the supervisor. However, apart from carrying risks in terms of timeliness and completeness, information exchanges are no substitute for hands-on responsibility in the field. The impetus to keep fully up-to-date with new developments in financial instruments, and their implications for risk management, diminishes if the central bank has no involvement with prudential supervision. Even when the central bank is not ultimately responsible for supervision, some involvement in supervisory tasks is important. These arguments illustrate that there may not always be a single correct answer to the issue of where primary responsibility for supervision should lie. However, for the Netherlands at least, it is not obvious that alternative arrangements would be preferable.

The second issue concerns the centralisation of supervision within the euro area. The key argument in favour of a more centralised supervisory framework is the increasing internationalisation of the financial sector. These intensified links between institutions and markets have increased the risk that contagion could extent beyond national borders. Euro area centralisation would also reduce the scope for competition between regulators and align prudential supervision with the geographic boundaries of the monetary union.[2])

Clearly, although the increasing internationalisation of banks will determine supervisory arrangements in the future, it is not obvious that the establishment of a single European supervisor is the most effective response to increasing internationalisation. First of all, financial structures currently differ across Europe and can therefore better be supervised by national institutions. Second, such an institution (which should be independent in order to function effectively) would be very powerful and a system of checks and balances would be necessary.[3]) Finally, the absence of any fiscal union also plays a role here, as any major financial crisis is likely to have implications on national budgets. Currently it is not clear to what extent sovereign countries are willing to bear the financial consequences of the failure of institutions in other countries.

1 *This holds in particular for Europe. Monetary policy is supranational, implying that there is little conflict, as no single NCB is in a position to determine European monetary policy. More generally, even if banking supervision is delegated, the risk of a conflict of interest (albeit between different institutions) could still result in monetary policy reacting inappropriately to external pressure. Having banking supervision and monetary policy under one roof might allow a better solution because any trade-off can be explicitly made. It is not the existence of conflicts of interest that is the issue, but how they are dealt with. Here the solution is good monetary and prudential policies, not the physical separation of institutions.*

2 *See van der Zwet (2002) for a discussion of these issues.*

3 *The U.S. achieves these checks and balances via the existence of a number of supervisors. For small countries, the importance of achieving checks and balances may be outweighed by the need to ensure a strong and effective institution.*

What is required (and already occurs) is that the setting of basic rules of conduct takes place at the European level, and the practice of supervision is more harmonised, so as to ensure a level playing field within the single market and beyond. In addition, cross-country agreements between supervisors are established as banks expand across borders. These can be tailor-made for the specific banks' circumstances. Out of these arrangements a more co-ordinated system might evolve organically over the coming years, and we should encourage this to ensure that there truly is a level playing field for banks from different parts of the EU. This is preferable to attempts to impose a top-down European solution.

The Dutch situation might serve as an example: unlike other major European banks, our larger banks have tended to expand into the Americas, rather than into other parts of the EU. A common European solution may therefore not be the most efficient from the Dutch perspective, since our banks have different interests and needs than those from other euro area countries. The issue is currently under active consideration, with various proposals circulating for increased European co-ordination. What is important here is that all central banks are actively involved, regardless of whether or not they have primary responsibility for supervision.

**4.3 National Economic Advisor**

In a number of countries, national central banks have a formal role as an economic advisor to the government. In the Netherlands, for example, the president of De Nederlandsche Bank is an ex officio member of the Social and Economic Council (SER). This council is made up of members nominated by employers and unions, along with independent members appointed by the crown. The SER provides advice to the government across various social and economic issues. An advantage of this council is that its members represent various segments of society, ensuring that its advice is based on a range of perspectives (a variant of the checks and balances argument of section 2). DNB plays an active role in the SER. To some extent, the input that DNB provides reflects our insights stemming from our role in monetary policy formulation. This includes highlighting the implications of the common monetary policy for national economic policy in the Netherlands. The issues covered by the SER are, however, considerably broader than those where there is an obvious connection to monetary policy. Moreover, DNB's role as an advisor on economic issues extends beyond participation in the SER. What, then, is the value-added of DNB on issues unrelated to monetary policy?

The most important point is that it can be valuable for governments to receive objective advice from an independent organisation. At times, the advice from such an independent organisation may be unpalatable for a government. On the other hand, governments are also able to "hide behind" such independent organisations in order to advance policies that are seen as necessary but unpopular. Such a role as independent advisor does not have to be fulfilled by a central bank, but because of our historic involvement in these issues it makes sense. We have established a reputation and are perceived as credible by the public. This reputation is important if we – and our advice – are to be taken seriously. We also have the necessary infrastructure and are able to exploit synergies with some of our other tasks. This implies that we are able to undertake this task at relatively low costs (i.e. relatively efficiently).

An alternative to the national central bank would be to involve research institutes in this field. In the Netherlands there are already a number of such institutes and they fulfil a valuable role. But the comparative advantages of DNB in economic policy advice more generally include the fact that we are actively involved in policy-making. Our involvement in policy-making ensures that we do not operate in an ivory tower but are part of a world-wide network that gives us access to a wide range of policy-relevant information. As a result, if we criticise some specific economic policies, the government cannot dismiss our comment as readily as is possible with an academic research report. It would also take time and substantial investment before other institutions were able to build up the credibility and networks necessary to effectively carry out this role. It is therefore not evident that there would be any efficiency gains in transferring this role to another institution.

So our role as policymaker provides a counterpart to the valuable contributions of academic research. Our involvement in euro area monetary policy formulation strengthens our voice at the national level. At the same time, our knowledge of country-specific factors is higher, compared to a situation where the ECB would fulfil such a role. We are able to take relatively controversial positions, because of our high degree of statutory independence. Therefore it is highly likely that DNB will continue to fulfil this function even in the long run.

## 5 Concluding Comments

The history of European integration was politically motivated, but shows quite clearly that economic integration preceded political integration at times. Monetary policy (and in particular exchange rate arrangements) have tended to be at the forefront of these efforts.[1]) Despite deep economic integration, political integration still has a long way to go, as is inter alia evidenced by the rather weak role of the European parliament and the fact that the role of the Commission is not completely clear. One of the guiding principles of European integration is its co-operative nature. This is reflected in the Maastricht Treaty, which entrusts the ESCB as a system with policy tasks. This implies that all participating central banks, i.e. both the ECB and the NCBs, must jointly fulfil the roles assigned by the Treaty.

The unique history of the ESCB – formed when a group of sovereign countries surrendered their monetary policy autonomy to form a monetary union – goes a long way towards explaining why that is so. The central banks within the system operate together as a team. While a strong centre is important for the team to perform

*1 For a more detailed discussion on the history of European monetary union, see European Commission (2002) and Houben (2000). Houben also discusses the different monetary policy traditions in the various EU countries.*

well, the various national central banks are also crucial parts of the system. This is particularly important in the formulation of monetary policy, where public confidence in the policies of the system (and therefore their effectiveness) also depends on our communication skills and our knowledge of country-specific factors.

The European preference for subsidiarity reinforces the tendency for decentralisation. This preference yields a number of benefits, but at the same time entails certain costs. In particular, it has consequences regarding the extent to which efficiency gains can be achieved through centralisation. Viewed purely from an cost-consciousness point of view, there would appear to be scope for centralisation or greater regional specialisation in a number of areas. For example, increasing cross-border activity by financial and non-financial companies is likely to result in further harmonisation of payment systems and co-ordination in financial stability. A more harmonised payment system would in turn facilitate greater specialisation in the implementation of monetary policy. Banknote production and distribution is also an area where we can look for more efficiency gains. Inefficiencies need to be eliminated where they exist, without undermining the fundamental principles upon which monetary union has been founded. Looking ahead, it seems likely that the basic structure of the system will remain intact for the foreseeable future. More substantial changes are linked to the need for further political integration within Europe and the development of supranational institutions in other policy areas. As long as Europe remains a community of nation states, national tasks are likely to remain a key part of the work of NCBs, as the example of prudential supervision shows. Further economic and political integration would also allow a more centralised approach to be taken in areas such as international representation.

Even in a full-fledged political union, regional identities continue to be an important factor. Shared histories, cultures and, in particular languages, are fundamental in shaping identities. These factors will remain in place for generations. Institutions tend to be related to these feelings of identity, and may even outlive them. National central banks are therefore likely to remain in place, albeit in a different form, for a long time to come.

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# Comments on Arnout H. E. M. Wellink, "The Role of National Central Banks Within the European System of Central Banks: The Example of De Nederlandsche Bank"

## 1 Introduction

The paper by Arnout Wellink is very comprehensive and informative. It is divided in two main parts. In the first part he discusses the division of labour between the European Central Bank (ECB) and national central banks (NCBs) in the European System of Central Banks (ESCB). In the second part he describes and analyses the responsibilities of a NCB in the national context using the specific example of De Nederlandsche Bank (DNB). In my short comment I want to focus on the first part of the paper with a special view to the future role of NCBs in the monetary policy decision-making process of the ESCB. Due to the enlargement process it is obvious that this role has to be redefined in one way or another.

## 2 Current Situation and Prospects for the Division of Labour Between the ECB and the NCBs

As a starting point and theoretical framework for his discussion Governor Wellink uses two criteria which are laid down in the Treaty establishing the European Community: subsidiarity and efficiency. With this framework he analyses the current situation and future changes in the division of tasks between the ECB and the NCBs in six important areas:

– monetary policy decisions
– monetary policy implementation
– international co-operation
– foreign exchange operations and reserve management
– statistics
– payment systems and banknotes

The analysis shows that the division of tasks is currently characterised by a relatively high degree of decentralisation in all six areas. It reflects the specific political environment in which the ESCB is operating. For the time being Arnout Wellink regards this division of labour efficient. For the future he sees a trend towards more centralisation all areas. But for two fields he is clearly in favour of maintaining a decentralised approach: monetary policy decisions and foreign exchange market operations and reserve management. A more detailed survey of the results is presented in table 1.

## 3 What Role for the NCBs in the Field of Monetary Policy Decisions?

As I completely agree with this analysis, I want to use my comments for a somewhat more detailed discussion of the task of monetary policy decisions which is certainly the most important area for a participation of the NCB governors in the ESCB. A clear analysis of the division of labour in this field is of special importance since the EU enlargement process has already led to an intensive discussions of how to solve the "ECB's numbers problem" (Baldwin et al. 2001). In my view we have to find an answer for two interrelated questions:

Table 1

**Main Results of the Paper by Arnout Wellink**

| Present tasks of the NCBs | Assessment of the current situation | Assessment of changes in the future |
|---|---|---|
| **NCB governors participating in monetary policy decisions** | "Team effort with a strong, but not dominant centre" | "Benefits provided via competition, contribution to checks and balances, role in communication" |
| **Monetary policy implementation by NCBs** | "No scope for significant changes" | "Usefulness of implementing policy from every central bank will diminish" |
| **International co-operation: national responsibilities represented by NCBs** | "Setting can be regarded as appropriate" | "As European integration proceeds, European interests will increasingly replace national interests" |
| **Foreign exchange operations and reserve management by NCBs** | "Transferring of ownership to ECB problematic, Common reserve management not optimal" | "Scope for complete centralisation seems to be small" |
| **Statistics: collection of monetary data by NCBs** | "Efficient" | "Arguments for national collection of data diminish" |
| **Wholesale payment systems operated by NCBs** | "Justified by the decentralised implementation of monetary policy" | "Some or all NCBs ceasing to offer payment systems" |

– Is it advisable to give national central bankers a say in the formulation of the single monetary policy?
– If yes: What is their optimum share in the overall voting power of the Governing Council of the ECB?

In order to structure the discussion I want to analyse three basic policy options:

(i) A model for a *centralised approach:* it is provided by the Bank of England (BoE), where the Monetary Policy Committee council – with nine members – takes all monetary policy decisions. For the ECB this approach has been proposed by Baldwin et al. (2001).
(ii) A *decentralised approach* is provided by the status quo of the Treaty on European Union according to which the governor of each member country's central bank has a full voting power in the Governing Council. The guiding principle of this decentralised approach is "one member – one vote".
(iii) An *intermediate approach* can be derived from the Federal Reserve System (Fed). It would be characterised by a restricted voting power of the national governors. According to the U.S. model, the voting power could rotate among the governors so that e.g. not more than seven governors would have a vote at a given point in time.

For a discussion of these options the general principles of subsidiarity and efficiency are very important criteria, but they are – in my view – not exhaustive. If we want to identify an optimal constitutional framework for a central bank, we have to take into account those criteria which were specifically designed for monetary policy purposes. I think there is broad consensus among economists that they include above all:

– The principle of independence of monetary policy decisions from the general political process and – in the case of a supranational bank – also from national considerations.
– The requirement of a high degree of accountability which can be regarded as a natural corollary of a very independent legal status
– Of course, the requirement of efficiency is also very important, above all the need to react flexibly in situations with unforeseen shocks that could threaten the ECB's overall target of price stability or the stability of the financial system.

### 3.1 Monetary Policy Independence

Let me start the analysis of three institutional options with regard to their contribution to monetary policy independence. As I have shown in Bofinger (2001), one can differentiate between goal, instrument and personal independence. Since the three options are identical in terms of goal and instrument independence, we can focus on personal independence which is provided above all by

– long terms of office,
– a diversified decision making body, and
– a diversification in the nomination process.

It is obvious that all three options would meet these criteria. A sufficient degree of diversification would be already granted with an MPC of nine members that are elected by the European Council. But as the degree of diversification increases with the number of members, the status quo could be regarded as the best solution.

Under the specific conditions of European Monetary Union one has to be aware of the fact that independence has an additional dimension which is sometimes overlooked: *independence* *from national interests.[1])* A common monetary policy requires that the decision-makers feel responsible for the whole area and do not regard themselves as representatives of their own national interests. In this respect a monetary policy committee would be clearly superior to the two other solutions. This applies above all for intermediate solution. As it would require to abandon the principle "one country – one vote", the voting power of each governor is determined by his or her country of origin. Thus he or she would be permanently reminded of the fact that he or she is regarded as a representative of his or her country and not as individual expert who is held responsible for a single monetary policy. What about the decentralised approach which is provided by the status quo? In my view, the Bundesbank's experience has shown in an impressive way that the principle "one member – one vote" helps to transform individual standpoints that were shaped by a specific regional or political background into a common interest (the so-called Thomas Becket effect). I want to add that so far – at least seen from outside – this effect has also been working efficiently in the ECB's Governing Council.

### 3.2 Monetary Policy Accountability

In terms of accountability, which is especially important for a very independent central bank like the ECB, the centralised solution has serious disadvantages. Monetary policy is probably the most important field of overall economic policy and it has a very direct impact on the living conditions of all citizens in Europe. Above all, it is sometimes unavoidable that policy decisions are taken that have unpleasant short-term effects on output and employment. Given the general public mistrust in European politics which is obviously growing, it would be very dangerous to leave the management of the common monetary policy to a group of ten wise men. This could lead to a situation where politicians in many – or even all – countries criticise the ECB while there are no longer national governors and national central bank institutions that feel a responsibility for the common monetary policy. Given the NCBs' function of a "national economic advisor" this would also make it more difficult for the ECB to convey its views to the national governments. In this respect the intermediate solution which violates the principle "one country – one vote" is also problematic. Again, it would have the consequence that there are governors who have not participated in the voting process and who would not feel fully responsible for what is being decided in Frankfurt. In sum, the decentralised status quo solution clearly provides the optimum contribution to the requirement of accountability. In the words of Wellink:

"[I]t may be particularly 'reassuring' for the public in countries where economic developments diverge from the euro area average if 'their' NCB governor is seen to participate in the formulation of the single monetary policy."

### 3.3 Monetary Policy Flexibility

In terms of *flexibility,* a very large decision-making body certainly does not look very attractive. If each EU member country would have a say in interest policy, the Governing Council

1 *See Berger and de Haan (2002).*

could in the medium- or long-term include up to 28 governors plus 6 members of the board. As Arnout Wellink has stated, this would certainly go beyond an "optimal club size" for discussing the often very complex issues of monetary policy. Thus, under this criterion the centralised approach with a relatively slim monetary policy committee is clearly superior to any decentralised solution. As far as the flexibility of the intermediate solution is concerned, it is interesting to compare the number of interest rate changes decided by the Fed, the BoE and the ECB since January 1999. Based on this very rough evidence, one could come to the conclusion that the ECB has indeed been somewhat less flexible than the two other central banks with a more centralised decision making process (table 2). It seems obvious that with additional members the flexibility of the ECB's Governing Council would decline further.

However, it should be added that the overall macroeconomic performance of the ECB, if it measured with a standard social loss function,

$$L = 0.5(\pi - \pi^{\text{Target}})^2 + 0.5(\text{Output-gap})^2$$

has not been worse than the performance of the more centralised Federal Reserve System (table 3). The same implies for a loss function where only the inflation rate matters (inflation nutter). However, it should be noted that the very centralised Bank of England has been able to achieve the best performance. But again, this is a very rough evidence.

### 3.4 Assessment of the Three Options

The results of my admittedly very short analysis of the three main policy options can be summarised in table 4.

Table 2

**Interest Rate Changes Since 1 January 1999**

| Central Bank | Members with voting power | Share of members from the central institution | Number of interest rate changes |
|---|---|---|---|
| | *Number* | % | *Number* |
| Bank of England | 9 | 100 | 15 |
| European Central Bank | 18 | 33 | 12 |
| Federal Reserve | 12 | 58 | 17 |

Table 3

**Average Annual Social Loss (from 1999 to 2002)**

| | Bank of England | European Central Bank | Federal Reserve |
|---|---|---|---|
| | % | | |
| *Target inflation rate* | *2.5* | *2* | *2.5* |
| Loss with flexible IT | 0.1 | 0.4 | 1.1 |
| Loss inflation nutter | 0.1 | 0.3 | 0.4 |

Table 4

**Assessment of Three Basic Policy Options**

| Criteria | Centralised solution (Monetary Policy Committee) | Decentralised solution according to the principle: "one member – one vote" | Intermediate solution limiting the number of NCB governors with voting power |
|---|---|---|---|
| Independence from | | | |
| – political influence | + | + | + |
| – national influence | + | + | 0 |
| Accountability | – | + | 0– |
| Flexibility | + | – | 0+ |

It shows that we are confronted with the unpleasant outcome that none of the three options would perform well under all criteria. A centralised approach would provide flexibility and independence but it is clearly suboptimal in terms of accountability. The "one-member-one-vote approach" performs well in terms of accountability and independence but it cannot be recommended because of its inflexibility, especially if the number of EMU member countries will increase. The intermediate approach is not really bad, but it is second-best in terms of national independence, accountability and flexibility.

## 4 A Synthetic Solution

Since all criteria are equally important, it would be dangerous to adopt a solution with an insufficient or even a second-best performance in one criterion. Therefore, I suggest to increase the menu of options by a synthetic solution which tries to combine the advantages of the two polar solutions as far as possible.

Such a synthesis would make a difference between

– decisions which require a *fast and very confidential decision process,* i.e. above all decisions on interest rates, foreign exchange market interventions, and the provision of lender-of-last-resort facilities, and
– decisions which allow a more time for discussion and which are of a less confidential nature, above all decisions on strategic and institutional matters.

For the first group of issues my blueprint envisages a clear prerogative for the ECB Board:

– It would take such decisions with a simple majority.
– After this the decision would be discussed by the Governing Council. It should be given a veto power as well as the power to take another decision. However this would require a majority of two thirds of the votes.

For the second group of issues, decisions would be taken with a simple majority by the Governing Council. Of course with a large Council, it would be difficult to discuss complex questions in detail. However, from my experience with the Bundesbank I know that it is possible to have efficient discussion by an exchange of internal papers before the meetings take place.

This synthesis would have the advantage that it allows the Board to react in flexible way to changing economic conditions while at the same time it would keep all national central bank governors actively involved in the decision-making process for the single monetary policy.

In order to guarantee a sufficient degree of diversification in the Board this approach would require that the number of the Board members is increased to at least nine. It would be advisable to share the responsibility for economic analysis and research

Table 5

**Staff of Major Central Banks**

| | European Central Bank (2001) | Federal Reserve (2001) | Deutsche Bundesbank (2001) | Banque de France (2000) |
|---|---|---|---|---|
| | *Number* | | | |
| Staff in the headquarter | 1,043 | 1,650 | 2,412 | 5,924 |
| Staff in regional branches | × | 21,290 | 12,405 | 7,828 |

*Source: Annual reports.*

among the present chief economist and the additional members. This would provide some protection against the risks of a "dominant inhouse view that is intolerant of challenges to local orthodoxy" a quote from Willem Buiter that I found in the paper by Arnout Wellink.

A strengthening of the ECB's Board would also require that the number of its staff will be substantially increased. As table 4 shows the ECB's Board is obviously understaffed in comparison with the Fed, and even more so with the Bundesbank or the Banque de France.

## 5 Summary

The paper by Arnout Wellink has made very clear that a high degree of national representation will remain an important requirement for a successful performance of the ECB in the future. But given the challenges of enlargement, it will become more and more difficult to meet this requirement in a way that maintains the flexibility of the single monetary policy. A very centralised approach along the lines of the BoE's Monetary Policy Committee would be first-best in terms of independence and flexibility but it would impair an adequate representation of the ECB's policy in the national sphere and its accountability. A very decentralised approach would run the risk of paralysing of monetary policy which would have to be decided by a large Governing Council of 30 or even more members. Since an intermediate solution with a rotating voting scheme is second best in most respects, I have tried to design a synthetic solution which combines the advantages of a very centralised and a very decentralised solution. It gives the Board a dominant role in interest rate decisions but the Council would have the right to overrule Board decisions with a majority of two-thirds. In addition the Council would retain a full say in institutional and strategic issues. Thus, the response of my approach to EU enlargement is to strengthen the role of the Board so that it is able to cope with an increasing number of NCB governors which remain involved in the decision-making process. ❧

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# Comments on Arnout H. E. M. Wellink, "The Role of National Central Banks Within the European System of Central Banks: The Example of De Nederlandsche Bank"

## 1 Introduction

The main point of this thoughtful paper of Arnout Wellink is the following. National central banks continue to play an important role within the Eurosystem. This is the case not only in the formulation and implementation of monetary policy, but also in other areas, e.g. in the areas of financial stability and banking supervision. This role of the national central banks within the Eurosystem is not some remnant of the past that must be eliminated as quickly as possible. It also provides for a better functioning of the Eurosystem.

I share the view that national central banks have an important role and will continue to have one in the future. I also share the view stressed by Arnout Wellink that the degree of centralisation in the Eurosystem must proceed in step with further political integration. Yet in certain areas, the role of national central banks will have to be reduced very quickly.

I will concentrate here on the decision-making process within the Governing Council and the challenges that arise as a result of enlargement. This is an area where the role of national central banks must be re-evaluated.

## 2 Enlargement and Institutional Reform

The enlargement is bound to have important implications for the decision-making process within the Eurosystem. The present system is characterised


by equal representation of each member country in the Governing Council through the presidents (governors) of the national central banks. When, like today, the number of countries is limited to twelve such a system can work satisfactorily. In a future system where 27 countries could be sending a representative to the Governing Council the difficulties to achieve a consensus about the stance of monetary policy will be much greater than today.[1]) This is due not only to the larger numbers of persons involved in such a system, but also because there will be more asymmetric developments in an enlarged euro area. These asymmetries will necessarily lead to different perceptions among the national governors about what the most appropriate course of action is for the euro area as a whole.

The problem can be illustrated using a very simple model in the following way. In chart 1 we present the interest rates that are desired by the twelve governors of the Eurosystem. We take the view that there are asymmetric developments leading each governor to compute an interest rate, which is optimal for his own country.[2]) Thus each governor desires a different interest rate to prevail in the Eurosystem. For the sake of simplicity we assume that these desired interest rates are distributed uniformly between 3% and 4.1%. This is shown by the horizontal line. Chart 1 also shows the relative size of each country as measured by GDP. For example, Germany's GDP represents 30% of the total. It can be seen that Germany desires an interest rate of 3.4%. We make the further assumption that the ECB Board (six members) has the same desired interest rate and that this is obtained by an analysis of the euro-wide economic conditions. Thus the ECB-Board computes the optimal interest rate using the Eurosystem-wide average of inflation and output. This implies that the ECB-Board takes a weighted average of the nationally desired interest rates, where the weights are the GDP-shares.[3]) This yields the result that the ECB-Board desires an interest rate of 3.5%. Thus, seven members of the Governing Council (six Board

1 *See Baldwin, et al. (2001) for a detailed analysis of the decision-making problems in an enlarged European Union.*

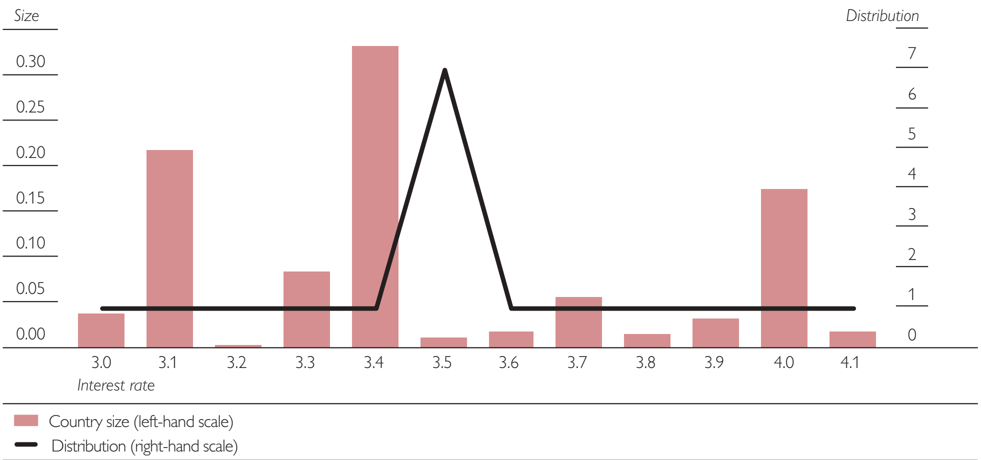
2 *Officially the governors are not supposed to do this. It is doubtful, however, whether governors do not take the national economic conditions into account. There is interesting evidence that even in the U.S. Fed, regional interests play a role in monetary policy decisions. See Meade and Sheets (2002).*

3 *See Aksoy, De Grauwe and Dewachter (2002).*

Chart 1

**Distribution of Desired Interest Rates and Country Size (Euro-12)**

**Symmetric Case**




members and one governor) desire the same 3.5%. This feature produces a peak in the distribution of desired interest rates around 3.5%.

It is now obvious that the ECB-Board will have a strategic position in the decision-making process. It will have to find only two extra votes to have a majority for its interest rate proposal. These can easily be found among the two governors that are close to the ECB-Board's desired interest rate. Note that it will be very difficult for other coalitions to beat the ECB-Board's proposal because such a coalition would have to span both those governors who desire a higher interest rate and those who desire a lower interest rate. The nice thing about this result is that the Governing Council will select the interest rate that is optimal for the system as a whole, even if each national governor is only concerned about the economic conditions prevailing in his country. It is clear that if the national governors disregard the national economic conditions and care only about the Eurosystem's average economic conditions (as they claim they do) the result will be the same. Thus in the present situation with 12 Eurosystem members, it does not make a difference whether the national governors care about the euro area-wide economic conditions or not.

The previous description is nothing but an application of the medium voter theorem. The ECB-Board which is averaging the desires of national governors will be close to the desired interest rate of the median governor, (at least if these desires are symmetrically distributed). In a majority voting system the median voter's preferences prevail.

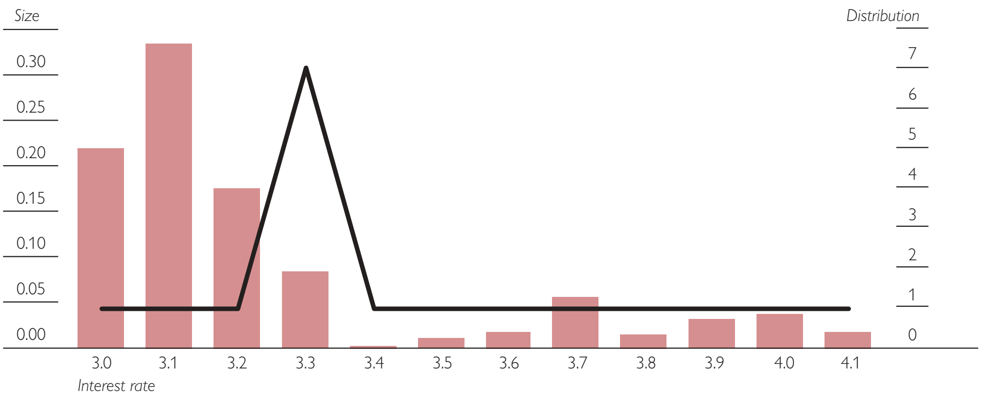
Note that since the strategic position of the ECB-Board is so powerful, it is unlikely that the members of the Governing Council will come to explicit voting. Everybody is aware that whatever the Board is proposing will almost certainly find a majority.

How is this result affected by different distributions of the desired interest rates? Suppose that this distribution is asymmetric in that the large countries (Germany, France, and Italy) have different desires than the small countries. This could arise when the large countries experience subdued economic activity while a large number of small countries experience booming economic conditions. We show an example

Chart 2

**Distribution of Desired Interest Rates and Country Size (Euro-12)**

**Asymmetric Case**




of such a scenario in chart 2. We now find that the ECB-Board's desired interest rate (3.3%) is significantly different from the median desired interest rate (3.55%). This follows from the fact that the large countries have a large share in the averaging procedure applied by the ECB-Board. Thus the ECB-Board desired interest rate is relatively close to the desires of the large countries (and rightly so because the three large countries represent about 70% of the Eurosystem's GDP).

It can now be seen that despite the fact that the ECB-Board's desired interest rate diverges from the median, the ECB-Board should have few difficulties in forcing its desire to pass in the Governing Council. All the Board has to do is to find three votes for its proposal. It will likely find it among the three central banks whose desired interest rate is close to 3.3%. In addition, despite the asymmetry in the distribution there are only eight governors available for a coalition in favour of a higher interest rate than 3.3%. In order to beat the ECB-Board's proposal ten votes are necessary.

We conclude that in the present situation the ECB-Board has a strategic position within the Governing Council, which is maintained even when the distribution of desired interest rates is very different among large and small countries. As a result, the decision-making process within the Governing Council ensures that the interest rate that will be decided is the optimal one from the point of view of the Eurosystem as a whole.

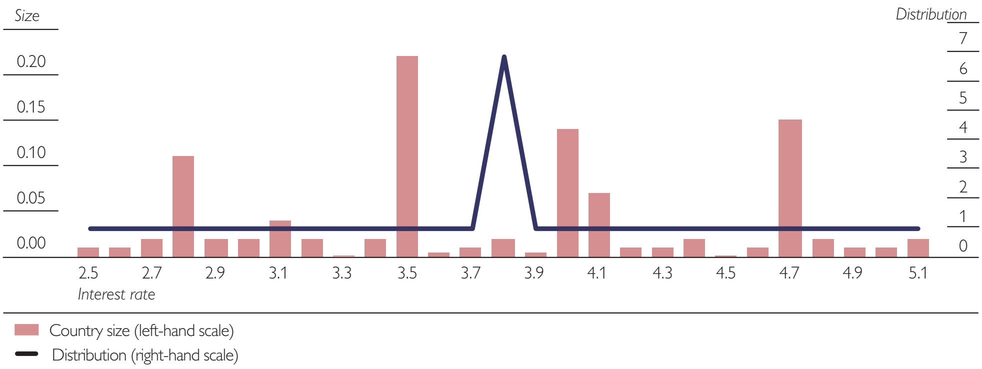
Things will be very different in an enlarged Eurosystem. We first present chart 3, which is similar to chart 1 and which presents the distribution of desired interest rates in the enlarged Eurosystem consisting of 27 members. Thus the Governing Council consists of 33 members, which means that an interest rate proposal must have 17 votes to obtain a majority. We assume that the distribution of the desired interest rates among small and large countries is approximately symmetric. As before the ECB-Board computes the desired interest rate for the Eurosystem as a whole (the weighted average of the nationally desired interest rates).

A first thing to observe is that the ECB-Board's strategic position is weakened. It will now have to find ten gov-

Chart 3

**Distribution of Desired Interest Rates and Country Size (Euro-27)**

**Symmetric Case**




ernors to back its proposal for its desired interest rate of 3.7%. Since one governor has the same desired interest rate of 3.7%, nine governors with different desires must be found to obtain a majority.

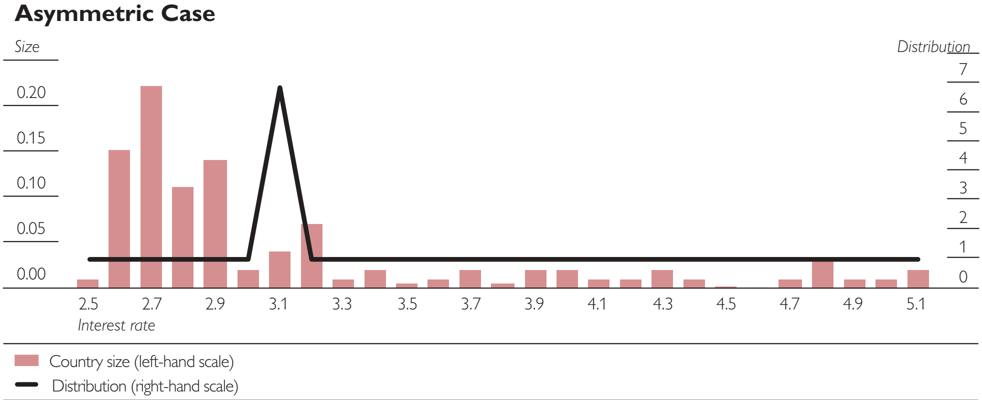
Despite the fact that the ECB-Board must make a greater effort to find the backing for its proposal, it can also be seen that the ECB-Board still has a strong position. The reason is that its proposal (the mean) is very close to the median proposal. As a result, coalitions to defeat the ECB's proposal will be difficult to find. For example, the number of governors in favour of an interest rate higher than 3.7% amounts to only 13 (remember that one needs 17 votes to form a majority). Similarly the governors desiring less than 3.7% can only muster 13 votes. Thus, the ECB-Board will most likely be able to find a majority.

The asymmetric case is shown in chart 4. As in chart 2 we now assume that there is an asymmetric distribution of interest rate desires between large and small countries. We assume that the four large countries (Germany, France, Italy, and U.K.) all desire relatively low interest rates while a large fraction of the small countries desire relatively high interest rates. Our results are now very different. The difference between the ECB-Board's desired interest rate, 3.1%, (the mean)

Chart 4

**Distribution of Desired Interest Rates and Country Size (Euro-27)**

**Asymmetric Case**



is now significantly lower than the median desired interest rate, 3.7%. As a result, a coalition of small countries desiring a higher interest rate than 3.1% can now be found, thereby defeating the ECB board's proposal.[1]) It is therefore possible that an interest rate decision is made that suits the interests of a coalition of small countries that represent a small fraction of the Eurosystem's GDP. This interest rate would not be optimal for the Eurosystem as a whole. If such a scenario were to materialise it would likely lead to grave conflicts within the Eurosystem.


How likely is the preceding scenario? The answer is difficult to give. The scenario has some plausibility, however. Most of the small countries in the enlarged euro area are less developed and therefore experience relatively large productivity growth. This is likely to lead to the Balassa-Samuelson effect, i.e. these countries will experience stronger inflationary pressures than in the rest of the Eurosystem. There may be other reasons why such asymmetries occur. In any case even if they are not likely, they may still occur at some point putting much strain on the Eurosystem.

The problem we have identified can be summarised as follows. In the present set-up the ECB Board has a strategic position in the decision-making process within the Eurosystem. This ensures that the interest rate decisions are made on the basis of the needs of the euro area as a whole. This is so even if the national governors are guided by the economic conditions that prevail in their own countries. Since the large countries (Germany, France, Italy) represent about 70% of the total, this decision-making model also ensures that the large country's interests are relatively well served, despite the over-representation of the small countries in the Governing Council. Because of the strategic position of the ECB-Board a consensus can usually be reached easily around the interest rate proposals made by the Board. As a result, formal voting is usually not necessary.

In an enlarged Eurosystem this consensus model is likely to break down. The reason is that the ECB-Board will loose its strategic position. It will be confronted by the possibility that its interest rate proposals will be overruled by coalitions of small countries who experience different economic conditions than the average (which is dominated by the large countries). This will create the possibility that interest rate decisions will be made on the basis of economic conditions that prevail in a relatively small part of the euro area. This is bound to lead to grave conflicts within the Eurosystem.

The essence of the problem is that the small countries are over-represented in the Governing Council and that in an enlarged Eurosystem this will have the fatal effect that interest rate decisions may not always be made on the basis of the average economic conditions that prevail in the union. The solution to this problem must therefore consist in reducing the importance of small countries in the Governing Council, so that the strategic position of the Board can be maintained. This can be achieved in several ways. We discuss some possible formulas.

– *The U.S. Fed formula:* this consists in allowing all governors to partici-

1 *This does not mean that such a coalition will necessarily be found. The point is that it is now a serious possibility.*

pate in the deliberations of the Governing Council but to restrict the voting rights to a limited number of governors (e.g. ten) on a rotating basis.

– *The IMF formula:* this consists in having small countries group together in constituencies and be represented by one governor.
– *The centralised formula:* this consists in restricting the decision-making to the Executive Board of the ECB. Today the Board consists of six members. In this formula there is some scope for expanding the size of the Board.

The third formula is probably too drastic. The advantage of the first formula is political. By introducing a system of rotation in the voting, one does not have to discriminate between small and large countries. The effect on the outcome will be broadly the same whether it is small or large countries, which are allowed to vote since this rotation system reinstores the strategic position of the ECB-Board. Large countries, however, may not like this solution. As a result, a combination of the first and second formula could be a reasonable compromise whereby groups of smaller countries delegate one of their governors on a rotating basis.[1])

## 3 Conclusion

I share the general philosophy of Arnout Wellink's very interesting and thoughtful paper, i.e. that there is merit in the decentralised set-up of the Eurosystem. However, there is one area where we will have to move to more centralisation quickly, i.e. in the decision modes within the Governing Council. This is necessary because in an enlarged Eurosystem, the present decision-making model will become unworkable. ❧

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1 *It is unclear, though, whether this solution is consistent with the Nice Treaty which says that the rebalancing of the votes should not introduce discriminations between countries.*

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# The European Industry and the Organization of Banking Supervision in Europe

The debate concerning the organization of prudential policy and banking supervision has become a highly sensitive subject in the present European context. This is so because it involves many aspects: the necessity to cope with persistent banking fragility and financial instability; the difficult balance to be found between centripetal forces (i.e. centralization or, at least, deeper coordination) and centrifugal forces (i.e. decentralization and the full respect of the subsidiarity principle) in the context of Economic and Monetary Union (EMU); the respective role of the Ministries of Finance, the European Central Bank (ECB) and the national central banks (NCBs) and, when they exist, of some more or less independent commissions or committees in charge of banking supervision; the conflicts and arbitrage between a lot of vested interests; etc.

The purpose of this paper is to review the facts and some of the arguments concerning the organization of banking supervision in Europe and to come to some policy recommendations.

## 1 The European Banking Industry: Where Do We Stand and Where Do We Go?

### 1.1 About the Effectiveness of the Single Market

The single market has dramatically accelerated banking and market integration in Europe. Nowadays the share of cross-border transactions within the euro area varies between 40% and 50% according to the type of transactions. For example, the average value of payments through TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) is around EUR 400 billion per day.

We have seen in the last couple of years an impressive acceleration in the bank's appeal to the supply of cross-border financial services. The launching of the fiat euro as of January 1, 2002, has been fostering competitive pressures including tax- and regulatory competition. Even if those competitive pressures are more intense in the wholesale and the middle market, they also affect the retail market.

Nominal and real convergence has progressed markedly in European banking. Nevertheless some relevant divergences and some important obstacles to a genuine single market still remain in place. I cite some of them.

(i) Divergences in the structure of financing of EU countries. These divergences are fully expected and normal since they reflect the specific historical path and the economic and cultural characteristics of each national financial system. Following Cecchetti (1999), the structure of financing refers here to three structural aspects: 1. *the financing of non-financial agents* (firms, households, the state, etc.), i.e. the respective share of intermediation and disintermediation in total financing. In EU countries like everywhere, disintermediation has been developing in parallel to financial innovation, deregulation, securitization, etc. The current trend is toward market-based financial systems (see Allen and Gale, 2000), but in most euro area countries, as opposed to the U.K., bank financing still amounts to nearly 50% of the overall external financing of non-financial units (see Boissieu, 2002, for the French figures); 2. *banking concentration.* Looking at the recent data particularly at the concentration ratios (the Herfindahl index, the share of the top five banks, etc.) calculated by the ECB staff (ECB, 2000), three groups of countries must be taken into consideration: highly concentrated banking sectors, to be found in small and open economies (Finland, the Netherlands, Belgium, Denmark, etc.; outside the EU Switzerland); medium concentration ratios registered in Austria, France, Italy, etc.; "under-concentrated" (at least in comparison to EU average) banking systems (Germany, Luxembourg, the U.K.). Everywhere concentration ratios have increased significantly since 1995 in EU Member States, with one important exception (the U.K.). In the meanwhile the standard deviation of concentration ratios within the EU area has not dropped significantly. By the way, when looking at the effectiveness of competition, the degree of contestability in the market for banking and financial services is more relevant than the banking concentration ratio. From the viewpoint of contestability there could be more convergence in European banking than when considering concentration ratios; 3. *corporate governance characteristics.* Both the single market and the single currency, by speeding up cross-border consolidation transactions, are generating some convergence in banks' corporate governance in Europe. But some national idiosyncrasies still prevail regarding the role of the board, the relationships between the management, the stockholders, the other stakeholders, the degree of transparency of information, etc.

(ii) Loopholes in EU legislation. An impressive set of European directives concerning the financial sector has been adopted and implemented since the mid 1980s, including the crucial 2nd Banking Directive (and its "home country" control rule as the principle, with the usual exceptions). When assessing this set of directives, we must in the same time acknowledge the progress already attained and notice the remaining loopholes and regulatory challenges. Some topics which are crucial for the establishment of a true "level playing field" are not yet covered by a European directive, such as the liquidity ratio, internal control rules and procedures or take-over bids (after the failure of the draft directive on take-over bids in 2001). Some draft directives have still to go through the lengthy but democratic process of adoption (e.g. the directive concerning the supervision of financial conglomerates). Other directives have generated a minimum harmonization through an adjustment on the "short side" of the regulation. For instance, the 1994 directive on deposit insurance is fully consistent with the current wide disparity in country deposit insurance schemes. I am not saying that we must converge to the same liquidity rules, internal control rules, and deposit insurance schemes or to the same level and structure of savings taxation. What I am saying that the gaps observed

in many dimensions of the regulatory framework are not consistent, in the medium and long term, with the euro and EMU. These gaps must not disappear but they have to narrow. This is necessary, but not sufficient, to come closer to a "level playing field."

(iii) Divergences in the attitude of public decision-makers. The general rule is that, for becoming effective, a European directive has to be transposed into the national law of each member country. Due to the significant room for maneuvers that exists into such a procedure, important competitive distortions remain despite the harmonization process. Banking consolidation is also a good example of persistent divergences. In January 1999, M. Fazio, governor of the Banca d'Italia, rejected the draft merger between IMI, San Paolo di Torino and Banca di Roma since it was unfriendly. Two months later the French Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI) authorized the launching of the twofold bid by BNP on Société Générale and Paribas despite the fact that it was unfriendly ("unsolicited" by the targeted banks) (in August 1999, after the market deal, the CECEI rejected the purchase of Société Générale by BNP mainly on the ground of corporate governance considerations). Is such a discrepancy in the attitude of prudential authorities consistent with a genuine single market? I have some doubt.

(iv) Persistent divergences in the behavior of private investors. I give two illustrations. First, the retail market (households, individual entrepreneurs, etc.) remains and will remain very sensitive to "proximity services" (proximity (or vicinity) refers here not only to geographical considerations, but also to cultural and commercial aspects). Therefore the relevant market area for such customers and for the retail bankers will continue to be local or regional despite the ongoing development toward financial globalization and the new technologies (including Internet). Second, a significant "national bias" does remain on the part of borrowers and investors and the reasons for this are numerous (asymmetry of information, transactions costs, remaining regulatory barriers to capital mobility and international diversification notwithstanding the single market rules, etc.).

### 1.2 The Outlook: Growing Externalities Coming from Further Consolidation and Integration

Given the "youth" of EMU and euro and given the time required to ensure the effectiveness of the single market, we could reasonably expect further integration as regards financial markets, payment systems and banking sectors in Europe. Notwithstanding the crucial implications of financial markets and payment systems for prudential policy and the management of systemic risks, I will here focus on banking reorganization and its main policy consequences.

(i) Europe in general, the EU area in particular are just in the midst of the banking consolidation process. The forces behind this process are still very active: deregulation, growing competitive pressures (the euro is not the cause of banking reorganization, just a catalyst for it), a persistent excess capacity at the world level (therefore, also in Europe) on many segments of the market for banking and financial services (intermediation activity, some market activities of banks, possibly e-banking, etc.). Therefore banking consolidation in Europe could last a couple of years more from now.

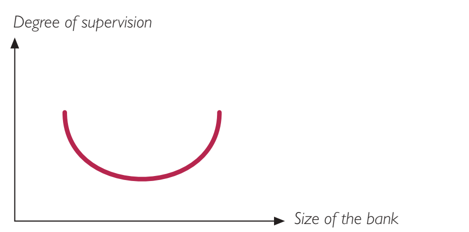
(ii) Due to the euro and a more effective single market, cross-border mergers or acquisitions are going to represent an increasing proportion of overall consolidation deals. Nowadays this proportion is still marginal. During the year 1999, cross-border consolidation transactions represented nearly 17% of the overall *number* (NB not the amount) of transactions. During the first half of 2000, the figure raised to nearly 26% (data collected by the Banking Supervision Committee of the ECB). In most EU member countries, banking consolidation has been taking place in two phases which are somewhat overlapping: first the creation of "national champions," second a growing cross-border dimension (e.g. the friendly bid on Crédit Commercial de France by HSBC).

(iii) Banking concentration will keep going on despite the controversy concerning the existence and the magnitude of economies of scale in banking. There is no doubt that Internet and the other new technologies are opening some additional room for scale economies. Nevertheless the critical size above which scale economies disappear and are transformed either in constant returns to scale or even in diseconomies of scale remains pretty low in banking in comparison with industry. Most merger and acquisition activities (M&As) in banking come from the search for bigger market shares rather than from actual economies of scale.

(iv) In Europe like elsewhere consolidation will progress in parallel to conglomeration. There is some economic foundation for such a trend: the evidence is more convincing for economies of scope than for economies of scale. However, from an empirical viewpoint, concentration and product diversification are often difficult to disentangle from each other. In 1999 consolidation across the various financial sectors (banking, insurance, brokerage, etc.) either domestic or cross-border represented 33% of the overall *number* of consolidation transactions in the EU. There is no clear token that this proportion could have already started to drop. Product diversification and despecialization are still overwhelming vis-à-vis the strategy of re-specialization by some financial intermediaries (e.g. some banks are leaving the non-life insurance business due to the lack of clear-cut comparative advantages). For the medium- and long run, three categories of banks are going to coexist (Boissieu, 2001): universal banks, multi-specialized banks (with a certain number of "niches"), mono-specialized banks (having one main comparative advantage). Subcontracting relations between those various categories of banks will continue to develop.

(v) We cannot dismiss the policy implications of further banking concentration. This concentration is not going to jeopardize competition and the protection of customers provided that the market stays contestable enough. Let us concentrate on the prudential consequences of banking consolidation. On the one hand, such consolidation is often the institutional answer to an actual and/or expected banking fragility (a lack of capital, a low return on equity by the sector standard, etc.). On the other hand, banking consolidation could generate another type of systemic fragility by enlarging the area of the "too big to fail" (TBTF) rule (see Berger et al., 1999). Therefore, in order to contain moral hazard, the supervision authorities must improve the monitoring of large banks and financial conglomerates. In effect, banking supervision has to concentrate on sizeable financial intermediaries (to limit the moral hazard generated by the TBTF rule) and also on small banks which stay under the critical size regarding the implementation of reliable internal control procedures. Chart 1 depicts the U-curve relationship between the size of the bank and the required degree of banking supervision (Boissieu, 2001):

Chart 1




To sum up the various and converging arguments, externalities (and also network effects) are going to develop in the European financial sector, relating to payment systems, financial intermediaries and financial markets. This trend unavoidably influences the organization of prudential policy and banking supervision.

## 2 Banking Supervision in Europe: What to Do?

### 2.1 Main Trends in Banking Regulation

At the world level we are observing important trends regarding banking regulation. I cite some of them.

(i) The development of *self-regulation* in banking and finance. The articulation between "external" regulation and self-regulation, namely the complementarity or substitutability between them, has become a topical subject. Since the mid-1990s, we have seen self-regulation procedures developing in over-the-counter (OTC) derivatives markets (leading to what I call OTC+, i.e. OTC plus private clearing houses, margin requirements, deposits, etc.) and in some other compartments.

(ii) The spread of *internal control* procedures and techniques within financial intermediaries, brokerage firms, etc.

(iii) The transition from the Cooke to the Mc.Donough ratio, which is going to imply the search for a new balance between centralization and decentralization. Each bank will have to choose either the standard model (relying mostly on the external grading by the rating agencies) or its own internal model for assessing credit risk (this free choice is the token of decentralization). But a "referee" (depending on the national institutional idiosyncrasies, the national central bank, the banking commission, the Financial Services Authority – FSA, etc.) will have to gauge the quality of internal models, requiring some centralization of information (about the content and the accuracy of each model). What is at stake for the last stages of the negotiations in Basel and Brussels is precisely the desirable balance between centralization and decentralization.

(iv) The gradual transition from the institutional control (i.e. by institution) to a functional control (i.e. by activity). This transition is a pre-requisite for a true "level playing field" and the implementation of the "same activity, same rule" principle. Realistically, for many reasons, the institutional control will keep prevailing but more functional control has to be incorporated.

Given these world-wide trends and the role of the Basel Banking Supervision Committee, Europe and the EU are not always the relevant dividing line when looking at the dynamics of banking supervision and prudential policy.

### 2.2 Banking Supervision in Europe: The Current Framework

#### 2.2.1 Taxonomy of Banking Supervision in Europe

In the EU three types of supervision organization could be distinguished:

– the central bank (CB) model, where banking supervision is assigned either directly to the CB (Italy, the Netherlands, Portugal, Spain, Greece, Ireland, etc.) or to a committee or a commission highly dependent on the CB (France);

– the dual model, where banking supervision is assigned to the Ministry of finance or to a commission attached to it, or to an independent committee. In both cases, the central bank brings an extensive technical assistance (for on-site inspections, etc.) but is not the lead supervisor. This formula, which prevails in Germany, Belgium and Austria (in both countries after the recent reform) requires a high degree of cooperation between the various supervisors. For instance, the German Bundesaufsichtsamt für das Kreditwesen appeals to the support from the Bundesbank;
– the FSA model, where banking supervision lies within the competence of an independent body which monitors all banking and financial activities (banking, investment firms, insurance firms, stock exchange markets, etc.) (the U.K., Sweden, Luxembourg, Denmark, Finland where the FSA enjoys the support of the central bank).

Despite a growing attention paid to the FSA formula, the institutional convergence within the EU and the euro area has remained moderate. The draft reform in Germany implies the creation of an FSA-type structure functioning in close cooperation with the Bundesbank whereas the draft law in Belgium keeps the general competence of the Commission Bancaire et Financière (a sort of FSA) while extending the supervisory role of the Banque Nationale de Belgique.

#### 2.2.2 The Present State of Cooperation

The current configuration is based on three pillars:

(i) Subsidiarity does apply to banking supervision, which remains a national prerogative. The ECB could exercise a consultative role on a large set of issues (article 105 para 4 of the Maastricht Treaty) and has to back the national competent bodies as regards the prudential control of credit institutions and financial stability (article 105 para 5).

(ii) According to the rules of the single market, banking supervision takes place on a consolidated basis. Namely, branches located abroad are controlled by the home country supervisor whilst the subsidiaries of a bank located abroad fall within the jurisdiction of the various host countries.

(iii) Both bilateral and multilateral cooperation has developed dramatically during the recent years. Cooperation concerning micro-prudential issues is mainly bilateral (Memoranda of Understanding, exchange of information about the situation of individual banks, etc.). It is delicate and even ineffective to disclose any confidential information at 15 (much more in a couple of years after the first wave of enlargement). In Europe, multilateral supervisory cooperation mostly relates to macro-prudential questions. It is currently implemented through several channels: the Groupe de Contact; the BAC (Banking Advisory Committee) composed with the national Treasuries, the NCB and national supervisors (when they are distinct from the central bank) and involved in the regulation-making procedure: the

BSC (Banking Supervision Committee), comprising the NCBs and national supervisors (if different from the central bank), close to the ECB and strengthening the exchange of information and convergence regarding macro-prudential policy.

### 2.3 The Main Scenarios

Two separate but de facto closely intertwined issues must be distinguished: the *cross-sector* dimension and the *cross-border* viewpoint.

As regards the possible ways to deal with cross-sector aspects, for the sake of simplification, I underline here three cases: 1. the full specialization of supervisors (each one in charge of a type of activity: banking, insurance, stock markets, etc.), a pattern which implements the principle of comparative advantage and something close to the assignment rule in the Mundell-Fleming model. This formula generates a big challenge for domestic supervision coordination. 2. the Australian formula or dual model where domestic coordination leads to two main groups of supervisors (the "twin peaks" model): the ones in charge of supervising the institutions and the others monitoring the functioning of capital markets (in France, Laurent Fabius, the former Minister of finance, has proposed to pass to a scheme close to this one and it is likely that the new government is going to endorse this proposal). 3. the full integration of domestic supervisors through a FSA-type system.

From the cross-border perspective I also propose to differentiate between three configurations: 1. the status quo, i.e. resorting to the existing network of cooperation tools: Banking Advisory Committee (BAC), Banking Supervision Committee (BSC), Groupe de Contact, etc. 2. the enlarged cooperation. In comparison with the present situation, this scenario would imply to delegate more own competence to the existing bodies (BAC, BSC) and/or to transform them into decision-making institutions. The Eichel-Brown proposal put forward during the Oviedo Council and currently under discussion clearly belongs to this category, as the proposed application of the Lamfalussy process to the banking field. 3. full centralization of banking supervision through the creation of a single banking regulatory body at the level of Europe.

Combining the two criteria, we come to nine possible scenarios (table 1).

Behind the choice of a combination in this (3,3) matrix, what is at stake deserves more attention. No doubt the balance between the "center" and the "periphery," i.e. the actual degree of centralization/decentralization as regards banking supervision and the competition and/or cooperation between national and European decision-makers, is the priority issue. But the relationships between the ECB and the NCBs on the one hand, the Ministries of Finance all over Europe are also at stake.

Table 1

**Scenarios for Banking Supervision in Europe**

| Cross-border | Cross-sector | | |
|---|---|---|---|
| | Specialization | Dual system | Full integration |
| Status quo | | | |
| Enlarged cooperation | × | | |
| Centralization | | | |

### 2.4 Some Policy Recommendations

Among the nine possible configurations (table 1), which one to favor? Many criteria would have to be taken into account before arriving to firm and reasonable normative conclusions. I underline three of them.

#### 2.4.1 Externalities and European Public Goods

According to Tinbergen (1954), the tools that generate externalities (either positive or negative) must be integrated in order to develop (positive externalities) or restrain (negative externalities) their use. We already suggested that externalities between national banking and financial systems are going to extend dramatically. Therefore a banking or financial crisis in Italy or France in five or ten years from now will not be only Italian or French. Due to the conjunction of many spill-over effects, it will become very quickly European (affecting several member countries) or even pan-European. Conclusion: the status quo in banking supervision (first row in table 1) is not consistent with the current and expected state of banking and financial integration in Europe.

#### 2.4.2 The Gathering and Treatment of the Relevant Information

I am convinced that despite Internet and the other new information technologies, local (i.e. national) authorities will keep their comparative advantage for gathering local knowledge and dealing with local information, monitoring domestic banks and assessing their global risk exposure. For the future, with the transition from the Cooke ratio to the McDonough ratio, national supervisors will be in a better position to implement Pillar 2, i.e. to exercise their ability to require additional capital (above the legal 4% and 8%) on a discretionary basis. The argument relies on the very notion of "proximity", which must be understood by combining geographic, cultural, informational and sociological aspects.

This criterion combined with the former one leads to support the "enlarged cooperation" solution (second row in table 1) which is consistent with the specialization or the integration of supervisors at the national level. Therefore a European Banking Commission replacing the national Banking Com-

missions or a European FSA would be much premature. We have to be pragmatic. In 2010 we will have to review the existing institutional arrangement and to see whether the transition from enlarged cooperation to more centralization is needed. Anyhow the importance of local information will keep necessitating some decentralization (see, for instance, the supervisory role of the regional Feds in the U.S. in conjunction with the Board of Governors).

#### 2.4.3 Managing the Risk of "Institutions Inflation"

Under the current circumstances goods and services inflation is less a threat than what I call "institutions inflation," i.e. the creation of new institutions and new levels of decision-making without abolishing the older ones. Since the 1987 crash we have been knowing that coordination between domestic regulators is as challenging as international coordination, sometimes more (with the FSA formula as one of the conceivable solutions). The multiplication of new bodies at the European level could generate additional coordination issues. Are they complementary to or substitutable for existing national authorities? To what extent? Instead of a general answer and solution, I would advocate a case-by-case analysis of information flows, decision-making procedures and of the enlarged cooperation required by the progress toward a more integrated banking and financial sector in Europe.

### 2.5 About the Lamfalussy Process and Comitology

The Lamfalussy Report (2001) brought several interesting proposals in order to speed up the legislative process in the field of investment services, particularly securities markets. Thereafter the cooperation between national securities and exchange commissions has been strongly reinforced by the creation of two new committees at the European level.

What is called today the Lamfalussy process corresponds to the combination: specialization plus enlarged cooperation (the space with X in table 1). It appeals to some basic goals: 1. to strengthen cooperation between national supervisors; 2. to speed up the completion of the single market; 3. to make the decision-making process in the EU more efficient (but also to circumvent existing rules such as unanimity, which could raise many political and democratic issues). Must we apply the Lamfalussy process to the banking area? The Eichel-Brown proposal and the counter-proposals by the Eurosystem and the European Commission, all currently under discussion, are not so different from each other. One way or another they apply the Lamfalussy process to banking supervision and favor the comitology approach, since they propose to give specific powers and roles to European committees. A three-tier model is put forward in all proposals: 1. a European Banking Committee (EBC; in the wording of the Eichel-Brown draft) (parallel to the European Security Committee), deeply involved in the legislative and regulatory process. This EBC would be a reinforced (or "augmented") BAC; 2. a Banking Supervisory Group, mainly consultative and in charge of regulatory convergence (this BSG is an "augmented" BSC); 3. a European Stability Forum which would transpose at the regional level the *modus operandi* of the Financial Stability Forum.

Significant divergences appear as far the composition of these various committees and groups is concerned. In some of the drafts the Treasuries do not participate to some committees (the national central banks and the ECB not participating to some other committees). We need a more cooperative monetary-fiscal mix in the euro zone. More cooperation between the Treasury and the NCB within each country is required as well.

Generally speaking, comitology raises several issues:

(i) The comitology approach assumes a clear-cut borderline between the principle and rules (which come under the competence of the legislative process: directives, etc.) and their technical application (competence of committees more or less independent vis-à-vis the central bank, the Ministry of Finance, etc.). In practice, this line could be rather uneasy to draw.

(ii) From a theoretical viewpoint, the development of comitology appeals to the delegated monitoring paradigm à la Diamond (1984) and to the principal – agent model inherent in the delegation scheme.[1]) In particular, it would be enlightening to focus on the right incentives structure and the risk of "free riding" in the Lamfalussy process.

(iii) Comitology has to go parallel to accountability and to a certain degree of transparency (vis-à-vis the European Parliament, the national Parliaments, the public opinion in general). I do not believe in the possibility of improving the banking supervision cooperation in Europe significantly and on a medium-term basis without democratic support.

### 2.6 Crises Management in Europe: Concluding Remarks

While banking supervision and prudential policy are mainly preventive, lender-of-last-resort (LLR) interventions are curative. However useful it could be, the distinction between the preventive and the curative phases of crises management must not be pushed too far since, for instance, deposit insurance enjoys the two dimensions.

The optimal degree of centralization or coordination is not necessarily the same for supervision as for LLR interventions. In the United States the LLR function rests with the Board of Governors and the Federal Open Market Committee (FOMC), whilst banking and financial supervision and monitoring is split among Federal entities (the Board of Governors, the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), etc.), regional entities (regional Feds), state or other local authorities, etc. Why the LLR function requires more centralization than supervision does? I see the conjunction of a couple of arguments:

(i) The fact that externalities are increasing dramatically during systemic crises.

(ii) The fact that such systemic crises call for a very quick intervention by the LLR(s) (e.g. in case of a macro liquidity crisis). Centralization or at least an intense coordination could be necessary to accelerate the decision-making process.

(iii) The established fact that local knowledge is less decisive for LLR intervention than for banking supervision. Therefore the comparative advantage of national authorities over European authorities is less evident for LLR activities than for banking supervision since the externalities argument prevails over local knowledge considerations as far as LLR intervention is concerned.

In a paper prepared for the *Conseil d'Analyse Economique* (Aglietta and Boissieu, 1999), we discussed the Fischer (1999) proposal concerning the international LLR and we extend the analysis and the policy recommendations to EMU. My view is that the ECB will have to act in the coming years as a LLR at the euro area level (and possibly at the world level, in case of a world-wide crash, etc.), in conjunction with the NCBs. As far as banking supervision is concerned, a European banking regulator is premature. For the five years to come, a Lamfalussy-type process applied to banking supervision seems to be the best solution, provided that this process be respectful toward the national idiosyncrasies concerning the specialization or the integration of domestic regulatory authorities.

1 *A recent and interesting application of this paradigm to the German banking system from 1800 to 1914 is proposed by Guinnane (2002).*

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# Comments on Christian de Boissieu, "The European Industry and the Organization of Banking Supervision in Europe"

Professor de Boissieu's paper describes the EU integration process in the field of banking supervision in positive as well as, to some degree, in normative terms. The author discusses the *institutional* dimension of supervision (who should supervise whom?) as well as the *international* dimension of supervision (what is the optimal degree of centralization?). In both, he takes a clearly European perspective and he argues as an economist. He uses externalities and the distribution of information as factors explaining institutional settings. Practical aspects, including cross-border and cross-sectional issues are given sufficient room. All in all, de Boissieu offers an interesting to read, balanced and circumspect piece.

The author is cautious in his policy recommendations. Regarding the *institutional* dimension of supervision he takes a pragmatic neutral view on what he calls the central bank approach, the dual approach and the Financial Services Authority (FSA) approach, thus largely following Goodhart et al. (1998). I would admit that the old world of single purpose institutions (the central bank regulating the money supply, the banking authority supervising banks) is probably a paradise lost. Maybe it was not even a paradise, as incentive problems and conflicts of interest created the dangers of regulatory forbearance or of liquidity provision for insolvent institutions.

Yet, today boundaries between institutions tend to become blurred. Central banks are more explicitly accepting their responsibility for systemic stability. They are thus increasingly confronted with questions traditionally faced by the supervisors. Conversely, supervisory actions may become more relevant for the macroeconomy. One reason is concentration in banking; another is the potential cyclical impact of the more risk sensitive capital requirements being considered by the Basel Committee on Banking Supervision (2001). It is thus difficult to take issue with a cautious, pragmatic approach as advocated by de Boissieu and others. Yet, the optimal division of tasks between central banks and supervisors remains an unsolved problem, and practitioners can only benefit from any further efforts by the academic community to understand optimal institutional mechanisms and informational arrangements.

Regarding the *international* dimension of supervision de Boissieu favors enlarged cooperation as a middle way between national autarky and full centralization. The author also takes the opportunity to warn against the main danger of international cooperation, namely the inflation in the number of institutions. Finally, tackling one of the issues in European monetary integration that are not explicitly settled, de Boissieu claims that lending of last resort should be more centralized than supervisory powers. One could argue that these policy recommendations, particularly the one just mentioned, are not rigorously derived from the analysis offered in the paper. However, it seems more fruitful to focus on the basic *leitmotiv* of de Boissieu's paper, namely the concept of regulatory competition.

Does competition among regulatory systems lead to the survival of the best rules or to a "race to the bottom"? Measured against other contributions to this conference, de Boissieu again is on middle ground, here between the skeptical view presented by Hans-Werner Sinn[1]) and the more optimist view offered by Gareth D. Myles.[2]) Starting from the skeptical side, I would agree that competition among bank regulators may fail for several reasons like the existence of externalities (international contagion, terrorist finance), network effects, transaction costs, and information problems. As Sinn put it: "Since states intervene where markets fail, the market of states is also likely to fail."

Unfortunately, harmonization might fail just as well as regulatory com-

1 *Please refer to the paper entitled "The New Systems Competition" by Hans-Werner Sinn published in this volume.*

2 *Compare the comments by Gareth D. Myles on Hans-Werner Sinn "The New Systems Competition" published in this volume.*

petition. de Boissieu touches upon some very relevant questions like: How can we harmonize implicit guarantees? Can we harmonize banking supervision, but not crisis management? Who stops the growth of committees? These are questions the advocates of international harmonization will need to answer if they want to have economists on their side. I would add a few more:

– Is the EU the right club for harmonization?
  My answer would be: quite definitely not. An optimal regulatory area might very well differ from an optimal currency area. The Basel Committee member countries, hosting most internationally active banks, to my view are a more plausible candidate for an optimal regulatory area.
– Where goes the regulatory laboratory after harmonization?
  To me this is a serious concern. Existing regulations have been found by trial and error. Adapting regulatory rules to a constantly changing environment thus involves making mistakes. Harmonization probably means that regulatory mistakes become less frequent but more expensive. The loss of today's world-wide regulatory laboratory may thus involve high costs in the long run.
– Are regulatory cartels any more stable than other cartels?
  Some countries may perceive a conflict between their contribution to international financial stability and a desire for improving the competitive position of their domestic banks. As supervisory acts are difficult to monitor in sufficient detail internationally, there are always opportunities to free-ride on harmonized rules by applying them with regard to the national, rather than an international interest.

There is one dimension in the "centralization versus regulatory competition" debate that deserves more attention than it got at this conference, namely the choice among rules *within* a jurisdiction. One example is company law which in most countries offers individual firms a menu to choose from. Such a choice among individual rules is more likely to lead to a survival of the best rules than the choice among bundles of rules (as represented by jurisdictions). It is thus unclear to me why we should bother about product bundling in the Microsoft case, e.g., but not in the case of competition among jurisdictions. In a similar vein, Sunder (2002) strongly argues in favor of competing accounting standards.

The new Basel Capital Accord (Basel II) is a good example of a pragmatic and flexible approach that combines centralization (common standards) with choice among a menu of rules (different approaches) as well as with decentralized application (national implementation). The main rules, laid down in the so-called Pillar 1, are common standards supposed to be followed by all countries represented at the Basel Committee (and likely to be followed by many more). However, banks will be able to choose individually among different approaches: most importantly among a relatively simple "standardized approach," and a more sophisticated "internal ratings-based approach" for which two options ("foundation" and "advanced") are available. The Committee thus explicitly stimulates competition among rules. A decentralized element enters with national implementation and application of Basel II. Under Pillar 2, national supervisors are expected to apply the capital standards according to their spirit: Banks shall be asked to hold additional capital wherever they face higher risks than assumed in the Accord. Yet, decentralization opens some scope for competition; the Committee will thus probably want to follow the national implementation and interpretation of the Accord rather closely. Its task – to find a pragmatic and flexible way between (excessive) centralization and national autarky (potentially leading to an erosion of standards) – seems to be quite in line with de Boissieu's recommendations. Finally, Pillar 3 defines standards for disclosure and transparency designed to support market discipline. The Committee thus recognizes the complementary nature of market discipline and of supervisory discipline. If Sinn argues that, in controlling bank's risks, the market, the state, plus the market for states may fail, I understand the Committee to take the pragmatic view that the optimum solution is a combination of all three imperfect forces.

De Boissieu and other speakers at this conference have offered interesting and mostly plausible views on many aspects of centralized versus decentralized European institutions. Yet, they have also made obvious that many issues are still undecided. Progress can only be made through further continued research and through interaction of researchers and practitioners, hopefully very much in the spirit of this conference. ❧

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# Regional Stock Exchanges – Is There a Future?

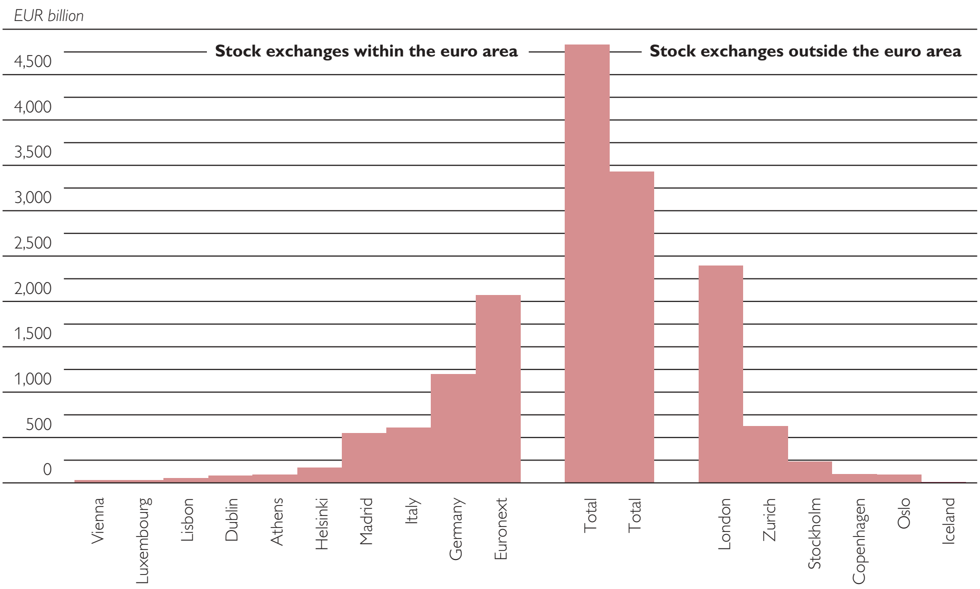
I used to be the chairman of the Brussels Exchanges, which admittedly was a regional stock exchange until 21 months ago, when we merged with Paris Bourse and the Amsterdam Stock Exchange to create the first cross-border exchange in Europe: Euronext. Euronext is now also covering Portugal and last but not least, we acquired the London-based derivatives market LIFFE. So based on this experience, I would like to cover two points.

First of all, what are the challenges for the regional stock exchanges? We will look at some charts and some other aspects. In the second part we will consider how to carry on and how to try to combine the global approach to size, which is essential, with the local relevance.

First some challenging facts. The major event for stock exchanges in Europe is the arrival of the euro. If you look now at the split between euro stock exchanges and non-euro stock exchanges in Europe, you can see that in terms of market value the stock exchanges within the euro area represent

Chart 1

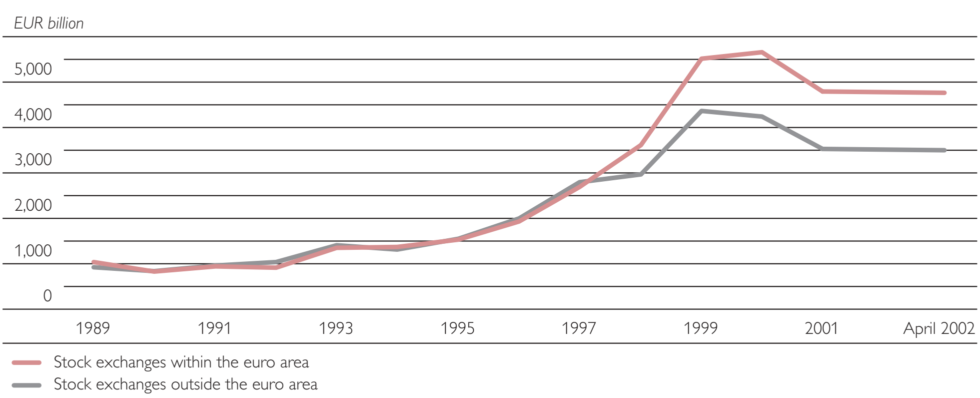
**Market Value of European Stock Exchanges**




Source: Euronext.

Chart 2

**Market Value of European Stock Exchanges**



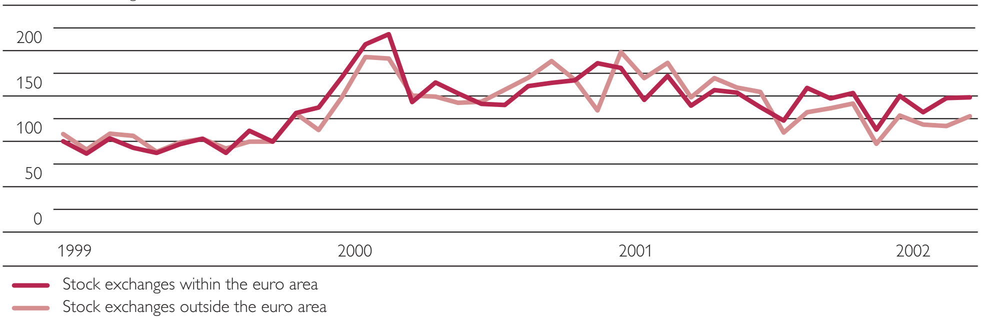

Source: Euronext.

a higher market value than the ones outside of the euro area. The largest one out of the euro is obviously London, while the largest one within the euro area is Euronext. If we look at the impact of the euro on market valuation, there has apparently been an influence on the relative evolution of the market value of the stock exchanges both within and outside of the euro area. If we look at the turnover, there is apparently no impact of the euro. However, if you compare the turnover of the large stock exchanges and the regional stock exchanges in Europe over the same period, you see a very significant evolution between the two. One reason might be that international diversification of portfolios is asymmetric, meaning that when diversifying, the investor sells domestic shares and rather switches to a cross-border sector-based investment pattern. By doing so, he first looks at

Chart 3

**European Stock Exchanges Turnover**

*Index: 1999 average = 100*

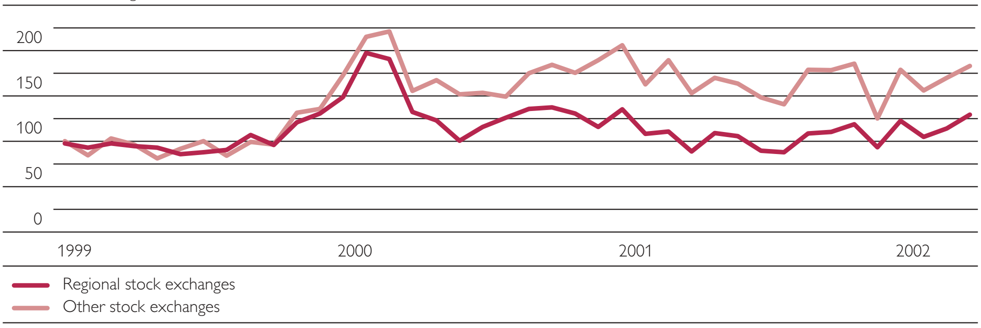



*Source: Euronext.*

Chart 4

**European Stock Exchanges Turnover**

*Index: 1999 average = 100*



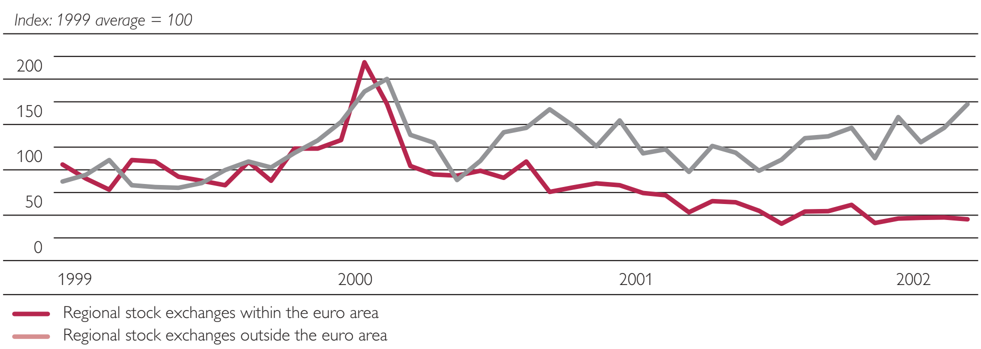

*Source: Euronext.*

the most liquid shares and obviously the larger market. It is even more striking if we compare the regional stock exchanges belonging to the euro area and the regional stock exchanges outside of the euro area. We can clearly see that the pattern of turnover of the regional stock exchanges outside suffered much less than was the case for the regional stock exchanges within the euro area. This is another indication that the boost given by the monetary union to the diversification of portfolios was stronger within the euro area. Within this zone, the bias has been in favour of the larger stock exchanges to the detriment of the smaller ones. So, that is the first challenge for the regional stock exchanges, and in particular it is a challenge for the regional stock exchanges within the euro area.

The organisation of the equity market along national borders is not relevant any more and no longer matches the behaviour of the market participants. Another aspect, another challenge and even a driver of the consolidation in Europe is the construction and the business model of an exchange. A stock exchange is a provider of an infrastructure with computing capacity, with financial guarantee, with financial regulation and credibility enhancement. This means a significant infrastructure cost but means high fixed costs, relatively low marginal cost: adding an additional listed company would not increase the cost very much, for adding an additional member the

Chart 5

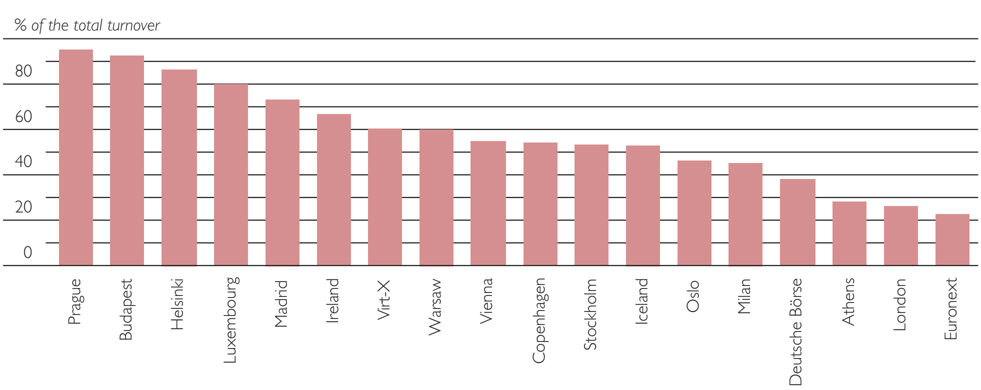
**European Stock Exchanges Turnover**




Source: Euronext.

Chart 6

**Top 5 Most Traded Shares**




Source: Euronext.

marginal cost is close to zero. So, size matters in terms of business profitability for a stock exchange. Some smaller stock exchanges try to mitigate that as Vienna did for example by using the technology of a larger stock exchange.

The third challenge for smaller stock exchanges is the concentration of the activity in a limited number of listed companies. I take the example of Brussels as I know it well. Between 1997 and 2000, we lost eight of the twelve largest listed companies following mergers and acquisitions: most of them by either Dutch or French companies by the way. This means that the impact on profitability as a stock exchange can be highly exposed to cross-border mergers of key listed companies.

On chart 6, you see a sort of indication of the concentration rate of the various stock exchanges in Europe, i.e. the proportion of the total turnover that is concentrated on the top five most traded securities. You see that the smaller stock exchanges are on the left-hand side of the graph. In Helsinki, Nokia alone represents 65% of the activity. You have the largest stock exchanges, Deutsche Börse, London Stock Exchange and Euronext, with the surprising exception of Athens, on the right-hand side of the scheme. This is an important source of concern. Of course, this should be refined, taking into account the probability of some companies being taken over. – Is it probable that Nokia would be taken over by another company? – You also have to consider this from a qualitative and quantitative point of view. Nevertheless, this certainly is a source of concern for smaller stock exchanges. The question is: how can we meet these challenges? My answer will be based on our own experience; I will call it the "Euronext answer".

First of all we have to bring a multinational dimension, not only an international dimension. We have to deliver synergies, that is the size-effect on the cost-side and we have to deliver efficiency. Most European markets are very efficient locally, in terms of vertical straight-through processing from trading, clearing to settlement, but on a cross-border basis we still have problems. Obviously we have to gain credit.

If you look at a way to reduce European fragmentation and to consolidate the market in terms of equity trading, you basically have two views. The first, "old view", is to claim, as a stock exchange, that you are pan-European and try to attract all the activity to your initial jurisdiction. It has traditionally been the attitude of some large stock exchanges, e.g. London or Frankfurt. It has also been the ambition of some new commerce in the market: Tradepoint a few years ago, now Virt-X and Jiway and some others: these initiatives did not succeed until now. The main reason is that liquidity is sticky. You do not move liquidity from one stock exchange to another easily. The reason is very simple, i.e. when you trade equities, the total transaction cost is for a minor part composed of the stock exchange fees, on average about 12% of the total cost. The largest part of the total cost is the price impact of the transaction. Obviously on the stock exchange already concentrating trading on a specific security, the orders on the buy and the sell side will minimise this largest component out of total transaction cost. That is the reason why liquidity can hardly be moved from one stock exchange to another.


The second difficulty is that if you want to force all the activity into one jurisdiction, let's say the U.K. jurisdiction, which is the largest financial centre in Europe, you will put additional adjustment costs on the shoulders of the clients of stock exchanges, either issuers, listed companies or even members because they will have to act mostly in a different jurisdiction than the one they are familiar with.

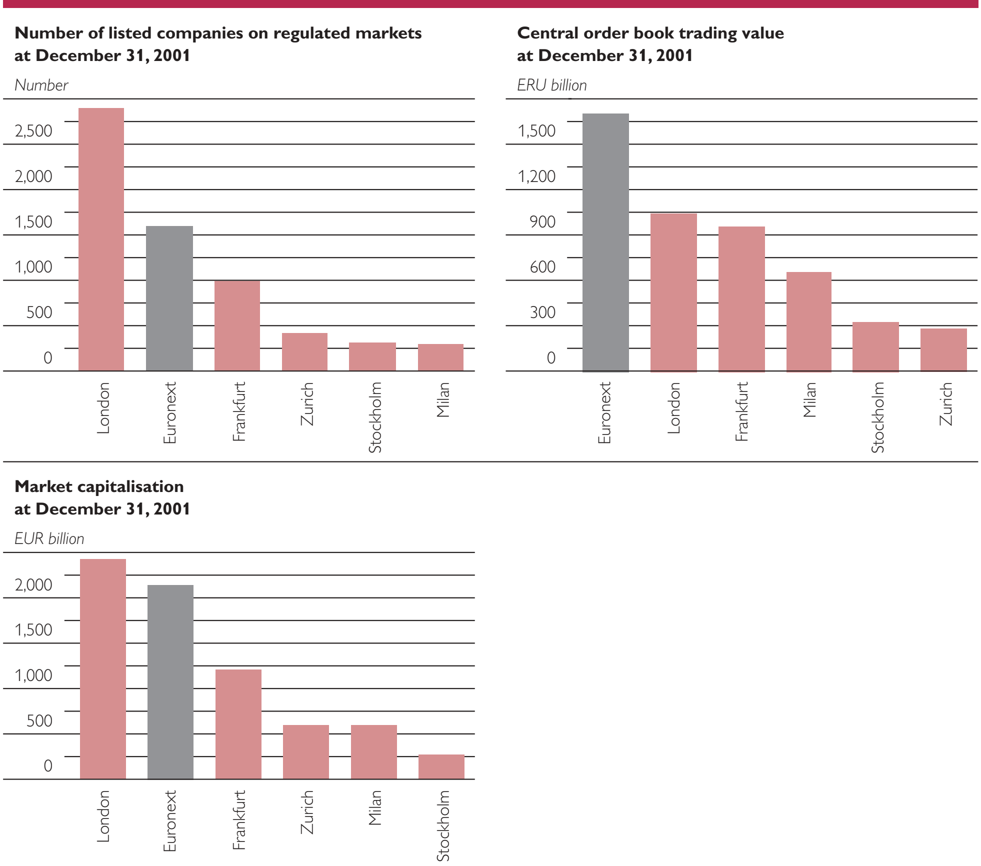
Last but not least, it is a negation of the home market value, which remains important in the equity market. The equity market is a market based on information and obviously issuers benefit from a sort of free information in the country or in the region in Europe they are coming from. This is obvious for smaller and mid-sized issuers in Europe, but also for larger issuers: if you look at their shareholder base, you still see a national bias. Look at Deutsche Telekom – obviously a big one –: despite of an international shareholdership, it still has a German bias, while France Telecom would have a French bias in the shareholdership. We have to find a solution which combines the global and the local dimension. Basically it is the approach that we have developed at Euronext by saying: if we cannot move the liquidity from one stock exchange to the other, let's buy it, apply an active merger and acquisition policy, let's put all these liquidity pools on the same systems in order to bring synergies and accessibility while keeping the local attributes for the members and the issuers. That is the way to bring continuity to them and to offer the additional value of a larger dimension, without asking them to move from one country to another, which would make little sense. This is basically the way we are structuring the market.

Practically, how did we do that? Initially we started with three jurisdictions when we merged and we kept our licenses as a regulated market in the sense of the European directive in the three jurisdictions. Some people say we do that for political reasons. No, it is not for political reasons, but for commercial reasons, to be close to the customer. Because this gives us the possibility to offer to the listed companies or the members the choice of the entry point to Euronext.

At the same time we unified the market, not only by putting it on a single technical platform, the NSC platform, but also by creating a

Chart 7

**Strong Position in the Equity Market**




*Source: FIBV, Fese, Euronext – December 2001.*

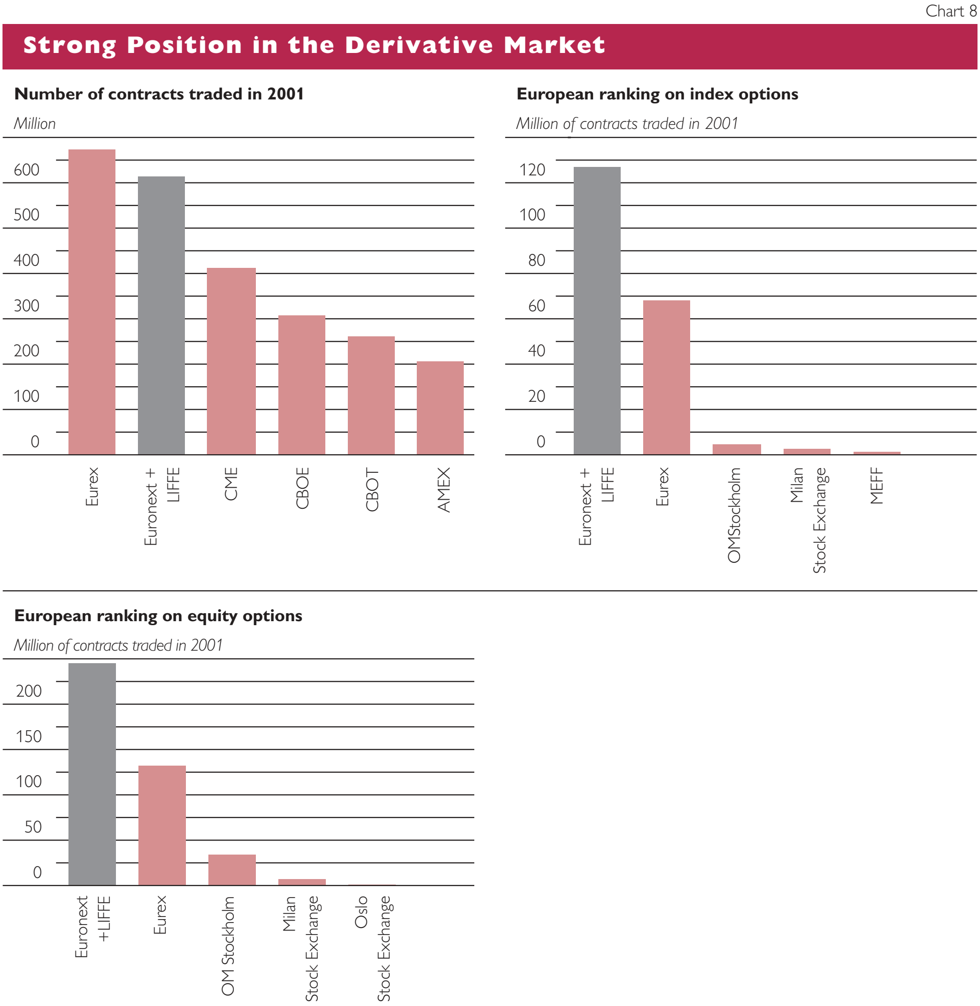
cross-border rulebook, the so-called ”Rulebook I” in the Euronext jargon. By doing that, we combined the local and the global dimension.

The beauty of the model is also that you can generalise it by adding other jurisdictions as we now do for Portugal and for the U.K. for the derivatives market. Synergy obviously really pays off when three systems, four, five, maybe more, merge into one system. This has been done for the cash market. We will do the same for clearing and settlement and for our derivatives market, where we today operate seven different systems.

As for vertical integration, that is vertical straight-through processing from trading to clearing and settlement: contrary to Deutsche Börse, we have decided not to take control of settlement but to sell our settlement activity to Euroclear in a more horizontal approach of the various stages. I will not elaborate on that.

If you look at the structure of the exchange industry, we now have three big players in Europe for the equity market. On the derivatives market, consolidation is done in Europe, basically with two major players, Eurex and Euronext, including LIFFE. By the way, these first two European derivatives

Chart 8




Source: FIA, Eurex, Euronext.

markets are also the largest two in the world, larger than the four derivatives markets in the U.S.

So, an important aspect from a client point of view, from an issuer point of view, is that they want to see their visibility enhanced by a merger of exchanges. If you look at the share of Euronext-listed companies in for example the MSCI, a European index, you can see that no serious investor worldwide can afford not to have access in one way or the other to such a large stock exchange. If I remember the position of Belgium before the merger, it was absolutely not obvious that we would be a must for an institutional investor. So, this enhanced exposure is certainly bringing value for the issuers.

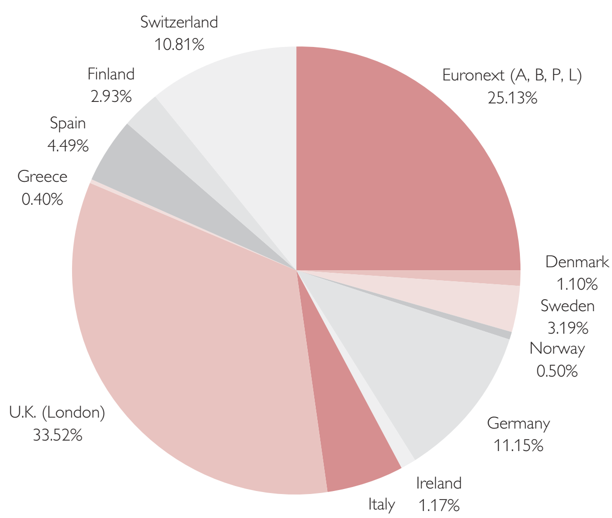
Now let me conclude a little bit bluntly on the question that was raised: is there a future for regional stock exchanges? The answer, I am afraid, is "no", not on a stand-alone basis. The consolidation is bound to go on in Europe one way or another, but there is still relevance to keep a regional dimension in the exchange business. We do not believe that concentration of the equity activity will happen basically by moving everything into, let's say, one jurisdiction, for example in London. This would increase the cost of capital for local or smaller issuers in Europe and I do not think that this is the purpose of the game. The purpose of the game really is to keep the value of proximity, keep the value of the regional market, the regional dimension and, at the same time, combining that in terms of cost exposure synergies and accessibility with a true international dimension. That is basically what we are trying to achieve with Euronext.

Now I conclude with two brief comments in saying first of all that we are very optimistic on the fact that we will deliver and we have already delivered a number of steps in this integration. We will continue to do so. I have to be modest, if you ask me: do we see already today the positive impact for example on the turnover of the Belgian companies at this stage?

Chart 9

**MSCI Pan-Europe Index**

*January 2002*




*Source: MSCI.*

I say "no", that obviously is too early. In fact, we should have more time to look at this in terms of turnover for all regional stock exchanges now included in Euronext, notably because the integration is not yet completed. It will be about one year from now, from trading to settlement.

The second comment I would like to make in my conclusion is that this is our recipe. We do not pretend that it is the only one. But the challenge for regional stock exchanges is very serious and this is a possible route to mention. ❧

Stefan K. Zapotocky

Stefan K. Zapotocky
Joint-CEO,
Wiener Börse AG

# The Challenges and Chances of Regional Exchanges[1])

## 1 Introduction

The last decade has seen a long-lasting boom on stock markets, especially in the U.S., which has led to a problematic development for a number of small regional markets with respect to their function as a source for raising capital:

The large stock markets experienced a surge in the liquidity volumes of large institutional investors, especially of U.S. pension funds, which soon led to the concentration on a few liquid stocks with relatively high levels of capitalization. In Germany alone, for example, about 85% of the trading volume is in the 30 DAX stocks. The phenomenon of the passive index management strategy pursued by large funds with their year-long practice of asset allocation according to the regional and sector weightings of a few international index systems (such as the MSCI, STOXX 50, etc.) augmented the global concentration on investments in a few hundred, mainly Anglo-American stocks.

At the same time, the outflow of capital from European regional markets that had high concentrations of small

1 *This paper has been published in: Société Universitaire Européenne de Recherches Financières (SUERF). Is There a Future for Regional Banks and Regional Exchanges? The Strategies of Selected Austrian Finance Institutions. SUERF Studies, No. 19, 2002.*

caps and mid caps accelerated, affecting precisely markets like the Austrian capital market.

Even after the collapse of the new economy boom (in 2001: Neuer Markt –60.10%, NASDAQ Europe –64.15%, NASDAQ U.S.A. –24.54%) several hundred massively overvalued stocks stood in stark contrast to thousands of undervalued stocks.

The significant function of (regional) capital markets for the economy and for local policy goals, growth and employment is thus at high risk: this is precisely where the challenges and chances lie for the further development of efficient regional stock markets such as Wiener Börse and the Austrian capital market. In the following, I am going to investigate whether or not the growing trend of consolidation and concentration among international exchanges invariably leads to the dissolution of regional exchanges, especially national stock exchange systems and what alternative strategies are feasible, using the example of Austrian capital market as a model.

Starting out from a general discussion of the major international benchmarks for capital markets and stock exchanges, and the scenarios of how stock exchanges are responding to the current challenges, especially within Europe, I will focus on the starting situation and development possibilities of Wiener Börse as a regional and national stock market.

## 2 International Developments in the Stock Market Environment

### 2.1 Benchmarking Capital Markets

Efficient capital markets form the optimal interface between supply and demand for capital (chart 1).

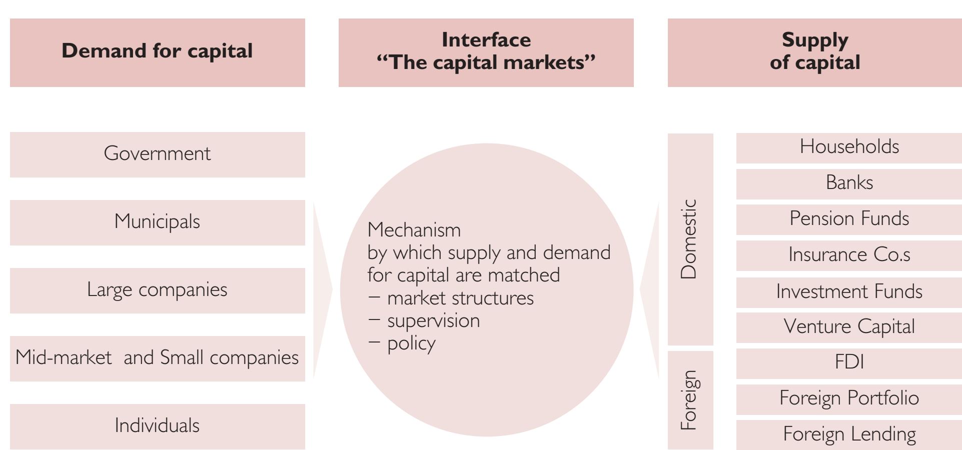
At the same time, they also make a crucial contribution to wealth creation and corporate government improvement (chart 2).

Studies in Germany and the U.S. prove that listed companies with the option of raising capital externally also make a major contribution to the development of the labor market (chart 3).

Financing of takeover deals is increasingly being done through the exchange of shares – the company with the "stronger" shares often has an advantage over a company of equal value without an adequate exchange listing (chart 4).

Chart 1

**The Market Place for Capital**




*Source: BCG analysis.*

Chart 2

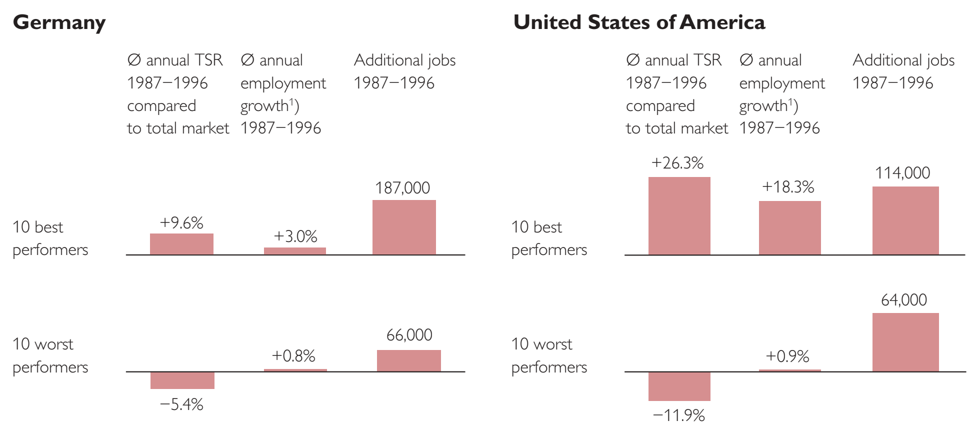
## Wealth Creation as Well as Corporate Improvements

### … Driven by Developed Capital Markets

- Long term opportunities for investors to diversify risks and increase returns
- Improvement of corporate governance
- Companies have increased access to risk capital and more flexible financing choices
- New sources of capital based on increased foreign investments
- Increased entrepreneurial behavior

Chart 3

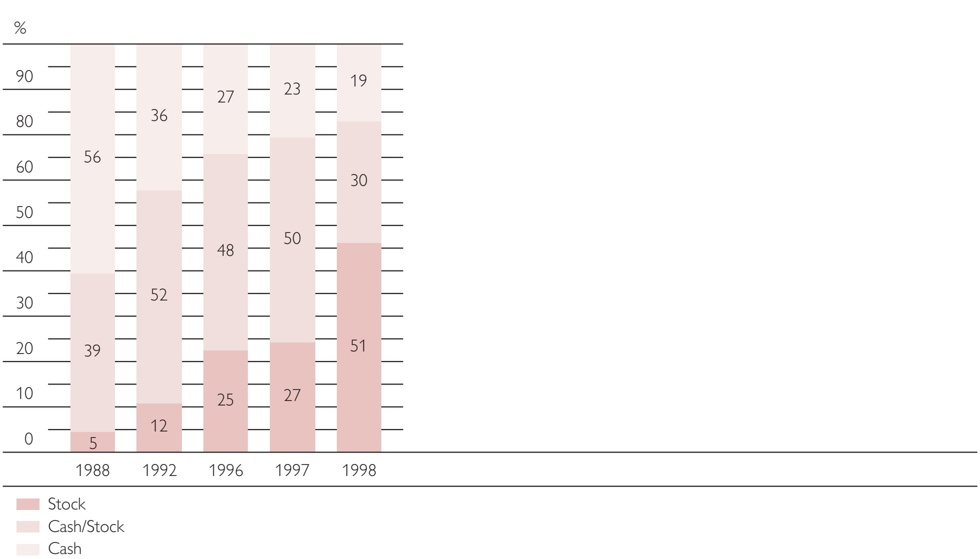
## Top Performers as Employment Drivers




*Source: Datastream; BCG Top Performer Study; BCG analysis.*
*¹) Including acquisitions.*

Chart 4

## Financing of M&A Deals – Acquisition Currency




*Source: CSFB, WBAG analysis.*

A breakdown by market infrastructure, exchange systems, investors, issuers and financial intermediaries shows the main factors in the ranking of successful European stock markets:

### Infrastructure of Capital Markets

- The existence of an independent *supervisory body* with comprehensive and far-reaching powers of intervention and control to prevent market abuse (insider trading, frontrunning, non-disclosure of important company news, etc.).
- The existence of an independent *takeover commission* with far-reaching powers of decision in the case of takeovers of listed companies.
- EU compliant legislation for all aspects of the legal framework of the capital market.

The work in this area will be finalized by 2005 – according to the intentions of the Commission – and will include more or less harmonized rules and regulations for the admission to listing, listing prospectuses and supervisory tasks. I hope that these efforts will not create hypertrophic central authorities, but efficient, optimally harmonized decentralized systems, which will be especially important for the improvement of the framework for the development of regional capital markets.

### Stock Exchange Structure

- The use of *state-of-the art trading and clearing systems with optimized cost structures embedded in international networks* and operating in a closely knit and coherent value chain.
- A market *segmentation* according to criteria relating to issuer quality (disclosure practice, free float, reporting practice, etc.) and which is easy to understand and use.
- *Attractive range of products on the cash and derivative markets.*
- *Transparency for all market participants.*
- The highest possible *market capitalization* and a higher free float to achieve:
  - *optimal liquidity*
  - *highest possible number* of efficient *market participants* who are optimally equipped

### Investors

- Growing significance of investor protection to prevent violations by intermediaries (dealers) and issuers.
- Massive increase in the *investment volumes of retail and institutional clients.* It is precisely this trend that runs against the expansion of investment opportunities and also contributes to the current phenomenon of the overvaluation of few investment instruments.
- Beside higher investor protection standards, market transparency will play an increasingly important role as a benchmark.

### Issuers

- A stronger focus on *shareholder value.*
- Ad hoc disclosure of price-sensitive information.
- Use of *corporate governance* rules modeled after the Anglo-American system.
- More active *investor relations.*
- More need for new opportunities to *raise capital through capital markets* (cf. Basel II).

### Financial Intermediaries/ Trading Participants

- *Liquidity providers* and market makers will play an increasingly important role for maintaining markets with high trading volumes. Trading systems without market making commitments are at a disadvantage even now.

– *Direct distribution channels to end customers* – especially via efficient brokerage platforms for retail customers and institutional investors trading directly.
– The higher degree of transparency in markets and the easy comparability due to the euro will increase the pressure to install an optimized fee structure.
– More competition through *trading volumes.*

**2.2 Capital Market Trends in the EU**

Currently, there are about 30 national – and within states also smaller regional – stock exchanges in Europe that operate about 14 different trading systems. Clearing and settlement is carried out through some 20 different national institutions. Only two of these institutions are focused on international markets or are investing efforts in supranational activities (Clearstream and Euroclear).

According to a study by Accenture, European stock exchanges (over 30 traditional exchanges) can be grouped into a few leading exchanges (a center field group) and many small niche exchanges with low market shares.

The consolidation that had been expected in Europe for a while now and was believed to result in two central exchanges at most within the next few years has become much less likely than at the time the first 3 to 4 large alliances with differing structures were formed (full merger and use of joint platform, keeping regional independence). Even now, there are signs of group formations (chart 5).

According to the study cited above by Accenture, 70% of all experts interviewed expect to see a common path towards consolidation as regards trading platforms and clearing and settlement institutions.

It is precisely in the area of clearing and settlement that the consolidation pressure to create a more competitive European approach vis-à-vis the U.S. markets is much stronger than in the

Chart 5

**Alliances in Europe**

**Only two stock exchange alliances are operative**

**Euronext**
- Belgium (BSX)
- France (SBF)
- Netherlands (AEX)
- United Kingdom (LIFFE) – in process
- Luxembourg
- Portugal

**Norex – Nordic Exchange Alliance**
- Sweden (OM)
- Denmark (CSE)
- Norway (OSE)
- Iceland (ISE)

**Xetra-Group**
- Germany
- Austria
- Ireland

**Eurex (derivatives exchange)**
- Germany
- Switzerland
- (Finland)

**NEWEX**
- Germany
- Austria

Chart 6

**Exchange Reactions to Industry Trends**

**Binding of Issuers**
- Implementation of new segments (e.g. Star Segment)
- Increased service level (IR support)

**Binding of Institutional and Retail Investors**
- Decline of trading fees
- Special programs and services for investors
- Increased transparency
- Shift to higher level of investor protection through stricter reporting requirements for issuers
- Introduction of corporate governance rating
- Increased marketing
- Special education programs

**Outsourcing or Leveraging of IT Development**
- IT outsourcing (e.g. Dublin, Vienna, Helsinki)
- Facility management (e.g. DB, OM, SBF)

**Product Diversification**
- Regional offshore markets (e.g. EAGAK, Newex)
- New products (e.g. energy, ETF, etc.)
- Value added services (e.g. IT, training, consulting)

**Value Chain Integration**
- Integrated Value Chain – from Exchange to CSD (e.g. DB, Euronext)

**Growing Trend to Alliances – Two Main Forms**
- Mergers (e.g. Euronext)
- Loose form of alliance (e.g. Norex)

area of trading systems. The large European stock exchanges that use systems like Xetra and the trading platforms Euronext, Virt-X and OM group already have strong market positions. There is an enormous improvement potential in closing the value chain within the stock markets (from trading to clearing) and within the context of European integration and consolidation of clearing and settlement systems.

Stock exchanges will respond to all these challenges by creating sets of measures of which the main ones are listed in chart 6.

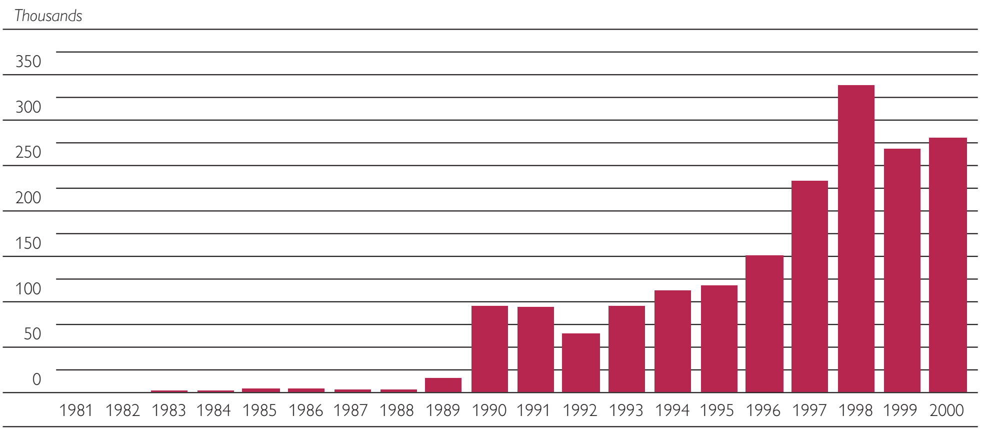
## 3 Developments on the Austrian Capital Market

### 3.1 Starting Situation

Bonds, which have always dominated the Austrian capital market, especially those issued by the public sector and banks, were supplemented by equity issues only as late as at the end of the 1980s, when a timid revival of stock issues and stock trading on Wiener Börse took place after a break of actually 70 years. The trading volumes and market capitalization in equities started to grow on Wiener Börse only as of 1987, especially due to the privatization of formerly state-owned

Chart 7

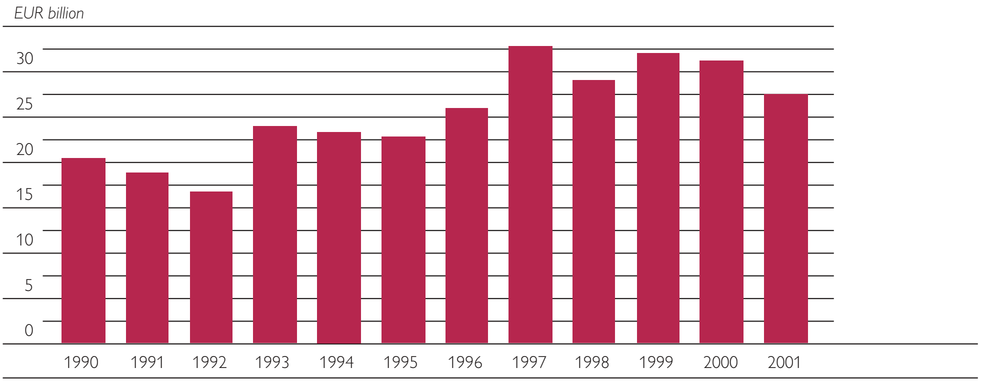
## Turnover in Domestic Shares From 1981 to 2000




*Source: Wiener Börse AG.*

Chart 8

## Market Capitalization Domestic Shares to the Ultimo of Each Year

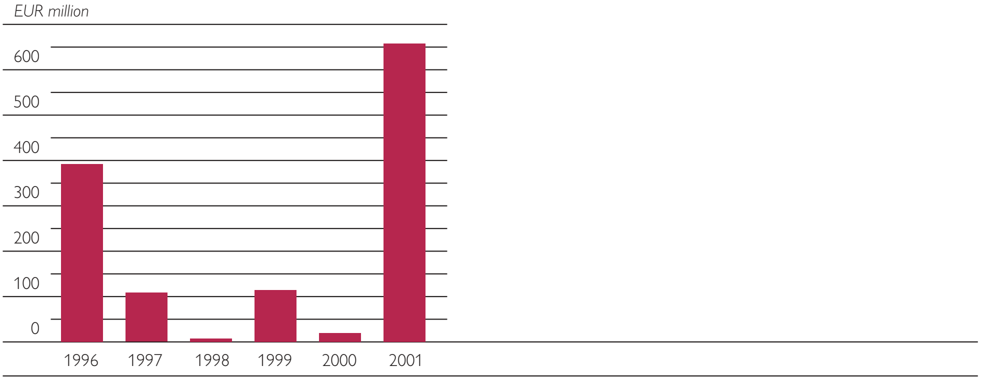



*Source: Wiener Börse AG.*

Chart 9

## Corporate Bonds

### Issuing Volume Corporate Bonds




*Source: Wiener Börse AG.*

companies and a few private IPOs (chart 7 and 8).

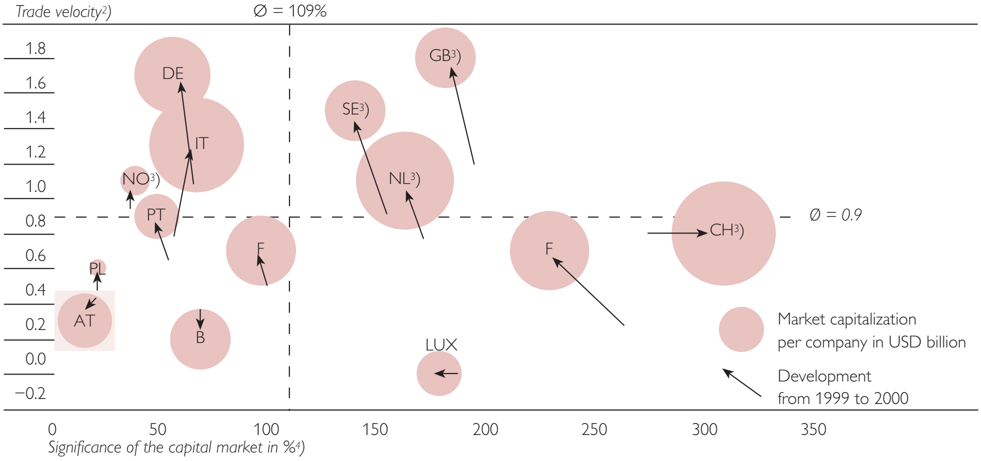
Corporate bonds also experienced a revival, though only as of 2001. This trend will become stronger and take a place alongside the predominant loan financing among businesses due to, among other things, the dramatic changes in risk margins of banks that will become necessary after Basel II (chart 9).

On the whole, the capitalization of the stock market is only 13.1% of GDP (= EUR 30 bill) and below average

Chart 10

**Current Situation: The Austrian Capital Market Is Underdeveloped**

**Comparison of European Markets 2000[1])**




*Source: Datastream; FIBV 2000; Economist Intelligence Unit; BCG analysis.*

*1) All data exclusively for domestic listed companies.*

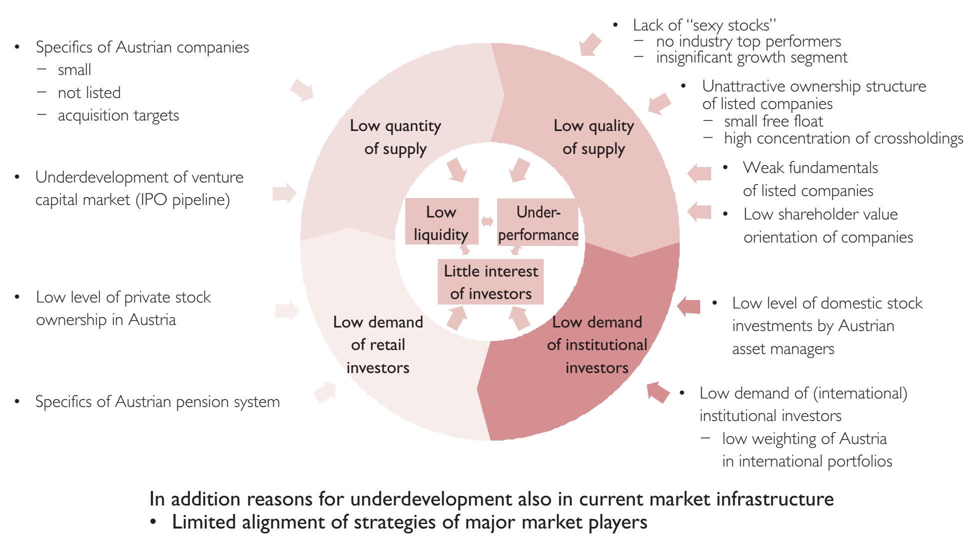
*2) Trade velocity = Trade volume of shares in 2000 according to trading system view in comparison to 2000 market capitalization; low level of free float as dominant reason for Austria's low trade velocity.*

*3) According to regulatory view, due to trading system view being unavailable.*

*4) Market capitalization as % of GDP (1999 due to unavailability of data for 2000).*

Chart 11

**Major Reasons for Underdevelopment of the Austrian Capital Market**




*Source: BCG analysis.*

in a European comparison, a situation which is unsatisfactory for the future equity capital needs of the Austrian economy (chart 10).

A study commissioned by Wiener Börse, the Federal Ministry of Finance and the Oesterreichische Nationalbank (OeNB) conducted by Boston Consulting Group states the following reasons for this situation (chart 11).

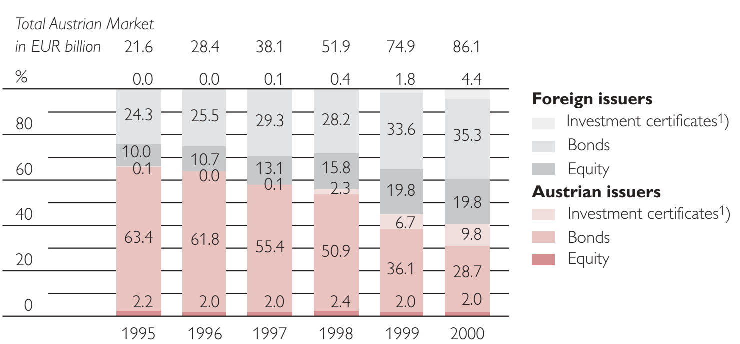
The dilemma of the Austrian market is clearly illustrated by the current structure of Austrian investment funds managed by domestic market participants: less than 2% of the strongly growing volume of money invested in funds is invested in Austrian stocks (chart 12).

While the amount invested in Austria in domestic stocks is less than EUR 2 bill, this share in Germany is at least 13% of German investment funds, for example, which corresponds to at least EUR 90 bill. This is 40 times more!

Although successful in steadily raising the interest of private investors

Chart 12

**Dominance of Austrian Bonds in Austrian Investment Funds Declining ...**




*Source: OeNB, BCG analysis.*
*1) Fund of funds.*

Table 1

**Venture Capital Is the Main Source for IPOs**

| IPOs | Participation VC | VC–Partner of FGG |
|---|---|---|
| **1999** | | |
| AvW Invest | – | – |
| CyberTron | × | × |
| Libro | × | × |
| Palfinger | × | × |
| **2000** | | |
| BetandWin | × | × |
| Feratel | – | – |
| JoWooD | × | × |
| Head | – | – |
| HTA | × | × |
| PerformanceAG | × | – |
| Stage1.cc | × | × |
| Telekom | – | – |
| **2001** | | |
| Teletrader | – | – |
| BLUeBULL | – | – |
| Euromarketing | × | – |
| Andritz | × | – |
| CLC | × | × |
| webfreetv.com | × | – |
| Admiral | – | – |
| Σ 19 | Σ 12 | Σ 8 |

*Source: Factbook 2001.*

(in 1997, the year of the stock exchange reform and the foundation of the new Wiener Börse AG as a single cash, derivatives and commodities exchange, only slightly less than 4% of the Austrian population owned shares[1]) and by 2001 it went up to 7%!), a lot remains to be done in order to catch up with the Western European average.

A very positive contribution to the development of an adequate base for further stock transactions on the Austrian capital market was provided by the privatization projects (cf. OMV, VOEST, Telekom, etc.) and the still small but growing venture capital scene. An attractive, specifically Austrian instrument for promoting the formation of the equity capital base of young companies is the equity capital guarantee of the Finanzierungs-garantie-Gesellschaft (FGG), which is considerably involved in preparing Austrian companies for a going public (table 1).

### 3.2 Six Hypotheses on the Positioning of Wiener Börse as a Regional Stock Exchange and the Austrian Economic Region in a Single European Market

Hypothesis 1

The establishment of a strong capital market in Austria is vital for maintaining and expanding the region as a business location and for securing stability in the labor market. Efficient, tradable instruments of equity and external capital need to be developed in a joint effort with potential issuers and regional retail and institutional investors as well as with domestic and foreign investment banks and trading participants in the Austrian market.

There is no other stock exchange organization that is better qualified than Wiener Börse, being specialized in the regional economic area of Austria, to organize a platform for the listing of new issues and trading in equity and debt capital for the Austrian market. It is also the only stock exchange organization that has a direct interest in the development of the domestic capital market.

Wiener Börse AG will implement the following projects in the future:

- The organization of an inexpensive market model that optimizes liquidity for trading in the cash and derivative markets.
- Quality segmentation and surveillance of the market (cf. prime market).
- Best possible services offered to regional issuers in the area of stocks and bonds (new growth segment: corporate bonds):
  - Support for IR strategies
  - Consulting services in preparations for public offerings
- Optimal support for the market environment for private investors.
- Flexibility in the new design of products.

It is precisely the small and medium-sized structure of the Austrian economic area that calls for this type of specialized strategy. The potential

1 *Excl. funds.*

for boosting the capital market is high and definitely exists:

The percentage of the population of private individuals owning shares is currently 7.5% and it should be possible to increase it to 12% to 15% by 2005.

The capitalization of the Austrian stock market is currently EUR 30 bill and only about 13.1% of the GDP. Further privatizations and IPOs by private companies on Wiener Börse should help to raise the percentages considerably in the next 5 to 10 years.

#### Hypothesis 2

By using the international trading platform Xetra on the cash market, Wiener Börse is actively involved in the alliance of the Xetra Group of Deutsche Börse Frankfurt. This means that the stock market in Vienna and with it the Austrian capital market is not a regionally limited one, but rather globally accessible.

The trading participants (remote members) are linked either via direct lines to the Xetra system or since October 2001 via the Internet broker system of Wiener Börse. This makes it possible to take advantage of the benefits of the technical and economic aspects of an international stock exchange alliance for a regional market and to create inexpensive structures.

#### Hypothesis 3

The direct vicinity of regional exchanges to local markets, as in the case of Wiener Börse AG, and the direct broker platforms of the banks and trading participants are used for gaining more private investors by taking customized measures to meet the needs of such regional markets. The additional range of information and marketing services offered by Wiener Börse AG makes it extremely competitive over alternative competitors.

#### Hypothesis 4

Optimally organized and internationally integrated regional exchanges contribute substantially to improving the quality of decentralized, regional markets. Not only with respect to the ongoing monitoring of quality and disclosure standards for listed companies, compliance with trading norms and the efficient settlement of transactions, but also with respect to the high degree of legal certainty achieved by closely collaborating with supervisory authorities.

Moreover, the activities of a well-functioning, specialized regional exchange are crucial for maintaining many areas of work for the region in the fields of banking and finance industry, law and fiduciary service, consulting, etc.

Training and education institutions, especially also universities benefit greatly from these activities. The creation and preservation of jobs in a region that requires highly qualified staff profit in particular from the activities of the local exchange.

#### Hypothesis 5

The technological revolution in trading and settlement systems and the technical feasibility of inexpensive, virtual "pseudo exchanges" in conjunction with the one-sided arguments for minimal system costs have brought to light the main tasks of an exchange, namely:

- Optimal framework for local companies wishing to raise capital.
- Full independence from all involved "customer groups" (market participants, investors, issuers) especially from the trading interest of the large global banks.
- Attainment of the highest possible trading volumes in a single security instead of the dispersion of possible volumes across several competing alternative market systems.

This should be taken into account all the more considering that a modern regional exchange such as Wiener Börse AG offers the advantages of efficient electronic trading and information systems anyway.

### Hypothesis 6

Even in an economically unified Europe with one single currency the specific cultures and languages of the different countries or regions will last. To motivate and mobilize the regional potential will require a future organization that truly represents the unique characteristics of the region. That way an optimally structured regional exchange will be an integrative partner of a European platform and a local marketing specialist with an optimal marketing strategy to meet the local needs of their region. ❧

Gertrude Tumpel-Gugerell, Tagungsvorsitz/Chair
Alexander Italianer
Richard Portes
Sinikka Salo
Gerhard Schwödiauer

# Podiumsdiskussion:

# Regionale Wirtschaftsstrukturen –

# Wie viel Divergenz ist tragbar?

# Panel:

# Regional Economic Structures –

# How Much Divergence Is Sustainable?

Gertrude Tumpel-Gugerell
Vice Governor,
Oesterreichische Nationalbank

# Introduction

It is a pleasure for me to open the last session of our conference which deals with regional economic structures and the question of how much divergence is sustainable. These issues are closely related to both real and nominal convergence, which are the cornerstones of the proper functioning of a monetary union.

What does the last decade show us about nominal convergence in the euro area? Since the beginning of the 1990s, we have undoubtedly seen a convergence of nominal variables such as inflation rates, market interest rates, and the reduction of budget deficits and debt levels among EU Member States. The rules-based fiscal policy as defined by the Maastricht Treaty and, subsequently, by the Stability and Growth Pact, has contributed to improving public finances across different EU Member States, as most countries have reduced their debt-to-GDP ratio and improved their budgetary positions.

This process has been accompanied by long-term movements toward real convergence of income levels. EU Member States with lower per-capita-income have significantly caught up with the living standards of more advanced Member States; being supported by structural and cohesion funds. Moreover, the growing economic integration of Europe and, in particular, the start of the Economic and Monetary Union (EMU) has reduced the volatility of GDP growth rates across economic regions over the past decade. Business cycle instability tends to shift from the production side to financial assets. Financial cycles have become broader and more complex and these financial cycles play an increasing role in the business cycle.

Factors that may have triggered real cycles are not only shocks resulting from economic policy (EMU) and exogenous shocks like productivity shocks, but also "endogenous" factors, in particular erroneous expectations by households and companies.

Recently, however, we have seen a standstill – and in some cases a turnaround – in the process of nominal convergence within the euro area. This is the case both for public finances as well as for inflation, where divergence is presently growing. The slowdown in economic growth contributed to growing fiscal deficits in some countries, while others continued fiscal consolidation irrespective of the economic development.

Some observers view the present divergence of inflation rates among countries in the euro area with growing concern: inflation rates of countries in the euro area currently range from 1.6% in Germany and Austria to 5.0% in Ireland. Some explanation might be found in the Balassa-Samuelson effect of higher inflation rates in countries catching up. On the other hand this effect cannot lay at the grounds of the Netherland's high inflation rate of 4.2% in May 2002. The question is whether this is a serious economic problem for which a "policy answer" is needed or whether it is just a matter of fact that inflation rates vary from one economic region to the other – within a monetary union or even within a country. A further question is whether temporarily diverging fiscal balances are an indicator for different budgetary sensitivities to the economic cycle across countries or whether there is a danger of deviating from the stability path of the last years.

Those are questions which are of high interest, in particular at the dawn of an enlargement of the European Union. I hope our distinguished panel will give some answers to those questions and shed some light on the issue of convergence and divergence in a monetary union. ❧

Alexander Italianer
Director, European Commission
Oliver Dieckmann
European Commission

# Are Divergent Macroeconomic Performances in a Monetary Union a Reason to Worry?[1])

## 1 Introduction

The first three years of the euro area's existence have reminded economists of the need to monitor carefully divergences in macroeconomic performances across the participating economies and to think about the extent to which such divergences are sustainable in a monetary union. The relevance will even increase further with the perspective of EU enlargement and the eventual participation of new Member States in the euro area. However, the issue of a symmetric shocks and the availability of adjustment instruments to those shocks already figured prominently in the early literature on the Economic and Monetary Union (EMU).[2]) Over the years the issue of diverging performances has become a domain that has many angles to it. This article will focus on four points:

(i) the longer-term developments as far as economic growth in the Member States is concerned,
(ii) business cycle synchronisation across economies and prospects for cyclical convergence in the euro area,
(iii) inflation diversity and why it should be a subject of attention, but not necessarily a matter to worry about once it has been identified, and
(iv) external imbalances and their relevance in a monetary union.

Certainly this list could easily be extended, but this would widen the scope too much. Here budgetary policy or labour market performance come to mind as an example. As regards labour markets, differences in human capital matter for economic growth, market rigidities affect the cyclical pattern of employment, wage settlements are an important determinant of inflation diversity and migration affects external imbalances.

## 2 Economic Growth: Convergence and Divergence

The study of convergence has been on the agenda for decades in economics and the emergence of the "New Growth Theory" in the second half of the eighties has stimulated research and provided us with numerous of studies on the topic.[3]) For many of them and for the topic of convergence and divergence in EMU a story Milton Friedman has told ten years ago appears still relevant.[4])

Friedman told the story of Francis Galton, a cousin of Charles Darwin, who studied human height, especially the relation between the height of parents and children. He examined a sub-sample of fathers selected for their exceptionally high stature, and noted

*1 Disclaimer: the views expressed in this paper are those of the authors and do not necessarily correspond to those of the European Commission.*

*2 See Emerson, M., D. Gros, A. Italianer, J. Pisani-Ferry, and H. Reichenbach (1992). One Market, One Money. Oxford University Press.*

*3 See e.g. Barro, R. J., and X. Sala-i-Martin (1998). Economic Growth. MIT Press; and Sala-i-Martin, X. (2002). 15 Years of New Growth: What Have We Learned? In: Loaiza, N. (ed.) The Challenges of Economic Growth. Central Bank of Chile, forthcoming.*

*4 Friedman, M. (1992). Do Old Fallacies Ever Die? In: Journal of Economic Literature, December, 30(4), 2129–32.*

that their sons exhibited on average statures closer to the mean stature of the general population than to the mean height of the tall fathers concerned. This has been interpreted as a regression towards the mean. Obviously a similar finding could have been demonstrated for exceptionally short fathers and their children. Galton's fallacy was to wrongly infer from these valid observations that a general contraction of the spread of heights in the population was taking place; a reduction in the variance of heights. And it is such an (invalid) inference which economists risk drawing when searching for convergence and divergence. This fallacy denotes a problem arising when convergence (or divergence) is tested in a cross-country framework (often referred to as Barro regressions), a point of particular relevance to the EU integration process.

A large number of economists have tried to answer the question as to whether economies tend to converge to similar levels of per-capita income in the long run. In the simplest economic models the answer will always be "yes" since capital will migrate across borders as long as rates of return differ. Thus, countries with lower income levels can be expected to experience faster growth. Many empirical studies have tried to find evidence for this hypothesis, often based on simple regression techniques, and found that countries with an initially lower income would display higher rates of growth. If this hypothesis were true, it would imply that there would be growth differences in the short run because the poorer countries would tend to grow faster than the richer ones. Does this mean that there should be no reason to worry about growth divergences in the short run?

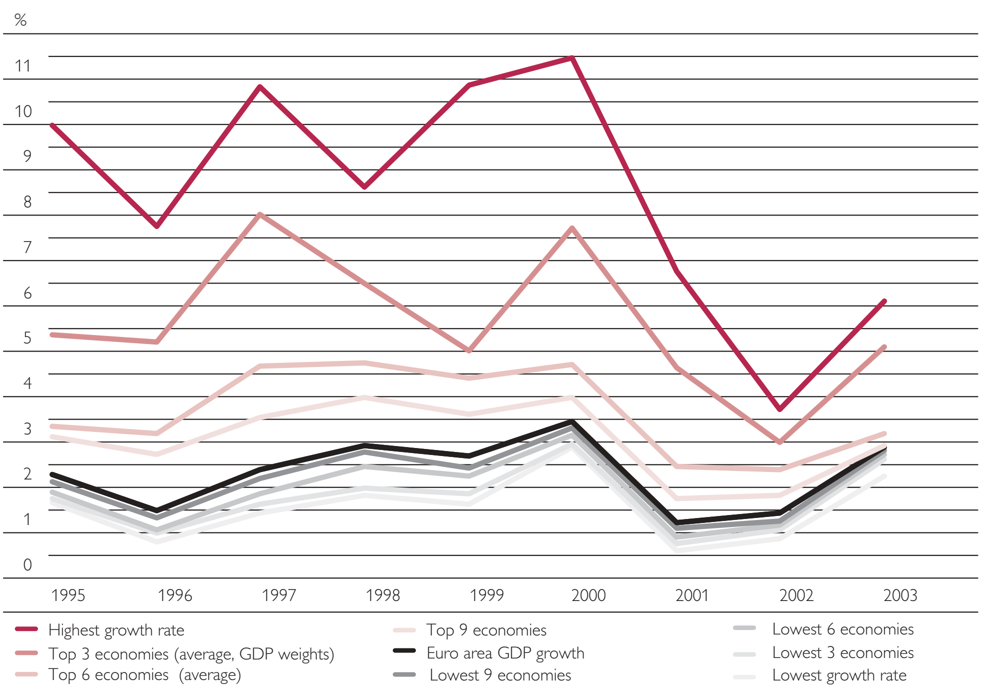
The answer to this question cannot be unequivocally negative. The Barro-regression models disregard many of the factors that are important for economic growth like technological shocks, externalities, labour force characteristics, human capital, the legal framework, etc. Moreover many of the empirical studies suffer from shortcomings like the aforementioned Galton's fallacy. So it seems too simple not to worry about growth divergences only on the basis of such stylised convergence models.

The conclusion to be drawn is that even in the presence of convergence phenomena in terms of income per capita, and therefore of diverging growth rates over a longer period, there is every interest to smoothen the variations around these growth paths. If all policymakers in a monetary union support efforts in this direction, there is no particular reason to worry about sustained economic growth differences.

In the euro area many efforts have been made to put in place an environment that is conducive to stable economic growth. And the results displayed in chart 1 indicate a substantial success of these efforts. If one disregards the three fastest growing economies the growth rates registered throughout the last decade are very close to the euro area growth path.

Chart 1

**Dispersion of Real GDP Growth Rates from 1995 to 2003**




*Source: Ameco database, Commission services' Spring 2002 Forecasts.*

Looking for reasons one just has to look at the sound economic policy architecture that characterises the euro area. This framework is characterised by a number of principles enshrined in the Treaty: the commitment to open markets and free competition, price stability and sound public finances, which are supportive to sustainable economic growth. On this basis, the responsibility for the single monetary policy is with the independent European Central Bank (ECB) guided by its primary objective is to maintain price stability in the euro area as a whole,[1]) while the principle of sound public finances has been translated into the Stability and Growth Pact. This particular euro area architecture of "policy convergence" creates the conditions for sustainable medium-term growth. When there are divergences occurring, such as for instance the slower growth performance of Italy and Germany since the mid-1990s, it is important to find out whether they are just a question of the short run with cyclical aspects dominating, or whether there are underlying structural impediments. To name just a simple example, diverging ageing performances can be a source of long-term growth divergences, *ceteris paribus.*

1 *While the ECB has not yet explicitly named regional developments as a determinant of its decisions, a recent study presented evidence that regional developments mattered for Fed decisions; see Meade, E.E., and D.N. Sheets (2002). Regional Influences on U.S. Monetary Policy: Some Implications for Europe. International Finance Discussion Paper No. 721, Federal Reserve Board, February.*

## 3 Business Cycle Synchronisation

Closely linked to growth differences are cyclical differences and asymmetric shocks (see chart 1). But before thinking about indicators one has to answer the question as to whether a monetary union is bound to experience increased cyclical convergence. Several arguments have been presented in favour of convergence:[1])

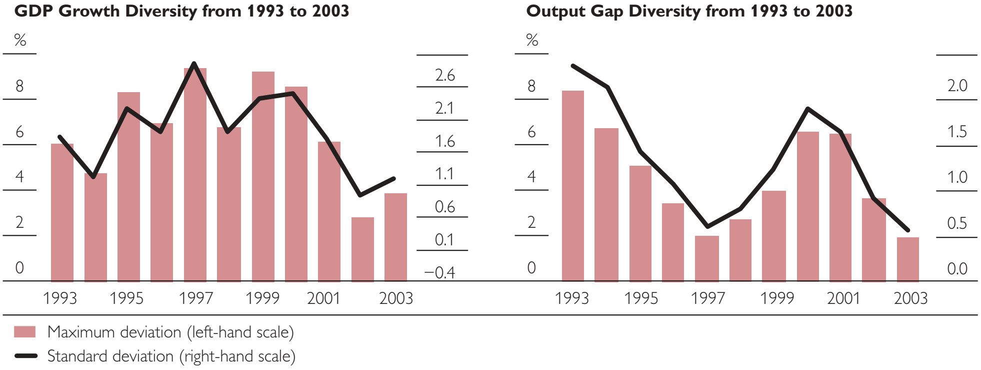
- Economic interdependence is increasing due to larger intra-union trade and inter-company links as for instance induced by foreign direct investment.
- Linkages between financial markets are strengthening in a huge internal market, in particular due to growing non-resident portfolios and confidence-spillover effects.
- Macroeconomic policies are coming to rely more on the same stability-oriented "policy convergence" framework than in the past due to the single monetary policy aimed at price stability and the sound fiscal framework.

A main counter-argument has been provided by Krugman, who argued that the organisation of production inside a monetary union inevitably brings along a specialisation that makes single countries (or regions) more vulnerable to global shocks. This could decrease co-movements in output fluctuations. Increased intra-industry trade, on the other hand, could have the opposite effect.

In order to answer the question about the extent of synchronisation one has to identify cyclical diversity. Here almost all observers start with a common set of tools: cyclical differences between the Member States can be identified by reference to the evolution in output gaps, i.e. the growth rate of GDP relative to that of potential output. While in the run-up to the start of Stage 3 of EMU measures of dispersion seemed to indicate a certain reduction (e.g. maximum cyclical differen-

Chart 2

**Diversity in GDP Growth Rates and Output Gaps from 1993 to 2003**




*Source: Ameco database, Commission services' Spring 2002 Forecasts.*

1 *See e.g. Wynne, M.A., and J. Koo (2000). Business Cycles Under Monetary Union: A Comparison of EU and the US. In: Economica, 67 (267), August: 347–74; further arguments have been presented and tested in the growing literature on business cycle synchronisation in general and the emergence of a euro area business cycle in particular; see e.g. Artis, M. J., and W. Zhang (1999). Further Evidence on the International Business Cycle and the ERM: Is There a European Business Cycle? In: Oxford Economic Papers, 51(1), January: 120–32; Döpke, J. (1999). Stylised Facts of Euroland's Business Cycle. In: Jahrbücher für Nationalökonomie und Statistik, 219(5–6): 591–610; Breitung, J., and B. Candelon (2001). Is There a Common European Business Cycle? In: DIW Vierteljahreshefte zur Wirtschaftsforschung, 70 (3): 331–8.*

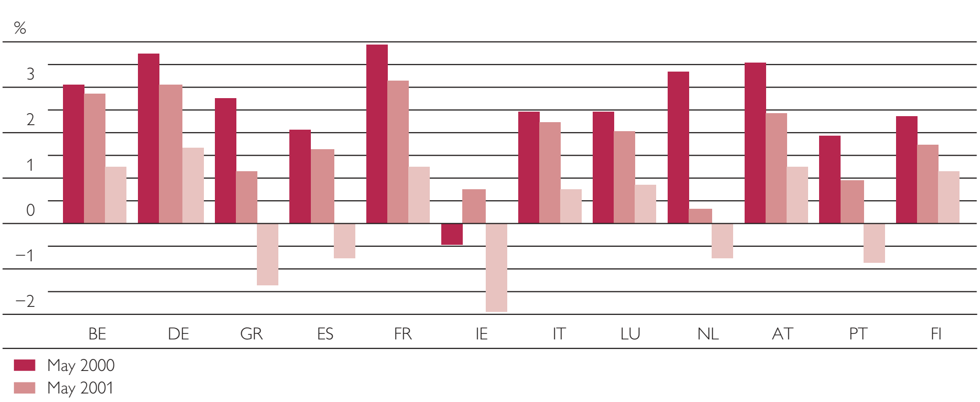
ces, standard deviation across Member States), the more recent data display an inverse U-shaped pattern (see chart 2). However, it should be mentioned that these results depend in particular on the performance of the relatively small economy of Ireland. This suggests being cautious in using standard measures of cyclical differences. In particular the "sample period" since the start of EMU might be too short to draw reliable conclusions at this stage.

Where cyclical differences occur among euro area Member States, they could for instance reflect corresponding differences in monetary and financial conditions, in external competitiveness or in labour-market developments (particularly in terms of productivity growth). Non-cyclical factors are also likely to be relevant, such as differences in the sectoral composition of output leading to asymmetric effects of changes in the common external environment, or structural aspects such as tax systems and pension funding. It is beyond the scope of this article to examine all of these factors but two of them – monetary and/or financial conditions and external competitiveness – are of particular interest insofar as they have been specifically affected by the introduction of the euro and because they are related to the adjustment instruments in order to respond to shocks.

– *Real interest rates.* Euro area Member States share single nominal money-market rates, but the underlying real interest rates can vary per country due to inflation differentials. While real short-term interest rates had declined in almost all Member States up to 1999, developments since then are not that uniform (see chart 3). In general real interest rates have tended to be below average or even negative in those Member States that were least in need of stimulus to economic activity. Although there is an element of causality involved, it may thus seem that real interest rates tend to display pro-cyclical behaviour.
– *Long-term interest rates.* These rates had also converged downward ahead of the introduction of the euro in 1999 and in the time since spreads have been negligible. Thereby, they tended to accentuate the effects of differences in underlying real interest rates between Member States.

Chart 3

**Real Short-Term Interest Rates**




*Source: Eurostat's NewCronos database, ECB, own calculations.*

– *Price and cost competitiveness.* Economic growth differences in the euro area also relate to differences in the external competitiveness of the Member States vis-à-vis the euro area, as reflected in several cost and price indicators. For instance an increase in the price and cost indicators (equivalent to a real exchange rate appreciation) need not be a cause for concern, if it is consistent with relative productivity performance. For example, a catching-up Member State may experience relatively high productivity growth and inflation rates. More generally, real appreciation may reflect improvements in economic fundamentals related for instance to non-price competitiveness factors, or changes in underlying savings and investment patterns. However, there may be circumstances in which real appreciation would signal a build-up of competitiveness problems that would ultimately result in subdued economic growth and rising unemployment. In these cases, there would be a need for corrective action that would mainly have to take the form of wage-cost adjustment relative to euro area partner countries.
Data on price and cost competitiveness can be produced with several types of deflators (see table 1), but generally one finds the same tendencies as regards losses or gains in competitiveness. In many cases, the data suggest that cost and price pressures are linked to advanced cyclical positions and therefore influence competitiveness accordingly. Through its impact on the trade balances, the price/cost adjustment channel therefore seems to contribute to dampening cyclical fluctuations, although there is again an issue of causality involved.

These observations suggest that the observed cyclical diversity so far has not been a source of major worry for the functioning of EMU. Again, the choice of an appropriate policy framework (and obviously its steady development over time) is crucial in coping with divergent patterns when they emerge. In these terms the euro area has shown a

Table 1

**Relative Cost and Price Indicators Relative to the Euro Area[1])**

| | Over the last year (1st quarter 2002 against 1st quarter 2001) | | | Over the last two years (1st quarter 2002 against 1st quarter 2000 to 4th quarter 2001) | | | Relative to average (1st quarter 2002 against 1987 to 2001) | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total ULC | Manuf. ULC | GDP deflator | Total ULC | Manuf. ULC | GDP deflator | Total ULC | Manuf. ULC | GDP deflator |
| BELU | 0.4 | –0.1 | –0.2 | 0.5 | 1.2 | –0.4 | 3.8 | – 2.2 | 1.3 |
| DE[2]) | –1.4 | 0.5 | –0.9 | –3.4 | –0.4 | –2.9 | – 5.0 | 4.6 | – 4.9 |
| GR | 0.2 | –2.6 | 1.1 | –1.9 | –6.9 | 0.1 | 9.3 | 5.8 | 10.8 |
| ES | 0.4 | 1.0 | 0.9 | 1.3 | 3.4 | 2.7 | 2.5 | 10.2 | 2.2 |
| FR | –0.4 | –0.7 | –0.7 | –0.7 | –1.2 | –1.6 | 1.0 | – 4.8 | – 2.5 |
| IE | 3.2 | 0.2 | 2.6 | 5.6 | –1.9 | 5.3 | 2.8 | –26.7 | 13.8 |
| IT[3]) | 0.1 | –1.0 | –0.1 | 0.6 | –1.4 | 0.7 | – 4.3 | – 0.3 | 0.7 |
| NL | 2.3 | 1.6 | 2.6 | 5.7 | 4.2 | 6.6 | 9.6 | 4.3 | 7.4 |
| AT | –1.2 | –1.9 | –0.6 | –2.0 | –4.1 | –1.1 | – 0.9 | – 9.0 | – 0.9 |
| PT | 2.5 | 0.5 | 1.3 | 6.4 | 3.3 | 2.8 | 15.9 | 6.2 | 15.1 |
| FI | 1.4 | 1.3 | –1.2 | 2.9 | 1.3 | 0.3 | – 9.1 | –18.3 | – 6.0 |

*Source: DG ECFIN, Price and Cost Competitiveness Report - First Quarter 2002, April 2002.*

[1]) *Changes in per cent calculated using total unit labour costs (ULC), manufacturing industry's unit labour costs, and the GDP deflator respectively. A "–"-sign indicates an improvement in cost competitiveness.*

[2]) *These indicators probably underestimate the unification-induced deterioration in German cost competitiveness.*

[3]) *Relative unit labour cost indices for Italy relative to any period before 1998 are distorted by the 1998 tax reform which shifted taxation from labour costs to value added but did not significantly change competitiveness.*

good record in the first three years. Whether this result can be extrapolated to the future will depend on the determination of participants to stick to the rules and to develop them further as much as necessary.

## 4 Inflation Diversity

Differences among national inflation rates (inflation diversity) could be a cause of worry in a monetary union if temporary inflation shocks become entrenched in inflation expectations at national level, potentially leading to a wage-price spiral that could durably affect competitiveness of the country concerned.

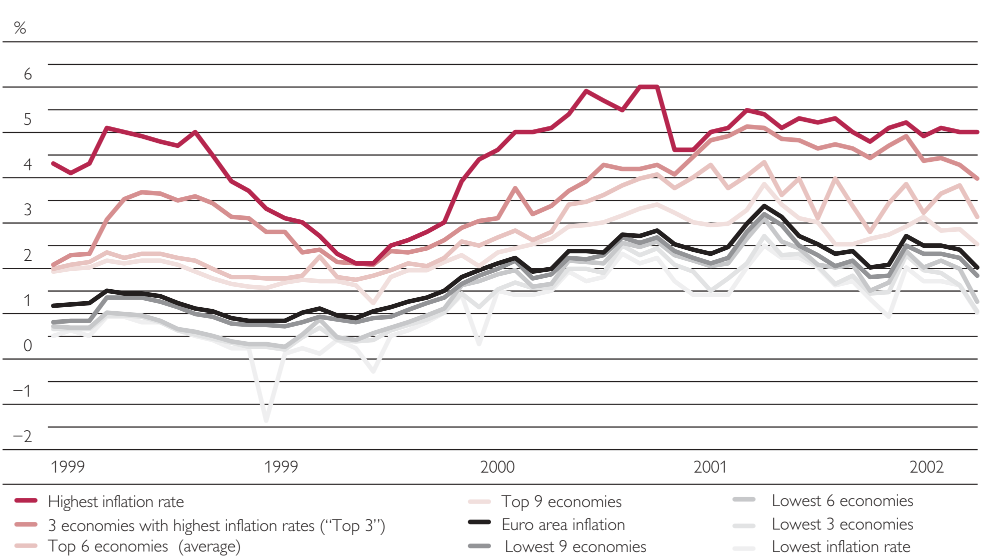
In the first three years of the euro area there has been inflation diversity, as illustrated in chart 4, which depicts the minimum and maximum inflation rates and averages of groups of best and worst performing countries in terms of Harmonised Index of Consumer Prices (HICP) inflation rates.

Some of the extreme inflation rates, the outliers, have been observed in small Member States as indicated by the big distance between the extreme lines and the other groups. But even discarding these cases, the diversity does not vanish as the lines for the other country groups also display distance from the euro area average (black line). The persistence of the range displayed is also mirrored in standard measures of inflation dispersion (see chart 7a).

In spite of the stability-oriented macroeconomic policy framework, the remaining cyclical differences can provide an explanation for some of the regional differences in inflation rates that have been observed so far in the euro area. Indeed a comparison of output gaps (independent of the way they are calculated) and inflation rates indicates that a more advanced position in the cycle has often been accompanied by higher inflation rates (see chart 5). Here the experience from Ireland, the Netherlands and Portugal has often been mentioned. However, in addition to cyclical determinants there are other factors we have to assess.

Chart 4

**Inflation Diversity in the Euro Area**

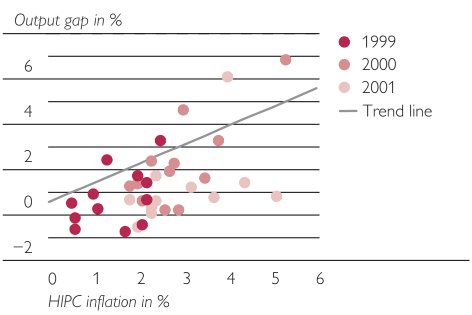



*Source: Eurostat's NewCronos database (extracted 25 May 2002), own calculations.*

Chart 5

**Output Gaps and Inflation Rates**

**(12 Euro Area Economies)**




Source: Ameco database, Commission services' Spring 2002 Forecasts.

– *External shocks.* The increase in energy prices in 2000 and 2001 has hit some countries more than others. Countries having a larger share of energy consumption in their HICP obviously show a stronger impact of oil price changes on HICP inflation rates.
– *Policy induced price changes.* Decisions about indirect taxes, administrative prices and fees are taken at the level of the Member States. They affect HICP inflation as for instance the example of the Netherlands has shown in 2001. Also the national introduction of ecological taxes could have a significant impact and explain differences.
– *Balassa-Samuelson effect.* It has been argued that productivity differentials between sectors producing tradable and non-tradable goods could justify inflation rates that differ from those of other countries without endangering the price and cost competitiveness and thus without giving any reason for being concerned.

These aspects deserve to be looked at in more detail.

### 4.1 Inflation Diversity at the Aggregate Level

In view of the different cyclical positions of Member States, national inflation rates cannot be expected to coincide (see chart 5). While the cyclical contribution to inflation diversity should diminish to the extent that a uniform euro area business cycle emerges (see section 2), differences may also reflect country-specific factors that are, at least partly, non-cyclical in nature. For example, it is well known that structural differences (e.g. energy intensity of production, natural resources, and import structure) make the impact of changes in prices of crude oil rather different across economies. Asymmetric impacts like this should become visible in comparisons of developments in HICP components. However, even if individual components would display a similar evolution in all Member States, the development in the overall HICP could be different due to differences in weights attached to single components in national HICP indices. An example is Ireland, where processed food constitutes around 20½% of the HICP, while it constitutes only about 13% of the HICP in the euro area as a whole. Further obvious differences are linked to climatic conditions and preferences that differ across countries.

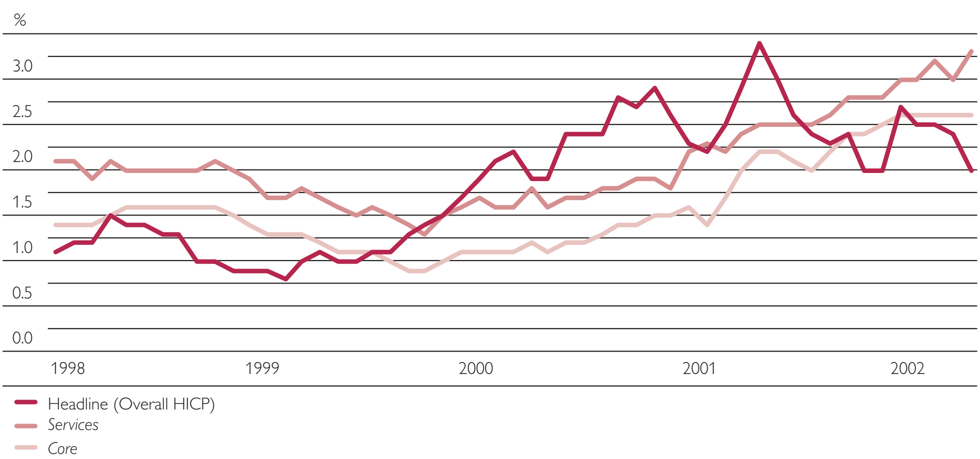
### 4.2 Inflation Diversity as Evident in HICP Components

In search of reasons for inflation diversity attention has been attracted by developments in the single components of HICP indices.[1]) On the one hand, specific groups of goods and services prices could explain some of the observed differences, on the other hand

1 *On this issue see also ECB (2000). Inflation Differentials Within the Euro Area (Box 4). In: ECB Monthly Bulletin, December: 31–33.*

Chart 6

**Headline, Core[1]) and Services Inflation**



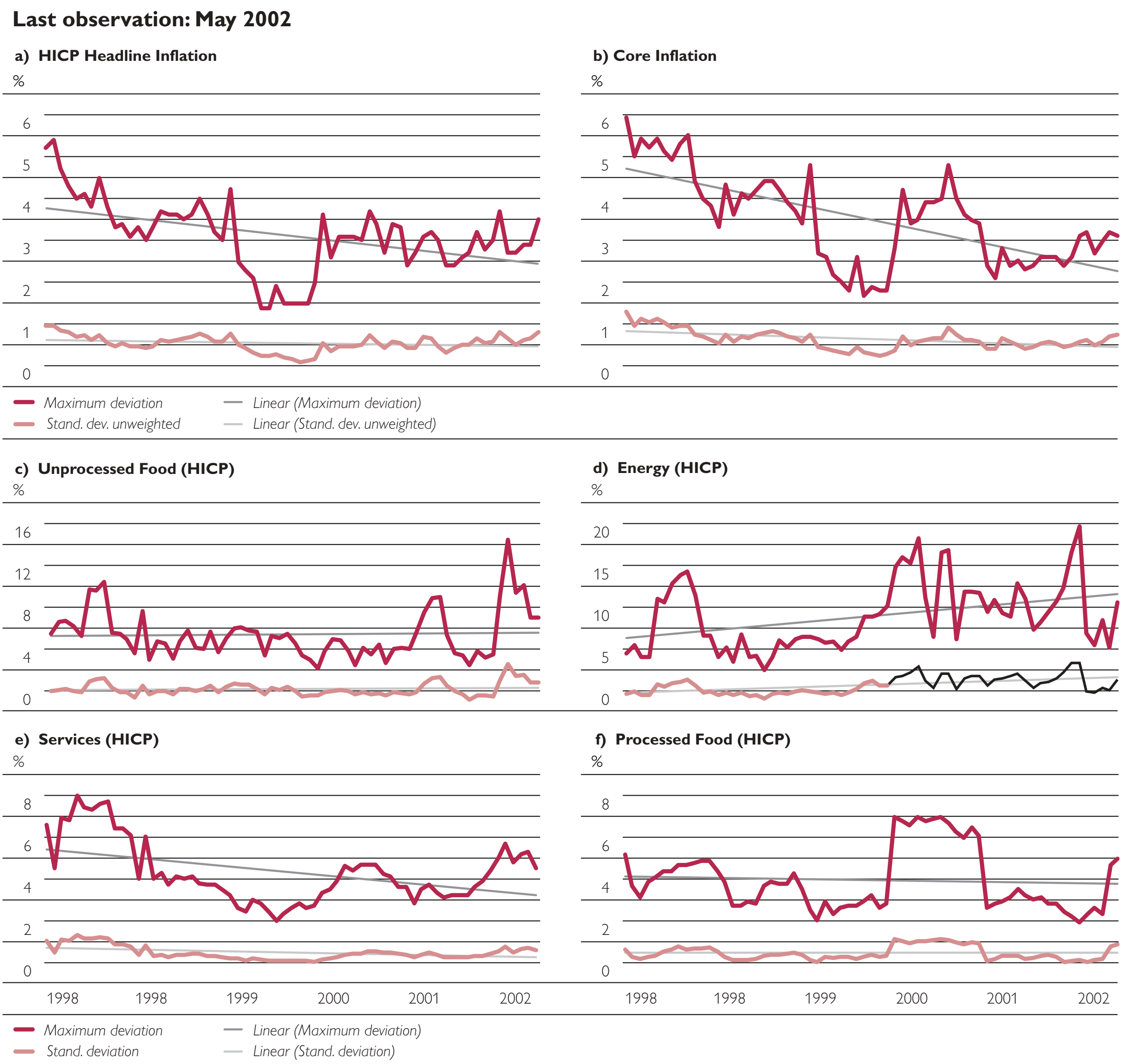

*Source: Eurostat's NewCronos database.*
*[1]) Core = HICP excl. energy and unprocessed food.*

an analysis of the main HICP categories can reveal their contribution to the levels and the dispersion observed in the overall index. Especially the observed differences between headline and core inflation rates (see chart 6) suggest that prices of unprocessed food and energy do not only show a higher volatility than others, but also that they could have been a major source of inflation differentials:

– *Unprocessed food.* Food prices are known to be the most volatile component in explaining country-specific differences, due to differences in seasonal patterns, weather conditions or country-specific reasons (e.g. the outbreak of foot-and-mouth disease in only a few Member States in 2001). This volatility implies a relatively large dispersion of price changes, but the absence of any clear trend in the dispersion measures of this component (see chart 7c).
– *Energy.* A comparison of the HICP energy component across economies indicates an asymmetric impact of higher oil prices resulting in high volatility indicated by standard measures. The periods with an above-average increase in the German index can be explained by increases in the so-called ecological tax, while the below-average increase in the French index points to a low level of oil-based energy production. Moreover, some governments have decided to soften the impact of temporary high oil prices on energy consumers, while others have not. These different responses as well as different tax schemes (e.g. "floating gasoline taxes" in France contrasting with "fixed" taxes elsewhere) could contribute to a further widening of inflation differentials.
– *Services* inflation has been on an upward trend between 2000 and May 2002 (see chart 6), reflecting strong demand and in catching-up countries also the need to pay wages similar to those in the high-productivity sectors (bringing the reasoning back to the Balassa-Samuelson argument). However, standard dispersion measures show a steadier development than other components (see chart 7e).

Chart 7

**Inflation Diversity in HICP Components**




Source: Eurostat's NewCronos database (extracted 25 May 2002), own calculations.

These selected subcategories suggest that differences can be traced back to differences in energy, as this has been the only graph displaying a positive slope of trendlines. However, a closer look at the twelve categories forming the HICP reveals that dispersion has increased only in four categories in 2001 (see table 2). Moreover, the main contribution to euro area inflation comes from alcoholic beverages and tobacco, which displays a rather low standard deviation. The calculation of contributions of items to the euro area aggregate also highlights the substantial changes in their contribution over time. As item weights differ substantially across countries this inevitably comes along with inflation diversity across the Member States.

The national contributions to the euro area aggregate are displayed in table 3. In 1999 Germany, Spain and Italy contributed most in absolute

Table 2

**Differences Between HICP Components[1])**

| Items | Euro area inflation rate | | | | | Standard deviation across euro area Member States | | | | | Contribution to euro area HICP inflation rate | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 1997 | 1998 | 1999 | 2000 | 2001 | 1997 | 1998 | 1999 | 2000 | 2001 |
| | % | | | | | *Percentage points* | | | | | *Percentage points* | | | | |
| 1 Food, non-alcoholic beverages | 1.0 | 1.5 | 0.2 | 1.1 | 4.9 | 1.30 | 1.16 | 1.34 | 0.95 | 1.12 | 0.19 | 0.28 | 0.04 | 0.18 | 0.80 |
| 2 Alcoholic beverages, tobacco and narcotics | 3.6 | 2.7 | 2.5 | 2.2 | 2.9 | 3.01 | 2.17 | 1.77 | 2.95 | 1.81 | 0.16 | 0.12 | 0.11 | 0.09 | 0.12 |
| 3 Clothing and footwear | 1.2 | 1.2 | 1.1 | 0.8 | 0.6 | 3.05 | 3.21 | 2.37 | 2.02 | 1.51 | 0.11 | 0.11 | 0.09 | 0.07 | 0.05 |
| 4 Housing, water, electricity, gas and other fuels | 2.8 | 1.0 | 1.4 | 4.3 | 3.3 | 1.53 | 1.16 | 0.86 | 2.03 | 1.53 | 0.45 | 0.16 | 0.23 | 0.67 | 0.51 |
| 5 Furnishings, household equipment and routine maintenance of the house | 1.0 | 1.1 | 1.0 | 1.0 | 1.9 | 1.61 | 1.50 | 0.80 | 1.12 | 1.10 | 0.08 | 0.09 | 0.08 | 0.08 | 0.15 |
| 6 Health | 4.4 | 3.4 | 2.3 | 1.8 | 1.2 | 2.98 | 5.29 | 1.17 | 3.11 | 2.84 | 0.03 | 0.02 | 0.02 | 0.06 | 0.05 |
| 7 Transport | 1.6 | 0.3 | 2.0 | 5.4 | 1.2 | 1.36 | 1.40 | 1.23 | 1.36 | 1.57 | 0.25 | 0.05 | 0.32 | 0.84 | 0.19 |
| 8 Communications | –1.3 | –0.9 | –4.4 | –4.5 | –2.8 | 2.59 | 2.47 | 4.02 | 3.43 | 3.91 | –0.03 | –0.02 | –0.11 | –0.11 | –0.07 |
| 9 Recreation and culture | 1.4 | 0.9 | 0.4 | 0.6 | 1.8 | 1.76 | 1.38 | 0.94 | 1.63 | 1.33 | 0.14 | 0.09 | 0.04 | 0.06 | 0.17 |
| 10 Education | 2.5 | 2.9 | 2.6 | 2.9 | 3.1 | 2.07 | 1.56 | 1.39 | 3.14 | 2.45 | 0.01 | 0.01 | 0.01 | 0.03 | 0.03 |
| 11 Restaurants and hotels | 2.2 | 2.4 | 2.3 | 2.7 | 3.3 | 1.68 | 1.61 | 1.54 | 1.22 | 1.48 | 0.19 | 0.21 | 0.19 | 0.23 | 0.29 |
| 12 Miscellaneous goods and services | 1.6 | 1.0 | 1.5 | 2.2 | 3.0 | 2.22 | 1.72 | 1.17 | 1.33 | 1.23 | 0.10 | 0.06 | 0.09 | 0.15 | 0.22 |
| All items (HICP) | 1.7 | 1.2 | 1.1 | 2.4 | 2.5 | 1.15 | 1.07 | 0.72 | 0.96 | 1.02 | 1.70 | 1.20 | 1.10 | 2.40 | 2.50 |

*Source: DG ECFIN, Price and Cost Competitiveness Report – First Quarter 2002, April 2002.*
[1]) *Under the heading euro area the aggregate of the 12 participating countries is displayed (for all periods). This applies to all tables and the text.*

Table 3

**National Contributions to the Euro Area HICP Inflation Rate**

| Country | HICP inflation rate | | | | | National contribution to euro area HICP inflation | | | | | Actual contribution minus contribution consistent with HICP weight | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 1997 | 1998 | 1999 | 2000 | 2001 | 1997 | 1998 | 1999 | 2000 | 2001 |
| | % | | | | | *Percentage points* | | | | | *Percentage points* | | | | |
| 1 Belgium | 1.5 | 0.9 | 1.1 | 2.7 | 2.4 | 0.06 | 0.03 | 0.04 | 0.11 | 0.08 | 0.00 | –0.01 | 0.00 | 0.02 | 0.00 |
| 2 Germany | 1.5 | 0.6 | 0.6 | 2.1 | 2.4 | 0.51 | 0.2 | 0.2 | 0.71 | 0.74 | –0.03 | –0.17 | –0.17 | –0.07 | –0.03 |
| 3 Greece | 5.4 | 4.5 | 2.1 | 2.9 | 3.7 | 0.11 | 0.09 | 0.04 | 0.06 | 0.09 | 0.08 | 0.07 | 0.02 | 0.01 | 0.03 |
| 4 Spain | 1.9 | 1.8 | 2.2 | 3.5 | 2.8 | 0.17 | 0.16 | 0.20 | 0.31 | 0.29 | 0.03 | 0.06 | 0.10 | 0.11 | 0.03 |
| 5 France | 1.3 | 0.7 | 0.6 | 1.8 | 1.8 | 0.28 | 0.15 | 0.12 | 0.37 | 0.37 | –0.06 | –0.09 | –0.10 | –0.10 | –0.14 |
| 6 Ireland | 1.2 | 2.1 | 2.5 | 5.3 | 4.0 | 0.01 | 0.02 | 0.02 | 0.05 | 0.05 | 0.00 | 0.01 | 0.01 | 0.03 | 0.02 |
| 7 Italy | 1.9 | 2.0 | 1.7 | 2.6 | 2.3 | 0.34 | 0.36 | 0.31 | 0.47 | 0.43 | 0.05 | 0.16 | 0.11 | 0.05 | –0.04 |
| 8 Luxembourg | 1.4 | 1.0 | 1.0 | 3.8 | 2.4 | 0.00 | 0.00 | 0.00 | 0.01 | 0.01 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 9 The Netherlands | 1.9 | 1.8 | 2.0 | 2.3 | 5.1 | 0.10 | 0.09 | 0.10 | 0.13 | 0.27 | 0.02 | 0.04 | 0.05 | 0.00 | 0.14 |
| 10 Austria | 1.2 | 0.8 | 0.5 | 2.0 | 2.3 | 0.04 | 0.02 | 0.01 | 0.06 | 0.08 | –0.01 | –0.01 | –0.02 | –0.01 | –0.01 |
| 11 Portugal | 1.9 | 2.2 | 2.2 | 2.8 | 4.4 | 0.03 | 0.04 | 0.04 | 0.05 | 0.09 | 0.00 | 0.02 | 0.02 | 0.01 | 0.04 |
| 12 Finland | 1.2 | 1.4 | 1.3 | 3.0 | 2.7 | 0.02 | 0.02 | 0.02 | 0.04 | 0.04 | –0.01 | 0.00 | 0.00 | 0.01 | 0.00 |
| Euro area | 1.7 | 1.2 | 1.1 | 2.4 | 2.5 | 1.70 | 1.20 | 1.10 | 2.40 | 2.50 | | | | | |

*Source: DG ECFIN, Price and Cost Competitiveness Report – First Quarter 2002, April 2002.*

terms, but as Germany as a large country also has a large HICP country weight it still contributed less than suggested by the weight, while Italy contributed over-proportional (0.11 percentage point). In 2001 the largest absolute contribution came from Germany, but the Netherlands were the country with the largest excess contribution (0.14 percentage point).

### 4.3 Inflation Differences at the Sectoral Level and Catching-Up

Some causes of inflation diversity could be linked to the sectoral level. Short-term differences can be induced by political measures like tax changes that are introduced by individual Member States for policy reasons (i.e. responses to oil price increases favouring transport companies).

Longer-term differences can be linked to catching-up processes: In particular, differences in sectoral productivity growth can result in economy-wide wage increases oriented towards those of the more dynamic sectors, imposing an upward bias to the inflation rate for the total economy. These sectoral causes of inflation diversity are most frequently associated with Balassa-Samuelson effects.[1]) But given that aggregate price levels vary markedly across euro area Member States,[2]) convergence in *price levels* due to greater market integration and productivity convergence will also inevitably be reflected in *inflation rate* differentials.

For *tradables,* the forces acting for price level convergence are those that increase market integration: single market rules, lower transport costs, increased price transparency, etc. The forces acting for convergence of *non-tradables* prices are more indirect and are mainly related to real economic convergence; cf the Balassa-Samuelson effect. In addition, a widening range of services is becoming tradable due to technological progress and this may add to convergence in non-tradables prices. Increased mobility of capital and labour across the euro area would also promote an equalisation of factor prices.

Concluding, it seems that the slight increase in inflation diversity that has been observed since the start of EMU seems related to the fact that the average inflation level has somewhat increased, to the direct or indirect impact of energy price increases and possibly to price level convergence in the wake of further integration for goods and services markets.

## 5 External Imbalances

The areas that have been looked at are obviously the ones that attract most of the attention when discussing diverging performances. However, there is another area on which there has been less focus so far, but which could get more attention in the future: the diversity in external positions.

Large external imbalances in Japan and in the U.S.A. have been at the centre of debate for a long time (see chart 8). Often they have been assessed as a risk to economic and financial stability. Adjustment scenarios were mostly based on cyclical or exchange rate changes providing the basis for adjustment of trade and capital flows. Compared to these external imbalances those registered for the euro area appear to be rather small.

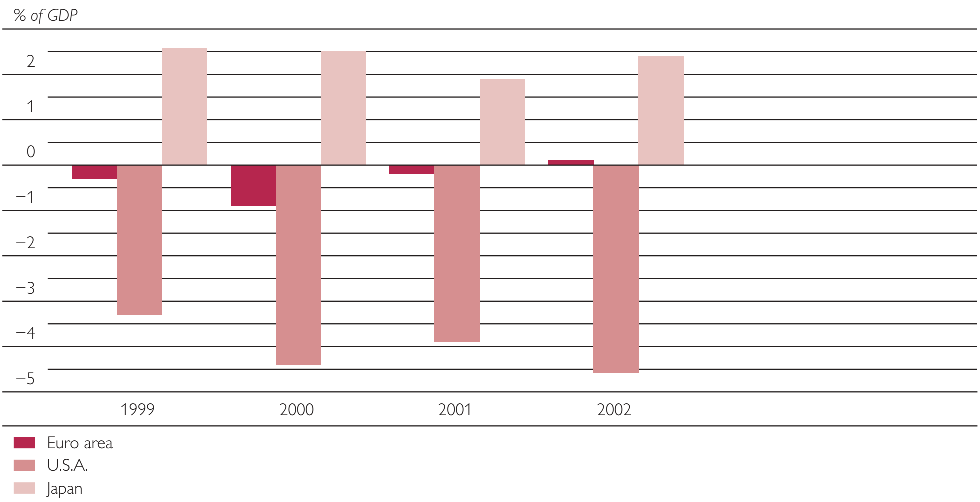
However, in the euro area some substantial external imbalances are registered at the level of the Member States (see chart 9). Such imbalances raise questions about the appropriateness and sustainability of national external imbalances in a monetary union.

1 *For an exposition of the Balassa-Samuelson argument see for instance ECB (1999). Inflation Differentials in a Monetary Union. In: ECB Monthly Bulletin, October: 35–44; Alberola, E.(1999). Is There Scope for Inflation Differentials in EMU? In: Banco de España Economic Bulletin, January: 69–73; Björkstén, N., and M. Syrjänen (1999). How Important Are Differences Between Euro Area Economies? In: Bank of Finland Bulletin, 73 (4): 20–25; and Alberola, E. (2000). Interpreting Inflation Differentials in the Euro Area. In: Banco de España Economic Bulletin, April: 61–70; for a discussion of policy implications see for instance Sinn, H.-W., and M. Reutter (2001). The Minimum Inflation Rate for Euroland. NBER Working Paper no. 8085, January.*

2 *See for instance European Commission (2001). Price Levels and Price Dispersion in the EU. European Economy Supplement A, July.*

Chart 8

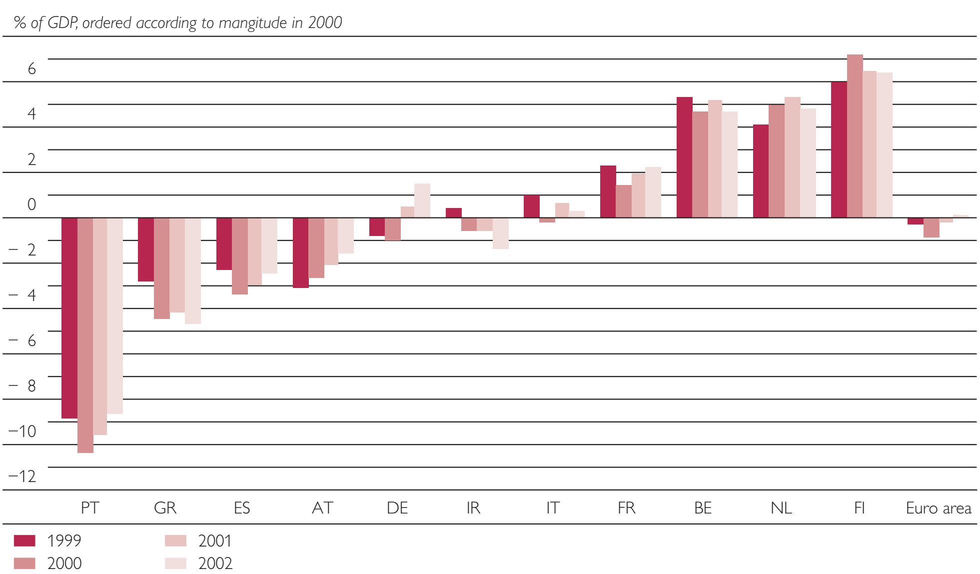
**Current Account Balances from 1999 to 2002**




*Source: Commission services' Spring 2002 Forecasts.*

Chart 9

**Current Account Balances from 1999 to 2002**




*Source: Ameco database, Commission services' Spring 2002 Forecasts.*

Do imbalances matter for Member States? Do they matter for the euro area as a whole? What can be done to reduce imbalances if deemed necessary? All these questions have received relatively little attention in recent years, in the absence of financing constraints and potential exchange rate tensions.

In general, current account imbalances at the level of the Member States have been persistent in the past too. But the euro has in important ways changed the situation, because the single currency makes it easier to finance deficits, and because exchange rates do not exist any longer among euro area countries as a tool for adjustment:

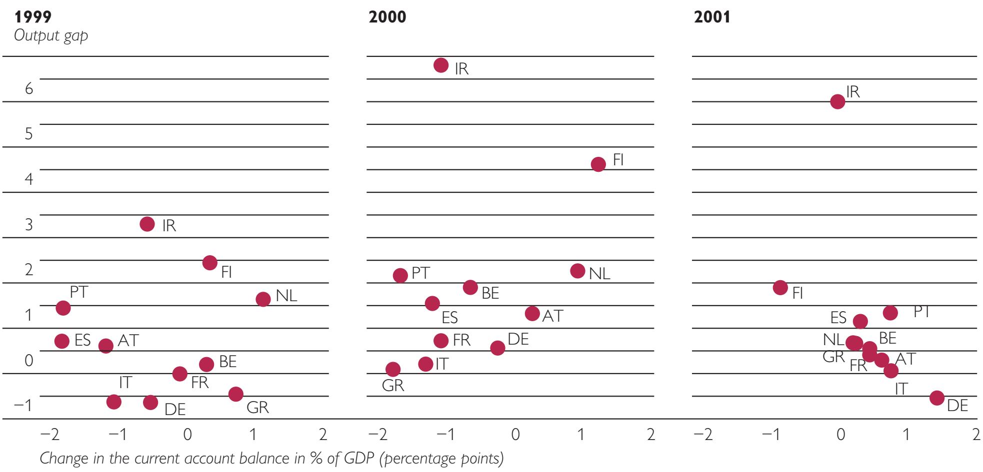
– *Easier financing of deficits.* Countries can run imbalances for a long time and accumulate large positive or negative net external positions. This is not inherently inappropriate, as there can be good reasons for current account deficits (e.g. in the context of catching up). Also one also has to acknowledge that imbalances often simply reflect private sector activity. However, an imbalance in a Member State's international account will imply ultimately a change in its net external position, and even without discussing the theoretical foundations of current account sustainability one can recognise that the accumulation of external debt as such is not unlimited.
– *No internal exchange rate adjustment.* Corrections cannot any longer take the form of nominal exchange rates changes; other channels affecting competitiveness have become more important. For a deficit country an improvement can be achieved by wage moderation and structural reform raising productivity. Structural reform has become particularly urgent to achieve the flexibility needed, as relative wage moderation is more difficult in the low-inflation environment of the euro area.

A key element will always be the early recognition of inappropriate imbalances. Thus there is some justification to monitor the development of external imbalances of the Member States to discuss adjustment where imbalances are deemed to be too large. Several elements could be taken into account for such a monitoring. Since the start of Stage 3 of EMU the euro area current account deficit now represents the balance of surpluses in Finland, the Netherlands, Belgium-Luxembourg, and France, roughly balanced current accounts in Italy and Germany and deficits in all the other Member States. As a percentage of GDP the diversity in current account positions is even more apparent. Strong surpluses of more than 4% of GDP in three countries contrast with deficits of more than 4% of GDP in two catching-up countries (see chart 9). Current account analysis offers a variety of explanations for observed developments as for instance cyclical determinants and changes in competitiveness.

– *Cyclical reasons.* Due to variations in domestic absorption, it can be argued that the part of the deficit in any particular country that is cyclical (higher import volumes induced by strong economic activity) can be expected to unwind as growth resumes (assuming the economy returning to its long-run trend). This would imply, *ceteris paribus,* an increase in current account deficits or a decline in surpluses in periods of above-average income growth and the opposite in times of below-average income growth. Such a correlation between output gaps and changes in current account positions would show up in the scatter diagrams in data points forming a downward sloping line between the northwest and the southeast. However, such a pattern is difficult, if not impossible, to detect in chart 10. For instance in all three years Ireland was in an advanced cyclical position, but registered relatively small changes in its current account and even an improvement in 2001. The cyclically advanced economy of the Netherlands reported current account improvements in all three years. However, during these years substantial changes in oil prices were observed,

Chart 10

**Output Gaps and Changes in the Current Account Balances**




Source: Ameco, Commission services' Spring 2002 Forecasts.

which were increasing the import bill and possibly hiding the cyclical component of current account changes. Moreover other important determinants (e.g. price competitiveness) and lags have affected current account developments.

— *Changes in competitiveness.* Price and cost competitiveness is a major determinant of trade flows among industrial countries. Changes in indirect taxes, wage settlements and country-specific factors change the cost situation of producers and affect their position in world markets. If for instance wage increases exceed productivity gains a resulting deterioration in terms of competitiveness can not be offset by nominal exchange rate changes, as it could before EMU started. Thus, one would expect deterioration in competitiveness to result in a larger current account deficit and vice versa.

The first three years of the euro area have seen some marked changes in relative cost and price indicators (see table 1). In particular Germany, France, Austria and Greece have achieved improvements in competitiveness as measured by all three indicators displayed. Also in the short-term (the last four quarters) most of the indicators hint at improvements in the relative position of these countries. Over the last year a deterioration has been observed in the cyclically more advanced economies of Ireland, the Netherlands, Spain and Portugal. In particular for Greece and Portugal, deterioration is reported relative to the 1987–2001 average. As the latter two countries register the largest external deficits (see chart 10), competitiveness factors appear to have contributed.

— *Competitiveness and profits.* Changes in competitiveness can be induced by rather different developments. Improvements could reflect cuts in costs or/and in profit margins. The latter could be aimed at gaining market shares and to compensate for lower margins by increasing the volume component. As this also works the other way round a deterioration in price competitiveness could also be induced by higher profit margins whereas a deterioration that comes along due to cost increases provides a more serious case of concern.

As economic policy-making is still largely decentralised in the euro area economy, it is useful to consider the current account situations in the individual Member States, since they tend to be masked by a more or less balanced euro area current account. Some countries (e.g. the Netherlands) have registered a significant current account surplus as they were at an advanced stage of the cycle. This would suggest that the economy could afford a real appreciation that would raise living standards. Countries having a current account surplus and high unemployment (e.g. France) could take structural or other measures in order to stimulate domestic demand. Other countries are experiencing a situation of real catching up (e.g. Ireland) with private sector confidence and a current account deficit. These countries seem to have benefited from the creation of large and liquid euro financial markets, implying a regime change for private sector borrowers in particular. Elsewhere (e.g. Portugal) the large current account deficit appears not only to reflect a catching up situation, but also low competitiveness and strong domestic demand driven by relatively loose monetary conditions. Germany and Italy, registering almost balanced current accounts and slow growth, need more push to economic growth coming from structural reform, which could lead to more flexibility and to a current account deficit.

## Conclusion

The four issues discussed in this article indicate that divergences in macroeconomic performance exist in the euro area. However, as has been argued, these differences are not necessarily a matter of concern. An optimal currency area is not so much characterised by completely convergent performance as well as by the capacity to deal with such divergences. For instance, what matters is not whether the Krugman hypothesis of specialisation is true, but how the economy adjusts to it.

Secondly, although it is too early to give a definitive judgement, the first almost three-and-a-half years of existence of the euro area seem to lend support to the view that the sound framework of price stability and fiscal prudence, established in EMU, in spite of some of the recent tensions, is capable of assuring a smooth and sustainable development. The structural reforms that already started in the run-up to the launch of the euro, and that received an additional impetus through the reform agenda agreed in Lisbon in the spring of 2000, have already born fruit in strong job creation and unemployment reduction.

All in all, there is good reason to be relatively optimistic about the ability of the EMU framework to cope with the challenges macroeconomic diversity might pose. Long-term growth differences are justified by catching up phenomena and can be expected to continue once the future Member States will have joined the euro area. Cyclical growth divergences seem to be manageable in size. Inflation diversity can be explained by the business cycle, integration effects, the adjustment to external shocks and Balassa-Samuelson effects. National external imbalances are not (yet) a prime reason for concern, but need to be monitored because they can have a signalling function for underlying imbalances.

However, in spite of the achievements already accomplished in the early life of the euro, there is no room for complacency and every reason to remain vigilant. So some of the divergent performances that were identified need careful monitoring and, where appropriate, corrective policy action in view of ensuring continued macroeconomic and structural policy convergence. This is exactly why there is such a thing as multilateral surveillance and the Stability and Growth Pact, and why the European Commission pointed to the delivery gaps in the Lisbon structural reform process in the run-up to the recent Barcelona Summit.

A credible macroeconomic policy framework combined with an ambitious, but socially balanced, structural reform process are key elements in safeguarding the sustainability of the encouraging performance of the euro area until now. ❧

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# Comments on Alexander Italianer and Oliver Dieckmann, "Are Divergent Macroeconomic Performances in a Monetary Union a Reason to Worry?"

This is an excellent paper, which I much enjoyed reading. I was particularly pleased with the careful balance drawn by the authors and their use of the evidence. And although their official position may make it difficult to answer very directly the question of the title, I can take advantage of the academic's prerogative to be controversial. I suggest that the paper gives us good reasons not to worry excessively about "real divergence".

Of course, a "one-size-fits-all" monetary policy will not in fact fit all. But the tensions that implies are common in any large country with diverse regions, and indeed even in a small country whose economy may be based on (say) a major natural resource export, tourism, and a small domestically oriented manufacturing sector – a not uncommon case. For the large country example, take the U.K., where our own "one-size-fits-all" monetary policy is having great difficulty in circumstances of an overvalued exchange rate, a housing price bubble, and significant disequilibria: a recession in manufacturing alongside a boom in services; a slump in investment alongside powerful growth of consumption; high unemployment in the north-east and tight labour markets in the south-east.

But the answer is not to be obsessed by the need for "real convergence". It is instead to recognise that monetary policy cannot deal with most of these disequilibria and should not try. It should focus on the inflation target, which does not of course mean that it should ignore employment, growth or the exchange rate. Although monetary policy manifestly cannot deal with structural issues, it can deliver inflation control, even when there is "real divergence" across a large economy. And that is what should be required of it – no more.

Conversely, although "real convergence" is desirable, and structural reforms are necessary to raise productivity growth, they are not necessary for the sustainability of Economic and Monetary Union (EMU). The "optimal currency area" (OCA) criteria have been grossly overemphasized. Doubtless if the Mundell paper had existed in the nineteenth century, no economist would have supported imposing a single currency on such a diverse geopolitical construct (recall it was not merely economically "divergent" – there was a major civil war and its aftermath). Even now, just as the U.K. or Italy or Spain, the U.S. has strongly divergent regional economic conditions – compare Silicon Valley and Chicago or Atlanta. Yet a single currency works perfectly well.

That success is not, in my view, primarily because of labour market flexibility or the fiscal transfer mechanism. Rather, it is because the single

Table 1

**Portugal: Savings, Investment and the Current Account**

| | 1974–1985 | 1986–1990 | 1991–1995 | 1998–2000 |
|---|---|---|---|---|
| | *% of GDP* | | | |
| Current account | – 6.60 | – 0.60 | – 3.10 | – 8.90 |
| Gross private savings | 22.90 | 28.00 | 23.10 | 16.10 |
| Gross national savings | 20.30 | 27.10 | 21.60 | 18.60 |
| Investment (rate of change) | – 1.30 | +11.00 | + 2.00 | + 7.00 |
| *Pro-memoria* | | | | |
| GDP (rate of change) | + 2.20 | + 5.50 | + 1.80 | + 3.40 |

*Source: European Commission, Spring 2001 Economic Forecasts.*

currency creates the conditions for financial market integration. The single capital market can and does – to some extent, automatically – finance disequilibria within the monetary union. The Mundell paper and the OCA criteria were out of date almost immediately, because the paper appeared just when capital markets emerged from the shackles that had bound them for thirty years. And this is what we see today, already, within the euro area. Monetary union has removed financial constraints on divergence. So although there are well-known reasons why the "OCA criteria are endogenous", insofar as monetary union raises intra-EMU trade and the common interest rate tends to synchronise business cycles, in fact the single currency and a unified capital market also permit more idiosyncratic developments across the union.

Ireland and Portugal are good examples. Let me take the latter, which featured in the 2001 "Update" of the *Monitoring the European Central Bank* series (CEPR). Portugal's entry to the European Union in 1986 was accompanied by a rise in the growth rate of investment, financed by domestic savings. Portugal's entry into monetary union in 1999 was also accompanied by a rise in the growth rate of investment, but this has been financed by foreign borrowing – to the extent of a current account deficit on the order of 10% of GDP. Such a deficit would have been impossible outside monetary union – there would have been a "balance-of-payments" crisis, and the escudo would have been forced out of the ERM. But

Chart 1

**PPP GDP and the Change in the Investment-GDP Ratio: EU, from 1995 to 2000**

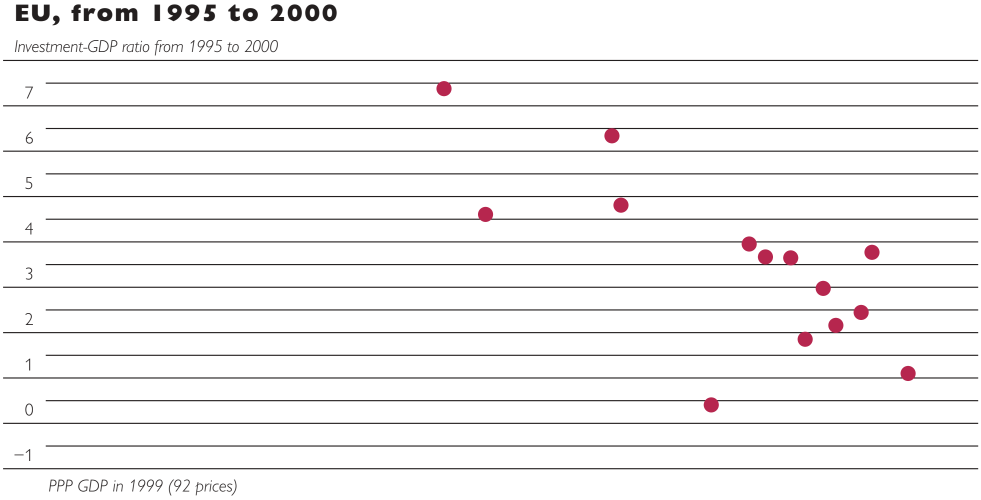


Chart 2

**PPP GDP and Current Account Deficits:**

**EU, in 1995**

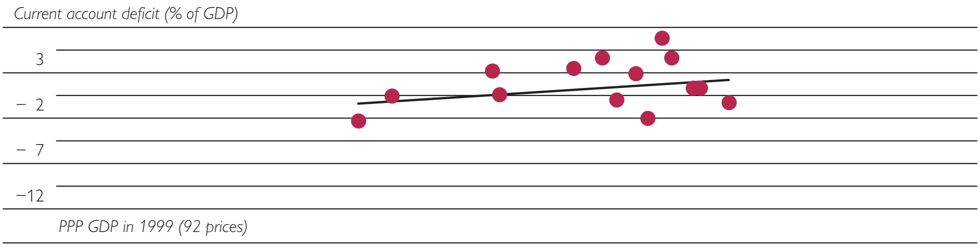
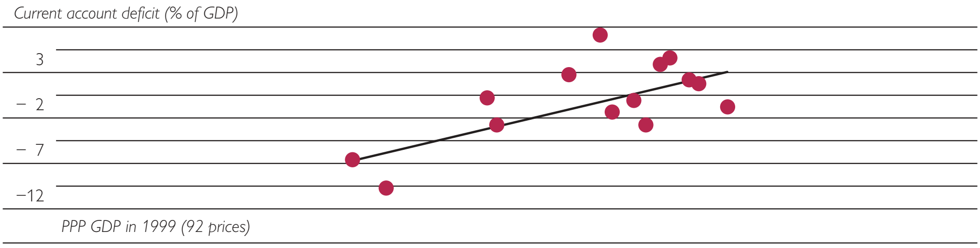



Chart 3

**PPP GDP and Current Account Deficits:**

**EU, in 2000**




there could not be a currency crisis, because the escudo no longer existed except as a unit of the euro, and financial integration meant that external financing of the deficit was automatic.

This case is representative of a more general phenomenon. Even before the single currency, and certainly since, monetary unification has promoted real convergence through the capital markets. We observe that during the period from 1995 to 2000, investment/GDP ratios rose most for the less developed (lower income) countries in the European Union.

The role of capital market integration is clear when we compare the pattern of current accounts in 1995 and in 2000. Whereas before monetary union, current accounts were hardly correlated with income, we find a strong correlation in 2000: poorer countries with higher investment needs can finance them from abroad, with no risk of a balance-of-payments crisis. That does not mean they can ignore the intertemporal budget constraint! But it is clear that monetary union facilitates the divergent investment performance that should lead to convergence of per capita output. So the answer to the question put by the title of this paper is "no" – the union itself and its central authorities should not overly concern themselves with divergent macroeconomic performances in the euro area, because in some respects they will be normal and healthy. And where they are not, it is for the domestic economic policymakers to deal with the divergence.

Sinikka Salo
Member of the Board,
Suomen Pankki

# Regional Policies and Differences in Economic Structures

In a globalising world, resources need to be continuously reallocated according to changes in demand for products, changing competitive positions and production methods. As technology has developed and economies have opened themselves up to trade, reallocation has taken place in much larger regional entities than earlier. There has also emerged a tendency for people and firms to cluster together with those that share their particular know-how and skills. Europe's economic geography is changing because of these trends and pressures known popularly as "globalisation". These regional developments do not originate from European integration, but are likely to have been strengthened through the increased competition it has brought about. At the same time integration – through increased trade, financial market integration and more similar macroeconomic policy frameworks – should have a synchronising impact on the economic performance of countries participating in the EU and in particular in the Economic and Monetary Union (EMU).

In general, assessments regarding performance of the monetary union during its first three and half years are positive. Alexander Italianer also concluded his illuminating presentation on differences in macroeconomic performance in the EMU by expressing "moderate optimism". Based on the Finnish experience, one can agree with the sentiment. Finland, as a small open economy with specialised industrial structure – paper and electronics (Nokia) – was generally regarded as most prone to asymmetric shocks. However, since the early years of the 1990s when the policies aiming at joining the EU and the EMU were adopted, the economic cycle has been more synchronised with the average cycle in the euro area, albeit with higher amplitude. Even during the last half of the 1990s, when GDP growth in Finland clearly exceeded the average growth in the EU, inflation remained rather close to that of the euro area average. Moreover, the recent rapid slowdown of demand in the IT sector, which hit the Finnish economy more heavily than other euro area countries, did not significantly change the situation. The ECB monetary policy reaction to a decrease in interest rates was largely taken as being well-suited to the Finnish IT sector and the economy as a whole, while a credible common monetary policy prevented the difficulties of the IT sector from spilling over into other sectors in the economy.

In the following, I am going to focus on differences in regional structures, questions of specialisation, and regional policies. I do not even try to answer the difficult question of how much divergence in structures is sustainable, posed in the title of this panel session – I refer to the "common understanding" that polarisation is bad and should be avoided.

According to recent studies, clustering and specialisation need not lead to polarisation, because – as it is argued – "most regions should be able to specialise in something". However, risk of polarisation cannot be ruled out, if policies try to freeze existing patterns of economic structures although they are no longer competitive. Therefore, issues of regional and cohesion policy have become increasingly important on the policy agenda in the EU, in the wake of enlargement.

The accession countries are a lot poorer than the current Member States. The planned enlargement of the EU into a Union of 25 Member States will therefore necessarily entail a dramatic increase in economic and social inequality in the Union, both between Member States and between regions. Even though this increase in inequality is, in a sense, only a notional consequence of the change in boundaries, the political consequences for the EU are by no means notional.

Increased differences will be duly reflected in political agenda. The allocation of the EU structural and cohesion funds is where the conflict of interest will be seen at its clearest, but similar tensions have arisen or are likely to arise in other fields, such as agricultural policy, freedom of movement, incomes policies etc.

There is, I expect, a broad consensus about what could be called the two-pillar approach for cohesion policy in the EU. The first pillar is the recognition by less prosperous nations and regions that they bear the primary responsibility in tackling their own poverty, which is crucial, for it is not only good economic policy, but is key to good governance. The second pillar is that the EU must provide support for its least developed regions. The distinction between these two pillars is of course clear only in theory. In practice national and community policies are highly interrelated, especially as far as regional policy in its strictest meaning is concerned. But nevertheless, it is conceptually and politically important to clearly bear this separation of responsibilities in mind.

With regard to national policies, in a welfare state well-developed public services and high level, highly progressive taxation tend to reduce inequality in society in general and consequently reduce regional inequality. In Finland, for example, the poorest of the country's 20 regions contribute, in the form of taxes to the central government budget, less than 70% of what they receive from the budget in the form of expenditure, whereas some other regions pay some 50% more than they receive. The effect of this redistribution of income on regional income differences is substantial. I doubt whether many accession countries at their present level of development could benefit much from an immediate adoption of a full-scale welfare state and it is likely that they have to tolerate much greater regional differences than most of the present Member States. But there may be something to be learnt from the underlying ideology of the (efficient) welfare state and some of its features could perhaps be adopted in the new Member States without too heavy a budgetary burden. In particular, in view of the high level of unemployment and rapid ageing of the population, one of the main challenges for the accession countries is to increase labour force participation and employment. This requires supportive infrastructure and services to be provided by a welfare state, notably such as facili-

ties for childcare and care of the elderly that particularly support the participation of women in the work force.

Wage moderation and increased wage differentiation according to productivity and skills are both essential ingredients in any policies targeted at higher growth and higher employment. Wage flexibility will remain important even after the elimination of fundamental labour market imbalances, especially for countries which aim joining the euro area in the relatively near future. In the monetary union each country has to live up to the goal of price stability. Countries joining the monetary union must have institutions, economic structures and policy discipline suited for specifically that. Meanwhile it should be stressed that for less prosperous accession countries, the main policy priority is to adopt an overall policy framework that is strongly oriented towards high and sustainable economic growth. This will entail encouraging new activities and combinations of activities, but regional policy objectives should be subordinated to aggregate economic policy objectives.

At the European Union level, one of the key issues in the policy debate is the establishment of a financial framework for the enlargement process. It is vital that some of the issues are solved for the period from 2004 to 2006, but the main problems seem to lie with the next financial perspective from 2007 to 2013. It seems that the continuation of present community policies after enlargement would imply substantial budget pressures. There is a risk that the current limit of 1.27% of GDP for the Community's own resources would be exceeded and by the end of the period this could be an excess that is more than merely marginal.

Instead of increasing the European citizens' tax burden, efficiency of the Community's policies should be more in focus. The main targets for improvements are the Common Agricultural Policy and Cohesion Policies, by the simple fact that they together take up some 80% of total Community expenditure.

It is generally accepted that the Community Cohesion Policy should continue to target the least developed regions. After accession into the EU, the least developed areas will be in the new Member States and thus structural and cohesion funds will be redirected to these countries. This will imply substantial transfers from the EU budget to the new Member States.

Great attention is needed to ensure that the recipients have the capacity to absorb them. Under the current rules for the period from 2000 to 2006, transfers from the Structural and Cohesion Funds are limited up to a maximum of 4% of national GDP a year in all Member States. In view of the limited administrative and absorption capacity of most of the new EU Member States, the Commission proposal in the recent information note *Common Financial Framework 2004–06 for the Accession Negotiations,* confirming the same ceiling for overall structural financial support for the period from 2004 to 2006, is a step in the right direction. This ceiling would seem appropriate even after 2006. Strict application of limits without exceptions would help prevent misunderstandings and the culture of rent seeking in the new Member States. In this regard one might question whether it is helpful to refer possibilities of additional financing in exceptional cases, such as "projects of a particular Community interest in relevant circumstances", as suggested by the Commission in its *First progress report on economic and social cohesion*.

To avoid the risk that cohesion policies freeze existing patterns of economic activity and thereby increase the likelihood of the polarisation they seek to prevent, refocusing of cohesion policies would be needed to contribute to the objective of increasing regional growth prospects and competitiveness. Instead of resisting inevitable changes, the authorities should perhaps even aim at speeding up the adjustment of the economy to the new economic-political environment. The experiences of some countries suggest that rapid adaptation to changing circumstances in the form of even large migration flows is feasible and in the end may even be optimal.

One approach to regional policy, that has sometimes been successful, is to favour viable growth centres. As an example, much of the northern part of Finland has become or is in the process of becoming very sparsely populated. At the same time, the main centre of the area, Oulu, has successfully transformed itself, over only a couple of decades, from a stagnant smoke-stack industry town into a dynamic business metropolis specialising in mobile and other information technology as well as biotechnology. This transformation has, without doubt, been helped by active regional policies that focused on the relatively rich local centre and not on the whole area. A decisive move was probably the establishment of the University of Oulu, which started its operation in 1959. In particular, the faculties of technology and medicine have played a central role as promoters of local growth and have close connections with the local high-tech companies.

In my contribution to the debate I have highlighted some aspects of regional policies in preventing polarisation in economic structures and performance. It is important to avoid policies that would freeze existing structures of economic activity if they were not viable. Let me finish my contribution by referring to recent discussions on institutional reforms: We need more transparency and efficiency, also in the administration of the community's regional policies, which is very complex. At the same time, very little is known of the effects of different programmes. It is important to recall the need for transparent and efficient programme evaluation, detection of fraud or non-conformity with financial rules, and harmonised application of sanctions in the different Member States in the case of shortcomings. More effective use of regional policies also requires greater synergy with other Community policies in the areas of research, innovation and education. ❧

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# Ought We to Worry About Regional Divergence in the European Monetary Union?

## 1 Introduction

Before doctors worry about a malady they try their best to ascertain whether the patient really suffers from it. And when they have convinced themselves that this is in fact the case, they will search for the cause of the ailment

before they prescribe a therapy. Frequently, unbearable divergence across EU regions or member countries has been diagnosed in order to justify the prescription of strengthened ex-ante harmonization areas of economic policy other than monetary policy and setting the rules guaranteeing the functioning of free and competitive European markets. Favorite prescriptions have been the stricter coordination or centralization of macroeconomic fiscal policy, the equalization of tax rates, the harmonization of social policy, centralized European wage bargaining, etc. A particularly popular idea in the public policy debate has been the claim that Economic and Monetary Union (EMU) necessitates a European transfer union (ETU) as part of a fully fledged fiscal federalist regime. The arguments in favor of a central fiscal authority and ETU have been either that without those supplements EMU would enhance economic divergence across European regions beyond a socially and politically acceptable level or that the existent heterogeneity, were it not reduced, would undermine the credibility of the anti-inflationary policy orientation of the European Central Bank (ECB) (a combination of both arguments is, of course, often encountered). Before discussing these claims, I will briefly sketch what the possible sources of regional heterogeneity may be and with respect to which dimensions divergence or convergence of European regions could be measured.

## 2 Sources and Dimension of Heterogeneity Across Regions

Sources of heterogeneity may be classified into variables that are

– exogenous, or
– endogenous

relative to the process of market integration and monetary unification. Classical examples of exogenous variables are preferences, primary factor endowments, and (to some extent) technology in the sense of available blueprints, but also policy-determined variables like tax systems, subsidies, labor laws, etc. Examples for endogenous variables are outputs, incomes, prices (relative and absolute), capital intensities, employment and unemployment rates, industry composition of regions, etc. Another useful classification of heterogeneity characteristics is based on whether they are

– the result of the individual decisions of market participants (implying endogeneity), or
– part of the institutional-regulatory framework.

Finally, we might distinguish between variables that account for heterogeneity in the

– short run, or
– long run.

In particular, the distinction between exogenous and endogenous factors of heterogeneity depends on whether we take a short-run or long-run perspective. Most elements of the institutional-regulatory framework appear to be exogenous in the short run but will, in fact, adjust in the medium and long run if cross-national and cross-regional competition among institutions is not precluded by ex-ante harmonization. On the other hand, market-endogenous variables like relative prices, real wages, employment, and cross-regional investment flows become quasi-exogenous in the short and medium run when they are caught in the straight-jacket of inadequate institutional arrangements, or are misguided by wrong policy-induced incentives, which cause severe hysteresis effects.

Shocks to exogenous variables may be
– symmetric (or common, in the sense of affecting all the regions or nations in EMU to the same extent),
– asymmetric (or idiosyncratic, i.e. region-specific of country-specific);

they may be of an
– aggregate nature, or
– industry-specific;

and they may be
– permanent (or highly persistent), or
– transitory (or cyclical).

The adjustment responses of endogenous variables can be classified accordingly. Preference shocks, e. g., are typically industry-specific and mostly transitory, they may have more or less asymmetric (region-specific) consequences, depending on the differing sectoral composition of regions, and more or less persistent effects on relative prices, employment and capital formation due to hysteresis phenomena. Technology shocks are permanent, mostly sector-specific, but sometimes (as in the IT case) also of an aggregate nature, and may affect regions asymmetrically at least in the shorter run, i.e., for an unchanged industry composition. As far as the spread of technological innovation is bound to physical and human capital it will have a pronouncedly endogenous character. Macroeconomic demand shocks, being by definition of an aggregate nature, are as such temporary but may have persistent effects (e.g., on private capital formation or inflation expectations) as well as asymmetric consequences across nations and regions. Even centralized monetary policy in EMU, geared to union-wide aggregate inflation indicators, will have asymmetric effects because of asymmetries in transmission mechanisms: Parts of these asymmetries are country-specific due to inherited national differences in the "credit channel" (the structure of the financial sector, in particular the importance of banks for financing investment), part are region-specific because of differences in the interest sensitivity of aggregate demand due to the heterogeneity of industrial structures (Mihov, 2001). Also nation-specific differences in labor market institutions can lead to asymmetrical reactions of wages, prices, and unemployment rates to shocks which are common to all the member countries of EMU. As Bruno and Sachs (1985) have shown with respect to highly symmetric negative supply shocks (e.g., energy price

shocks), countries with strongly centralized wage bargaining systems will fare better in terms of shorter duration and milder consequences of such shocks because trade unions are inclined to internalize the inflationary effects of wage increases. Also wage bargaining systems that are extremely decentralized down to the firm level (allowing for the internalization of the effects of wage claims on the firm's performance) cope much better with a shock to the price of a highly complementary factor of production than wage bargaining systems with an oligopolistic union structure (Calmfors and Driffill, 1988).

How rational economic policy should react to shocks – and whether it should respond at all – depends on the kind of shock. During the advent of EMU a vast empirical literature on the character of, and adjustment to, shocks in the euro area has accumulated (for an overview, see e.g. OECD, 1999).

This research had mainly been motivated by the debate about whether the European Union would be an "optimum currency area" and how EMU would compare to the U.S. or Canada on the optimal-currency-area (OCA) criteria. Some studies focused on quantity indicators, such as output and employment, others on relative prices, usually the real exchange rate, some examine both. As regards the symmetry of the impact of shocks in EMU the studies are divided in their conclusions. There is greater unanimity about the symmetry among six to eight "core" countries (Germany, France, Austria, Belgium, Netherlands, Sweden, to some extent also Italy and Finland), in particular for the time after 1992. This result is less robust at the EU regional level. In their comparisons with the U.S. most studies conclude that U.S. regions are more integrated, also with respect to factor mobility, than EU regions and therefore less affected by idiosyncratic shocks, and that adjustment to shocks is typically faster in U.S. regions. These empirical findings, based on data mostly from 1970 to 1990, are not a great surprise, however, since they compare a long-established economic and currency union with an EU before EMU and even before the enforcement of the "four freedoms" of the single domestic market. The real question is, of course, what the impact of further market integration promoted by EMU will be. Will the OCA test, even if not satisfied ante-EMU, be passed some time after the introduction of the euro? Before I turn to this point, let us take a look at the development of heterogeneity of EU regions in order to see whether divergence really is a problem.

While the EU cross-country dispersion of GDP per capita decreased in the 1980s and early 1990s, regional disparities did not show a similar tendency. Some studies even found some increase in the cross-regional dispersion (Fagerberg and Verspagen, 1996; Neven and Gouyette, 1995; Magrini, 1999). In a very careful analysis of EU regions at the Nomenclature of Territorial Units for Statistics (NUTS)2 level, testing for convergence versus divergence, Boldrin and Canova (2001) arrive at the conclusion that levels of regional GDP per resident did not converge during the period from 1980 to 1996. Their results reject, however, definitely the idea that regional development is driven by divergence and polarization. In fact, long-run growth rates of regional GDP per capita show a significant tendency toward uniformity so that relative differences can be expected to remain rather stable. GDP per resident (y) can be split into labor productivity (x), the rate of employment (e) and the rate of net-immigration into the regional labor market (m), y=x(e–m). It is interesting that Boldrin and Canova (2001) find some mild cross-regional convergence of labor productivities. However, neither the variation in labor productivity nor that in total factor productivity indicators can be explained by changes in capital-labor ratios. Given that inter-regional labor mobility is rather low and real wages rigid, the slight convergence of labor productivities was purchased at the price of some divergence in (un)employment rates (see also Overman and Puga, 2002). It is also important to note that Boldrin and Canova (2001) did not find any evidence for a positive relationship between the distribution of flows of EU Structural Funds, designed to support regional convergence, and either the variation of labor productivity or total factor productivity across regions. Typically, in the poorer regions receiving Structural Funds both public and private capital-labor ratios grew and converged toward those of the richer regions, but labor and total factor productivity indices did not. This, by the way, holds not only for the regions of Greece and Spain for which Boldrin and Canova (2001) have studied relevant time series data, but seems also to be characteristic for eastern Germany's "mezzogiorno syndrome."

## 3 Is EMU the Problem and ETU the Solution?

Traditional economic theory, assuming aggregate production functions with constant returns to scale, predicts that unhampered free trade of goods and services will lead to an international and interregional equalization of factor prices as long as nations or regions do not specialize on some of the traded goods because of a high degree of cross-national or cross-regional variation in relative factor endowments. Thus, for sufficient diversification cross-regional income convergence would come about even in case of complete factor immobility. In case that for given factor endowments specialization results and factor prices differ in equilibrium across regions, then interregional factor mobility would be necessary and sufficient for factor price equalization (if there are just two factors, capital and labor, then perfect mobility of one factor, e.g. capital, would suffice). Traditional theory would therefore suggest that the uncompromising pursuit of the EU Single Market program and the introduction of a common currency are the best means to ensure the convergence of member countries and regions in terms of real income.

This view has, however, not been adopted by the EU policymakers. On the contrary, the Delors (1989) Report claims that "Historical experience suggests that in the absence of countervailing policies, the overall impact [of more economic integration] on peripheral regions could be negative. Transport costs and economies of scale would tend to favor a shift in economic activity away from less developed regions, especially if they were at the periphery of the Community, to the highly developed areas at its center. The economic and monetary union would have to encourage and guide structural adjustment which would help poorer regions to catch up with the wealthier ones" (p. 22). Consequently, the European Commission's policy stance favors the allocation of Structural Funds to poorer regions (in the NUTS2 definition) and, in addition, of Cohesion

Funds to new-coming member nations (presently Greece, Ireland, Portugal, and Spain; rather soon another nine or ten countries). Why should there be need for long-term redistribution in favor of less developed regions and additional side-payments to joining countries (on top of the reasonably slow phasing-in of market integration) if traditional economic theory predicts benefits from integration for all participants and even actual convergence of labor and capital incomes across nations and regions?

The view that EU-wide market integration and adoption of a common currency generates a problem for which European fiscal federalism with centrally provided public goods and explicit redistribution via transfers, both financed by EU taxes, has received some academic support and intellectual credibility from the more recent theories of "endogenous growth" and Paul Krugman's work on international trade and economic geography. Both strands of thinking rely crucially on positive externalities (at the individual or local level) and increasing returns to scales (at the aggregate level).

Krugman (1991, 1993) has argued that closer market integration and intensified competition fostered by a common currency might result in greater regional specialization thereby exposing the regions in EMU to more and more pronounced asymmetries in the effects even of EU-wide common shocks. The empirical evidence from European data does so far not support Krugman's (1993) divergence hypothesis for EMU. Frankel and Rose (1997) refute empirically Krugman's conclusion. Moreover, the specialization hypothesis is very likely rather sensitive to the degree of regional disaggregation. At the NUTS0 and NUTS1 levels there is strong empirical evidence for declining specialization between 1980 and 1996 (OECD, 1999). At 2- and 3-digit levels of regional disaggregation the results are more ambiguous because the smaller the region, the more important will regional externalities and indivisibilities be. But even at the 2-digit level there is no convincing evidence for increasing heterogeneity in the EU regions' industry composition over the last 20 years. Moreover, the finer the regional disaggregation level at which divergence phenomena emerge, the less relevant to monetary policy in EMU will they be, and the stronger will be the arguments in favor of leaving cross-regional transfers under national jurisdiction. National fiscal federalism has coped quite well before EMU with regional heterogeneity, and is in no way hampered by EMU in continuing to do so in the future unless integration and the common currency would undermine the national governments' ability to tax decisively. This danger is, however, not big because of the low cross-national mobility of labor, due to language and other cultural differences much more important in the EU than in the U.S. or Canada. This is one instance when cross-national heterogeneity is not an argument in favor of EU-wide fiscal centralization. Heterogeneity among the member countries along cultural lines has a stabilizing effect on the tax bases of national governments, which allows them to borrow since they will be expected to be able to collect the taxes necessary to service their debts.

There is another reason why the long-run endogeneity of regional specialization may not result in EMU becoming a less optimal currency area ex post: Historically measured low degrees of inter-regional labor mobility in European national economies reflect the adjustment to a high level of diversification of regions in terms of industrial composition. Under such circumstances workers can afford to search within their region when some industry is hit by an adverse idiosyncratic shock. But it makes no sense to view the sectoral composition of regions as endogenous while assuming that cross-regional labor mobility stays exogenously fixed. If, in the long run, regional specialization in a monetary union should increase according to Krugman's hypothesis then we can expect labor mobility to increase too. In general, the pessimistic outlook of the early OCA literature on the prospects of EMU seems to suffer from a backward-looking bias (see, e.g., Mongelli, 2002).

In a currency union the burden of adjustment to shocks which hit nations or regions asymmetrically falls fully on fiscal policy. For the sub-regions of a nation which has become a member of EMU this is not a completely new experience. It had been a member of a currency union before. The plight of the sub-region is affected only in so far by her nation joining EMU as the asymmetry across nations is thereby increased – if only the within-nation asymmetry became more pronounced, the ability of the national government to support the region would in no way be impeded. Higher cross-regional asymmetries without concomitant higher within-nation correlation of regional shocks cannot be used as an argument for EU-wide transnational transfers. For the member nations of EMU giving up their independent currencies means, of course, the sacrifice of the flexibility of nominal exchange rates with its stabilizing function with respect to transitory or cyclical demand or supply shocks having nation-specific asymmetric effects. Stabilization has now to rely fully on counter-cyclical fiscal policy. Whether this is really such a loss for stabilization policy is debatable, however, since fiscal stabilization under fixed nominal exchange rates and high capital mobility (as in a monetary union) becomes more effective because of automatic monetary accommodation (no or little crowding-out for small countries). Besides, the distortionary allocational consequences of real exchange rate fluctuations, in particular of overshooting responses to monetary and real shocks,


and the uncertainty generated thereby are welfare losses avoided by members of a currency union. Moreover, the likelihood of nation-specific asymmetric demand shocks and strongly asynchronic business cycles, to a considerable extent owed to uncoordinated monetary policy actions, will be reduced in a monetary union.

Exchange rate flexibility does not only have a stabilizing function with respect to temporary asymmetric shocks for which counter-cyclical borrowing would be a substitute. Flexible exchange rate also performs an adjustment function with respect to permanent asymmetric shocks to technologies, preferences, resource endowments, tax systems, etc., affecting the equilibrium terms of trade when nominal prices and wages are rigid. Members of a currency union have renounced this adjustment mechanism, which after all works only in the absence of real wage and price rigidities, and, consequently, have to rely either on flexibility of nominal prices and wages to bring about the necessary adjustment in real exchange rates compatible with full employment, or on sufficiently high labor mobility. It is remarkable that despite the relatively low interregional labor mobility for subnational European regions, regional exchange rate flexibility is not greater than in currency unions with higher labor mobility like the U.S. (Obstfeld and Peri, 1998). This is certainly related to the existence of extensive systems of fiscal federalism in the member states of the EU which in addition to some stabilizing function (with respect to temporary asymmetric shocks) provide interregional redistribution that might be interpreted as a form of insurance against adverse permanent shocks (Fatás, 1998). While real exchange rate flexibility and factor mobility solve the problem of adjustment to persistent real shocks, fiscal transfers tend to hide the adjustment problem. Even if transfers are originally intended to be temporary aids to cope with the inevitable adjustment, they slow down the adjustment process and make additional transfers necessary.

Progressively developing regions (or national economies) with improving terms of trade will have higher inflation rates than less dynamic regions of EMU. Ireland is the prime example. Such a "divergence" of inflation rates is nothing to worry about, it reflects the adjustments of real exchange rates in the absence of adjustable nominal ones and poses no threat to an anti-inflationary stance of the ECB as long as the latter pursues an aggregate monetary target. In this respect, the admonition of the Irish government by the EU-commission (in spite of a significant Irish budgetary surplus!) was completely misplaced. Likewise, the observation of diverging current account balances should be no cause for alarm unless they are driven by government borrowing (or, as in the case of East Germany, huge cross-regional transfers) accommodating excessive consumption. It is in fact one of the virtues of EMU that it allows less developed regions to finance investment ratios well above their savings.

EMU per se does not make a convincing case for EU-wide interregional insurance. The loss of independent national monetary and exchange rate policies it entails affects mainly the speed of adjustment to shocks, and thus increases the volatility of temporary disturbances. This gives a greater role to national and regional borrowing which is facilitated by the integration of financial markets fostered by EMU. Neither does the implicit EMU-wide redistribution via the central provision of public goods receive much support from cross-regional heterogeneity: While the central provision of some public good internalizes cross-regional externalities, this has to be weighed against the cost due to imposing the same quantity of the public good on regions with heterogeneous demands for it (Alesina and Wacziarg, 1999). Some externalities that are invoked to justify steps toward an EU-wide harmonized social policy (e.g. the imposition of higher minimum welfare standards on the poorer member states to reduce the incentives for "welfare shopping" by migrants) are policy-induced and could be eliminated simply by changing the rules in favor of delayed integration of migrants into the national welfare systems (see the contributions of Tito Boeri and

Hans-Werner Sinn published in this volume).

The pressure for installing an ETU is, however, increased by an excessive interpretation of the so-called Stability and Growth Pact which promotes neither stability nor growth. On the contrary, it tends to hamper the stabilizing function of national and regional borrowing to cope with temporary asymmetrical shocks, and it stifles growth by diverting political energies from dealing with the true problems, in particular the reform of labor markets and of pension systems, Moreover, by casting doubt on the validity of the bail-out clause of the Maastricht Treaty and suggesting that the stability of the European currency depend on a politically manipulable agreement on national fiscal deficits, the Pact undermines the credibility of the ECB. As in the unfounded case for harmonization of social policies the externality which allegedly requires more centralization (here of fiscal policy to avoid negative effects of too big national debts on the viability of the European financial system which would eventually force the ECB to monetize the debts) is policy-induced and could be eliminated by changing the relevant rules, e.g. by putting higher equity capital requirements on banks in proportion to the share of risky public debt in their portfolios (see, e.g., Eichengreen and Wyplosz, 1998; Canzoneri and Diba, 1999).

## 4 Conclusion

Unsustainable regional divergence is certainly not a pressing problem for EMU that would have to be solved by ETU and a central European Economic Government. There is rather too much convergence in EMU toward the wrong institutional arrangements for labor markets, fiscal and social policy, and too much interference by European bodies in matters that are more efficiently dealt with by national or local governments. What EMU needs are unequivocal rules which guarantee the functioning throughout Europe of free markets for goods and services, labor and capital. These rules have to be centrally set and enforced. Good progress has been made; the introduction of a common currency was the single most important step so far. It will have to be followed up by policies to strengthen the Single Market program, in particular with respect to factor markets, and to create a coherent framework within which the heterogeneity indispensable for a market economy will not be viewed as a threat but as a productive force.

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# Concluding Remarks

At the end of this fascinating conference that we leave after many fruitful exchanges of views, it is difficult to sum up all that has been said. I would therefore like to convey three ideas that in my view characterize the main findings of this conference best:

(i) There are inherent limitations to how far we can push convergence, and we will have to learn to cope with these limitations.
(ii) There are different models to choose from; in other words, let us not search for the one and only.
(iii) The useful principle of diversity points toward a continuing important role for national central banks.

In general, I'm not that fascinated by football. These days it is, of course, an issue that is bound to crop up in conversations – especially when you talk with men. I must say, though, that there is one thing, linked to football, that has stuck with me, namely how the famous former Argentine football trainer Carlos Menotti once described football as a dialectical mixture between planning and adventure. Well, wouldn't this be a nice metaphor for the process of Economic and Monetary Union (EMU), too? Remember how most of us had a fairly straightforward idea of the convergence process, how we anticipated it to run smoothly? But as such processes go, things developed slightly different.

## 1 Divergence Will Remain an Economic Policy Challenge in EMU

From an economic standpoint what matters is the degree of price convergence across euro area markets. The results have been disappointing to a certain extent. In a number of further policy areas, the divergence of the euro area countries has not been reversed; indeed, it may even have worsened. Well, we knew right from the beginning that the euro area did not fulfill


all the criteria of an Optimum Currency Area (OCA), but many certainly expected the euro to work as a kind of catalyst for change in this direction.

What shall policy do to cope with divergence? An area that, in my judgment, has not gained the attention of economic policy it deserves is the issue of labor mobility. Relaxing restrictions on the international mobility of workers – and I do not just mean the mobility within the EU – stands to generate high economic benefits. Just look at the price wedges that have remained despite the liberalization of financial and goods markets. But in comparison with the sharp wage differences they are rather low.[1]) Up to now there has been almost no liberalization of markets for cross-border labor services. Thus, the potential of substantial welfare gains is there. On the other hand, immigration is highly unpopular in the European Union. This points to the political aspect that all economic questions, even so-called technical issues, involve. Economists too often just follow political realities when they should be challenging them through their intellectual efforts. That politically taboo issues need not put an end to economic inquiries, was shown by D. Rodrik from Harvard, who recently proposed a labor contract scheme that should benefit not only the industrialized countries but also the developing countries.[2]) But also Tito Boeri at this conference argued strongly in favor to enhance the mobility of the European workforce by increasing the portability of social security rights and actually enforcing the equal treatment principle.

## 2 Institutional Diversities Can Play a Valuable Economic and Social Role

Adam Smith once complained that businessmen seldom get together without their conversation turning into a conspiracy against the public. Well, central bankers seldom meet without envisioning a best-practice model based on the values of their institutions.

However, institutions and societies differ in the values and norms that shape their selections. To recognize that there is no unique rule-setting, that there is no institutional best practice solution to be found, will improve our policy debates.[3])

1 *Hourly wages (before tax, including special bonuses) in the manufacturing sector, euro area average: EUR 14.9, lowest wage: EUR 4.9 (Portugal), highest wage: EUR 21.5 (Germany); ratio Germany/Portugal: 4.4/1; Source: Eurostat, Labour Cost Index 1999, published in March 2001.*

2 *A forced saving scheme with a mechanism ensuring a high return ratio of immigrants.*

3 *This argument reflects the conclusions of the booming "varieties of capitalism literature;" a strand of literature highlighting the importance of strategic interaction among institutions.*

Integration in the EU will remain necessarily limited by the scope of institutional diversity at the national and regional level. Thus, I would argue that the decisive policy question is the adequate degree of an effective macroeconomic policy coordination between diverse institutions in EMU. As profound integration in the EU will remain a vision for a long time we rather have to look whether existing institutions conflict or complement each other. Sinikka Salo from Suomen Pankki launched an appeal to strengthening the Structural and Cohesion Funds. The message Christian de Boissieu gave us was that enlarged supervision cooperation is going to be the best solution in the short- and medium run. The close nexus between the central bank aims of monetary and financial stability has been mentioned several times and points also toward the need of strengthening cooperation between central banks and supervisory authorities. And Arnout Wellink stressed the important role the De Nederlandsche Bank has to play in the Social and Economic Council.[1]) The more general idea underlying all these efforts toward broad and deep cooperation was formulated by Joseph Stiglitz during his recent visit in Vienna. *We know that economic policy making is very complicated, thus, it ought to bring together all the affected parties.*

Furthermore, we discussed extensively the question of systems competition (Sinn) between the U.S. approach and the European approach. Normally we mean financial systems that have tended to move toward an Anglo-American model. Labor institutions remain rather divergent. And recent research by Marco Brecht and Colin Mayer (2001) confirms that Germany is still far from having converged on the British or American type of ownership structure. It seems that the Rhineland model is still alive and well.[2])

As you will recall, Hans-Werner Sinn suggested in a convincing way that there is a likely erosion of the European welfare state, inducing a race to the bottom leading finally to an erosion of national regulatory systems. To state it in his terms, the *selection principle[3])* may lead to the more likely outcome of a failure rather than a smooth functioning of systems competition.

For quite a long time there was a kind of unquestioned consensus that Europe was lagging behind and that it had to learn from the experience of the U.S. However, this convergence toward the American model was not seen as unavoidable by all our partici-

1 *The Social and Economic Council (SER) in the Netherlands is made up of members nominated by employers and unions, along with independent members appointed by the crown and provides advice to the government across various social and economic issues.*

2 *In more than half of the listed non-financial companies a single block holder controls more than 50% of the voting rights while the median block holder controls only 20% of the voting rights in France, 10% in the U.K., and 5% in the U.S.*

3 *The selection principle maintains that states take over those economic activities that the private market is unable to carry out.*

pants. The U.S. and the EU have different brands of capitalism and in the late 1990s the U.S. outperformed the EU on a number of key indicators of economic success but – and we should stress that fact too – generated much greater economic inequality. Thus, some believe that the *egalitarian EU can compete with the market-driven U.S.*[1]) Tito Boeri titled one of his recent papers *"Let Social Policies of USA and Europe Compete: Europe Will Win".*[2]) Thus, this is an unsolved policy question where the results largely depend on your normative evaluation criteria. My personal answer to the question whether there is an alternative model to the American approach would be a resounding "yes." The European welfare state with its long and successful tradition provides a rich variety of policy designs and this may become an important resource for Europe in the transatlantic race.

## 3 Diversity Underlines the Important Role of National Central Banks

Arnout Wellink took in his extremely interesting speech the long-run perspective and concluded that only some tasks of central banks are likely to be centralized, but that fundamental changes in the role of national central banks of the Eurosystem will be linked to further political integration within Europe. I agree completely with his concluding point that institutions tend to be related to feelings of identity. Thus, as long as Europe remains a community of nation states national central banks will have to play an important part.

Furthermore, we should envisage important tasks for national central banks directly related to European monetary policy. As I think that only in academic theory monetary policy can be regarded as optimal rule-following behavior; in practice, I would say, it is rather characterized by a kind of *constructive ambiguity*. A crucial aim of a central bank has to be to reduce uncertainty, which is why an extensive communication with the public and markets is so important. In this context national central banks in the Eurosystem have to fulfill a key role. In order to avoid misperceptions of the policy stance, they have to communicate to their national audiences in a consistent way the rationale of the policy followed by the Eurosystem. Even under the assumption that financial global players may need national central banks less in the future, for a long time to come our role will be to communicate and discuss with national politics, national wage bargaining institutions and national publics.

## Concluding Remarks

The EU will need to demonstrate that its institutions are prepared to deliver the policies that people want. Individuals look for an EU which delivers real benefits to them.

The Convention on the Future of Europe provides an important opportunity to reverse public disenchantment with the EU. The Convention's aim must be an EU which is prepared for the institutional challenges of an

1 *Title of a paper by Richard B. Freeman (2002).*

2 *Tito Boeri states that EU supra-national authorities should resist the temptation to impose a particular social model over the others and rely instead on the mobility of the European workforce as a driving force of political integration.*

enlarged EU, and is better understood by our citizens. We need to deepen the bond between the EU and its citizens based on a common attachment to a set of values and effective policies that deliver.

At the end let me mention one further point: an enlarged EU should also be a buttress against extremism. The criteria for EU membership have been clearly defined, not just in terms of economics but above all in terms of values, including support for the rule of law, human rights and respect for minorities. ❧

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## Franz-Weninger-Stipendien
## Franz Weninger Award

## Überreichung der Franz-Weninger-Stipendien der Oesterreichischen Nationalbank

Frau Vize-Gouverneur Dr. Tumpel-Gugerell überreichte am 13. Juni 2002 im Rahmen der 30. Volkswirtschaftlichen Tagung der Oesterreichischen Nationalbank die Franz-Weninger-Stipendien an drei Preisträger. Das Franz Weninger Stipendium wird von der OeNB jedes Jahr für hervorragende Dissertationen und Diplomarbeiten auf dem Gebiet der Geldtheorie und Geldpolitik vergeben und erinnert an den vor sechs Jahren tödlich verunglückten Leiter der Volkswirtschaftlichen Abteilung der Oesterreichischen Nationalbank. Die Stipendien werden vom Direktorium der Oesterreichischen Nationalbank auf Vorschlag einer Fachjury vergeben.

Diesmal wurden die Franz-Weninger-Stipendien den im Folgenden genannten Personen für Arbeiten mit dem jeweils angeführten Titel zuerkannt:

- **Mag. Gertrude Preslmair** für die Disseration „Der Transformationsprozess des tschechischen Bankensektors“,
- **Mag. Stefan Povaly** für die Diplomarbeit „Relationship between Stock and Currency Markets in Emerging Regions with Particular Relevance for Poland“ und
- **Clemens Jobst** für die Diplomarbeit „How to Join the Gold Club: The Credibility of Austria-Hungary’s Commitment to the Gold Standard 1892–1913“

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- Bankruptcy Priority for Bank Deposits: A Contract Theoretic Interpretation. In: Review of Financial Studies (13), 2000: 813–839
- Aktionärsstruktur und Unternehmenspolitik – Bedeutung für die Sicherheit des Bankensystems. In: Geld, Währung, Konjunktur (Quartalsheft SNB), 1995 (3): 265–277
- Finanzderivate – volkswirtschaftliche Bedeutung und Auswirkungen auf das Finanzsystem. (With W. Hermann and B. Rime), in: Geld, Währung, Konjunktur (Quartalsheft SNB), No. 4, 1994: 336–348 (French: 349–362)

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**Other Activities**

– Director of the Fondazione Rodolfo Debenedetti
– Associate professor of economics and research fellow of the Innocenzo Gasparini Institute of Economic Research
– Research fellow of CEPR and of the William Davidson Institute, University of Michigan Business School

**Selected Publications**

– Structural Change, Welfare Systems and Labour Reallocation. Oxford University Press, 2000
– Welfare and Employment in a United Europe. (With G. Bertola and G. Nicoletti), MIT Press, 2000
– The Role of Unions in the 21st Century. (With A. Brugiavini and L. Calmfors), Oxford University Press, 2001
– Institutional Determinants of Reallocation in Transition. (With K. Terrell), in: Journal of Economic Perspectives, 2002
– Pension Reforms and the Opinions of European Citizens. (With A. Boersch-Supan, and G. Tabellini), in: American Economic Review, 2002

## Peter Bofinger

**Date of Birth**

September 18, 1954

**Present Position**

– Professor at the Economics, Monetary and International Relations Department, University of Würzburg, since 1992

**Professional Experience**

– Member of the Scientific Staff at the German Council of Economic Experts from 1978 to 1981
– Teaching member at the Saarland University (Chair: Professor Wolfgang Stützel) before 1985
– Worked in the Economics Division at the Land Central Bank Baden-Württemberg from 1985 to 1990
– Visiting professor at the Universities of Kaiserslautern, Konstanz and Würzburg from 1990 to 1992

**Research Interests**

– Monetary theory and policy
– European integration
– Economic transformation

**Education**

– Studied economics at the Saarland University from 1973 to 1978
– Ph.D. (rer.pol.) in 1984
– University teaching qualification at the School of Law and Economics, Saarland University

**Other Activities**

– Research Fellow of the Centre for Economic Policy Research, London
– Editorial Board:
  – Economics of Transition
  – Economics of Planning
  – International Journal of Finance & Economics

**Selected Publications**

– Monetary Policy: Goals, Institutions, Strategies, and Instruments. Oxford University Press, 2001
– Kazakstan 1993–2000: Independent Advisors and the IMF. (With L. Hoffmann, H. Flassbeck, and A. Steinherr). Springer 2001; also available in Russian language
– Stabilitätskultur in Europa (with C. Hefeker and K. Pfleger), Stuttgart 1998
– A Framework for Stabilizing the Euro/Yen/Dollar Triplet. In: North American Journal of Economics and Finance, Vol. 11, Dezember 1998: 137–151
– Geldpolitik: Ziele, Institutionen, Strategien und Instrumente. (With J. Reischle and A. Schächter), München 1997

## Christian de Boissieu

**Date of Birth**

March 18, 1947

**Present Positions**

- Professor at the University of Paris I (Panthéon-Sorbonne)
- Professor at the College of Europe (Bruges)
- Consultant to the World Bank and to the European Commission

**Professional Experience**

- Post-doctoral fellow at Northwestern University and Harvard University from 1973 to 1974
- Visiting scholar at the University of Minnesota in 1978
- Visiting scholar at the Board of Governors of the Federal Reserve System (Washington, D.C.) in 1982

**Research Interests**

- Monetary analysis
- Economic policy

**Education**

- Ph.D. in economics from the University of Paris in 1973

**Other Activities**

- Economic adviser to the Paris Chamber of Commerce and Industry
- Member of the Conseil National du Crédit, Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI)
- Member of the Comité de la Réglementation Bancaire et Financiére
- Honorary president of the French Finance Association
- Former member of the advisory board of J. P. Morgan (France)
- Member of the European Shadow Regulatory Committee
- Member of the Council of Economic Analysis created by the French government

**Selected Publications**

- Banking in France. (Editor), Routledge, London, 1990
- Les mutations de l'économie française. (Editor), Economica, Paris, 1997
- Monnaie et Economie. Economica, Paris, 1998
- Les mutations de l'économie mondiale. (Editor), Economica, Paris, 2000
- Les Entreprises Françaises 2001. (Editor), Economica, Paris, 2001
- Les Entreprises Françaises 2002. (Editor), Economica, Paris, 2002

## Fritz Breuss

**Date of Birth**

September 6, 1944

**Present Positions**

- Professor at the Research Institute for European Affairs at the University of Economics and Business Administration Vienna since 1993
- Jean Monnet professor for Economics of European Integration at the University of Economics and Business Administration Vienna since 1995
- Economist, Austrian Institute of Economic Research (WIFO), Vienna/ Austria, since 1974

**Professional Experience**

- Visiting scholar at the Department of Applied Economics, University of Cambridge/England, from 1980 to 1985
- Visiting scholar at the Department of Economics, University of California, Berkeley/USA, in 1985
- Lecturer at the University of Economics and Business Administration Vienna (International Economics) from 1981 to 1985
- Associated professor (Dozent) at the University of Economics and Business Administration Vienna from 1985 to 1993

**Research Interests**

- International economics
- European integration

**Education**

- Magister (University of Vienna) in 1972
- Doctoral degree (University of Vienna) in 1974

**Selected Publications**

- Österreichs Außenwirtschaft 1945 bis 1982. Vienna 1983
- Die Vollendung des EG-Binnenmarktes. Gesamtwirtschaftliche Auswirkungen für Österreich. Makroökonomische Modellsimulationen. (With F. Schebeck), WIFO study, Vienna 1989
- The World Economy after the Uruguay Round. (Editor), Vienna 1995
- Reifegrad der mittel- und osteuropäischen EU-Beitrittswerber (Coordination). WIFO Study, Vienna 1999
- Vom Schuman-Plan zum Vertrag von Amsterdam: Entstehung und Zukunft der EU. (Edited with G. Fink and St. Griller), Springer Vienna–New York 2000

## Dirk Bruneel

**Date of Birth**

June 20, 1950

**Present Positions**

- Member of the Executive Committee, Dexia Holding, since 2001
- Director of FSA since 2001

**Professional Experience**

- ASLK-CGER Bank, Economics Department, from 1973 to 1993
  - Managing director as of 1992
- BACOB Bank s.c. from 1993 to 2001
  - Member of the Board of Management and managing director as of 1993
  - Chairman of the Management Board as of 1995
- Artesia Bank
  - Director as of 1997
  - Member and chairman of the Management Board in 1998
- Dexia Bank
  - Member of the Management Committee in 2001

**Research Interests**

- Financial markets activities

**Education**

- Degree in General Economic Sciences (Gent University, Belgium) in 1972
- Master Company Financial Management (VLEKHO, Belgium) in 1982

**Other Activities**

- Director of EHSAL and Erste Bank
- Treasurer of Vlaams Omroeporkest en Kamerkoor

## Paul De Grauwe

**Date of Birth**

July 18, 1946

**Present Positions**

- Professor at the Catholic University of Leuven, Belgium
- Senator and chairman of the Economic and Finance Committee at the Belgian Parliament

**Professional Experience**

- Economist International Monetary Fund from 1973 to 1974
- Associate professor at Catholic University of Leuven, Belgium, from 1974 to 1982
- Visiting professor Wharton School – University of Pennsylvania in 1983
- Professor College of Europe, Bruges, from 1984 to 1986
- Visiting scholar in the Bank of Japan in 1987
- Senior research fellow at the Centre for European Policy Studies, Brussels, from 1988 to 1991
- Belgian Parliament senator from 1991 to 1995
- Belgian Parliament member of the House from 1995 to 1999

**Research Interests**

- International monetary economics, more specifically in issues relating to monetary integration and exchange rate economics

**Education**

- Licentiaat-Doctorandus; Catholic University of Leuven, Department of Economics

- Ph.D.; The Johns Hopkins University, Baltimore, Department of Political Economy

**Other Activities**

- Chairman of Task Force preparing Belgian profit sharing legislation (2000)
- Chairman of Task Force preparing Belgian Corporate Governance legislation (2000)
- Member of Board of Editors of various journals

**Selected Publications**

- Central Banking: Art or Science? Lessons from the Fed and the ECB. In: International Finance, 2002
- Do Asymmetries Matter for European Monetary Policy? (With Y. Aksoy, and H. Dewachter), in: European Economic Review 46(3), 2002: 443–469
- Exchange Rates in Search of Fundamentals: The Case of the Euro-Dollar Rate. In: International Finance, Vol. 3, Issue 3, 2000: 329–356
- Monetary Policies in the Presence of Asymmetries. In: Journal of Common Market Studies, Vol. 38, Issue 4, 2000: 593–612
- The Impact of EMU on Trade Flows. (With F. Skudelny), in: Weltwirtschaftliches Archiv, Review of World Economics, Vol. 136, Issue 3, 2000: 381–402

## Willem F. Duisenberg

**Date of Birth**

July 9, 1935

**Present Position**

- President of the European Central Bank since June 1, 1998

**Professional Experience**

- Teaching assistant, University of Groningen from 1961 to 1965
- Staff member of the International Monetary Fund, Washington, D.C. from 1965 to 1969
- Adviser to the Governing Board of De Nederlandsche Bank from 1969 to 1970
- Professor of macroeconomics, University of Amsterdam from 1970 to 1973
- Minister of Finance, the Netherlands from 1973 to 1977
- Member of Parliament for the Partij van de Arbeid (Socialist Party) from 1977 to 1978
- Member and vice-chairman of the Executive Board of Rabobank Nederland from 1978 to 1981
- Executive director of De Nederlandsche Bank from 1981 to 1982
- President of De Nederlandsche Bank from 1982 to 1997
- President of the European Monetary Institute from 1997 to 1998

**Education**

- Degree in economics (cum laude) from the University of Groningen
- Ph.D. at the University of Groningen; doctoral thesis: Economic consequences of disarmament

**Other Posts**

- Chairman of the Board and president of the Bank for International Settlements, Basle from January 1988 to December 1990, and from January 1994 to June 1997
- Member of the Board of Patrons of the European Association for Banking History, Frankfurt since 1990
- Member of the Board of Directors of the Bank for International Settlements, Basle from January 1982 to June 1997
- Chairman of the Committee of the Governors of the Central Banks of the Member States of the EEC from January to December 1993
- Member of the Council of the European Monetary Institute from January 1994 to June 1997
- Governor of the International Monetary Fund, Washington, D.C. from January 1982 to June 1997

**Selected Publications**

Author of numerous publications and articles in the areas of economics and monetary policy

## Alexander Italianer

**Date of Birth**

March 16, 1956

**Present Position**

– Director for International Affairs at the European Commission, Directorate-General for Economic and Financial Affairs, since April 2002

**Professional Experience**

– Research assistant at the Catholic University of Leuven (BE) from 1980 to 1985
– European Commission
  – Econometric Models division from 1985 to 1989
  – Unit "Economic aspects of integration and evaluation of external policy" as of 1989
  – Head of the unit "Economic aspects of integration and evaluation of external policy" in 1994
  – Member of the Cabinet of President Jacques Santer of the European Commission from 1995 to 1999
  – Head of Cabinet to Commissioner Günter Verheugen, responsible for Enlargement, from 1999 until 2002

**Research Interests**

– Economic and Monetary Union
– Integration economics
– International trade and macroeconomic modelling

**Education**

– Graduated in econometrics at the University of Groningen (NL) in 1980
– Ph.D. in economics (cum laude) at the University of Groningen in 1986

**Other Activities**

– Member of the advisory board ("Centrale Plancommissie") of the Dutch Central Planning Bureau
– Member of the Editorial Board of its publication CPB Report

**Selected Publications**

– The Euro and Internal Economic Policy Coordination. In: Empirica, Vol. 26, No. 3, 1999: 201–216
– The External Implications of the Single Currency. (With A. Bénassy and J. Pisani-Ferry), in: Economie et Statistique, Special issue, 1994: 9–22
– Regional Stabilisation Properties of Fiscal Arrangements: What Lessons for the Community? (With J. Pisani-Ferry), in: J. Mortensen (ed.). Improving Economic and Social Cohesion in the European Community. St. Martin's Press, 1994: 155–194
– Whither the Gains from European Economic Integration? In: Revue Economique, Vol. 45, No 3, May 1994: 689–702
– One Market, One Money. (With M. Emerson, D. Gros, J. Pisani-Ferry and H. Reichenbach), Oxford University Press, 1992.

## Olivier Lefebvre

– October 1, 1957

**Present Position**

– Executive Vice-President and Member of the Managing Board of Euronext N.V.

**Professional Experience**

– Economist at the University of Louvain (UCL) in 1981
– Economic research department of Generale Bank (now Fortis Bank) for two years
– Advisor and later on chief of staff of Mr. Philippe Maystadt, the Belgian Minister of Finance, from 1990 to 1995
– President of the Executive Committee of the Brussels Stock Exchange and after its merger with Belfox and CIK in 1999 president of the Executive Committee of Brussels Exchanges s.a.

**Education**

– MBA (Cornell) 1984
– Doctor in Economics (UCL) in 1990

**Other Activities**

– Invited lecturer at several universities

## Klaus Liebscher

**Date of Birth**

July 12, 1939

**Present Positions**

- Governor of the Oesterreichische Nationalbank (OeNB) since September 1998
- Member of both the Governing Council and the General Council of the European Central Bank (ECB) since June 1998
- Represents the OeNB at the Bank for International Settlements (BIS) Governors' Meeting since June 1995
- Austria's governor to the International Monetary Fund (IMF) since June 1995

**Professional Experience**

- Raiffeisen Zentralbank Österreich AG from 1968 to 1995
- Member of the Executive Board from 1980 to 1995
- Chief executive officer and Chairman of the Board from 1988 to 1995
- President of the Vienna Stock Exchange Council from 1990 to 1995
- Member of the supervisory boards of several banks and other corporations in Austria and abroad from 1980 to 1995
- Member of the General Council of the OeNB from 1988 to 1998
- President of the OeNB from 1995 to 1998

**Education**

- Law degree (Dr. iur.) from the University of Vienna

**Selected Publications**

Author of numerous publications and articles in the areas of monetary policy and economics

## David G. Mayes

**Date of Birth**

May 30, 1946

**Present Positions**

- Advisor to the Board at the Bank of Finland since 1997
- Professor of economics at South Bank University in London since 1997

**Professional Experience**

- Chief economist and chief manager at the Reserve Bank of New Zealand
- Group head at the National Economic Development Office in London
- Director (CEO) of the New Zealand Institute of Economic Research in Wellington
- Senior research fellow at the National Institute of Economic and Social Research in London

**Research Interests**

- Future development of monetary and financial integration in Europe

**Education**

- MA (Oxford)
- Ph.D. (Bristol)

**Other Activities**

- Editor of the Economic Journal since 1976
- Adjunct professor in the National Centre for Research on Europe at the University of Canterbury
- Member of the Maas Group on the introduction of the single currency
- Co-ordinator of the ESRC and COST A7 programs on "The Evolution of Rules for a Single European Market" from 1990 to 1994

**Selected Publications**

Manifold publications in economics and related areas, including over 20 books

- Improving Banking Supervision
- Social Exclusion and European Policy
- Achieving Monetary Union
- Sources of Productivity Growth
- Sharpbenders: The Secrets of Unleashing Corporate Potential

## Gareth D. Myles

**Date of Birth**

January 2, 1961

**Present Positions**

- Professor of economics at the University of Exeter since 1995
- Research fellow at the Institute for Fiscal Studies since 1998

**Professional Experience**
- Lecturer in economics at the University of Warwick from 1987 to 1992
- Senior lecturer in economics at the University of Exeter from 1992 to 1995

**Research Interests**
- Public economics
- Microeconomic theory

**Education**
- BA at the University of Warwick
- MSc at the London School of Economics
- D.phil. at the Nuffield College, Oxford; Dissertation Supervisor: Professor Sir James Mirrlees

**Other Activities**
- Managing editor, Fiscal Studies, since 1998
- Production editor and editorial board, Review of Economic Studies, since 1996
- Associate editor, Journal of Public Economic Theory, since 1999

**Selected Publications**
- Income Distribution, Taxation and the Private Provision of Public Goods. (With J.-I. Itaya, and D. de Meza), in: Journal of Public Economic Theory, 4, 2002: 273–297
- Economic Mismeasurement and the Bias in Policy Choice. In: Journal of Public Economic Theory, 3, 2001: 139–166
- On the Membership of Decision-Making Committees. (With I. G. Bulkley, and B. R. Pearson), in: Public Choice, 106, 2001: 1–22
- Imperfect Competition and the Optimal Combination of Ad Valorem and Specific Taxation. In: International Tax and Public Finance, 3, 1996: 29–44
- Public Economics. Cambridge University Press, 1995

## Heinrich Neisser

**Date of Birth**
March 19, 1936

**Present Positions**
- Professor of political science, Jean Monnet Chair, Leopold-Franzens University of Innsbruck
- Honorary professor, University of Vienna, Institute for Political Science

**Professional Experience**
- Undersecretary of State, Federal Chancellery, from 1969 to 1970
- Member of the Austrian Parliament (first chamber) since 1975
- Minister responsible of Federalism and of the Reform of the Public Administration from 1987 to 1989
- Floor-leader, Austrian People's Party, Austrian Parliament (first chamber) from 1990 to 1994
- Second president of the Austrian Parliament (first chamber) from 1994 to 1999
- Member of the Convention elaborating a Charter of Fundamental Rights of the EU, 1999/2000

**Research Interests**
- The political system of the European Union
- Comparative parliamentary systems
- The role of bureaucracy
- Political reform in the new democracies in Eastern Europe

**Education**
- Studied sociology and economics at the University of Vienna
- Ph.D. (Law School) at the University of Vienna

**Other Activities**
- Chairman of the Kuratorium des Instituts für Höhere Studien (Institute for Advanced Studies – IHS)
- President of the Österreichische Forschungsgemeinschaft (Austrian Research Association)
- President of the Politische Akademie

**Selected Publications**

Author and editor of about 20 books and more than 80 articles in different journals and publications

- Die EG als politisches System. Wien, 1993
- Die Europäische Union. Anspruch und Wirklichkeit. (With B. Verschraegen), Wien, 2001
- The EU and Fundamental Rights. In: G. Bischof, A. Pelinka, and M. Gehler (eds.). Austria in the EU. Contemporary Austrian Studies, Vol. 10, New Brunswick and London, 2002: 12–21
- Auf der Suche nach Europa. In: H. Denz (ed.). Die europäische Seele. Wien, 2002: 241–254
- The Role of National Parlaments in European Integration. In: 32. Jahrbuch der Diplomatischen Akademie Wien, 1996/97: 129–135

## Reinhard Ortner

**Date of Birth**

January 6, 1949

**Present Position**

- Member of the Managing Board of Erste Bank AG since 1984

**Professional Experience**

- Erste österreichische Spar-Casse since 1971
  - Various functions in accounting/controlling from 1973 to 1977
  - Head of Accounting and Control from 1977 to 1984

**Education**

- Studies of social and economic sciences at the University of Vienna (specialization in monetary theory and monetary policy)
- Masters degree in economics

**Other Activities**

- Chairman of the Supervisory Board of
  - Erste Bank Hungary, Budapest
  - Erste & Steiermärkische Bank d.d., Zagreb
  - Slovenska sporiteľňa; Bratislava
  - VPK, Vereinigte Pensionskasse AG, Vienna
- Member of the Supervisory Board of
  - Generali Holding AG, Vienna
  - Oesterreichische Kontrollbank AG, Vienna
  - Česka spořitelna, Praha
- Member of the Board of The Austria Fund, New York

## Richard Portes

**Date of Birth**

December 10, 1941

**Present Positions**

- Professor of economics at London Business School since 1995
- President of the Centre for Economic Policy Research (which he founded in 1983)
- Directeur d'etudes at the Ecole des Hautes Etudes en Sciences Sociales in Paris since 1978

**Professional Experience**

- Assistant professor of economics and international affairs at Princeton University from 1969 to 1972
- Professor of economics at the University of London from 1972 to 1994 (head of Birkbeck College Department of Economics from 1975 to 1977 and from 1980 to 1983)
- Distinguished global visiting professor at the University of California, Berkeley, in 1999/2000

**Research Interests**

- International macroeconomics
- International finance
- European integration

**Education**

- BA, Yale University, 1962
- MA(Oxon.), 1965
- D.Phil., Oxford University, 1969
- D.Sc. h.c., Université Libre de Bruxelles; D.Phil. h.c., London Guildhall University

**Other Activities**

- Fellow of the Econometric Society

- Secretary-general of the Royal Economic Society
- Senior editor and co-chairman of the Board of Economic Policy
- Member of Commission Economique de la Nation (France)
- Member of Group of Economic Advisers to the President of the European Commission

**Selected Publications**

- The Emergence of the Euro as an International Currency. (With H. Rey), In: Economic Policy 26, April 1998: 305–343
- Information and Capital Flows. (With H. Rey and Y. Oh), in: European Economic Review 45, April 2001: 783–796
- Defining Benchmark Status: An Application Using Euro-Area Bonds. (With P. Dunne and M. Moore), CEPR Discussion Paper 3490, NBER Working Paper 9087, 2002
- Making Sense of Globalization: A Guide to the Economic Issues. (Co-author and editor), study commissioned from the Centre for Economic Policy Research by the Group of Policy Advisors to the President of the European Commission, Policy Paper No. 8, CEPR, July 2002
- The euro and the international financial system. CEPR Discussion Paper No. 2955, forthcoming in: M. Buti and A. Sapir (eds.). EMU: Early Challenges and Long-Run Perspectives

## Sinikka Salo

**Date of Birth**

September 30, 1948

**Present Position**

- Member of the Board, Bank of Finland since 2000

**Professional Experience**

- Primary economist, Directorate General Economics, European Central Bank from 1998 to 2000
- Head of Country Analysis, Monetary, Economics and Statistics Department, European Monetary Institute from 1995 to 1998
- Head of Monitoring Division, Monetary Policy Department; senior economist, Financial Markets Department, Bank of Finland from 1990 to 1995
- Associate professor of economics, University of Helsinki; on secondment from the Bank of Finland from 1992 to 1993
- Senior research fellow at The Research Institute of the Finnish Economy (ETLA) from 1974 to 1990

**Research Interests**

- Monetary policy, financial markets, housing markets and finance, household saving/investment, labor markets

**Education**

- Doctor of Political Sciences (economics) at the University of Helsinki in 1990
- Licentiate in Political Sciences (economics) at the University of Helsinki in 1985
- Master of Political Sciences (statistics) at the University of Helsinki in 1974
- Bachelor of Sciences (mathematics) at the University of Helsinki in 1970

**Other Activities**

- Member of the International Relations Committee of the Eurosystem 2000
- Member of the Economic and Financial Committee of the European Union 2000
- President and member of the Board of the Finnish Economic Association from 1993 to 1996

**Selected Publications**

Author of monographs and articles in economic journals and books as well as in economic newspapers

## Anthony M. Santomero

**Date of Birth**

September 29, 1946

**Present Position**

– President of the Federal Reserve Bank of Philadelphia since 2000

**Professional Experience**

– Various academic and managerial positions at the University of Pennsylvania's Wharton School for thirty years

**Research Interests**

– Financial risk management and financial structure
– Financial institutions and markets
– Financial negotiation

**Education**

– AB in economics from Fordham University in 1968
– Ph.D. in economics from Brown University in 1971
– Honorary doctorate from the Stockholm School of Economics in 1992

**Other Activities**

– Chairman of the Mayor's Council of Economic Advisors for the City of Philadelphia
– Chairman of the Economic Advisory Board of the Stockholm Institute for Financial Research
– Member of:
  – Visiting Committee for the School of Business at the University of Delaware
  – Advisory Boards of the Wharton Financial Institutions Center
  – Penn Institute for Economic Research
  – Copenhagen Center for Law Economics and Financial Institutions
  – Italian Bankers Association's European Banking Report
– Consultant for leading financial institutions in the U.S. and abroad

**Selected Publications**

More than 100 articles, books and monographs on financial sector regulation and economic performance

– Financial Markets, Instruments, and Institutions. (With D. Babbel)
– Challenges for Modern Central Banking. (With S. Viotti, and A. Vredin)

## Albrecht Schmidt

**Date of Birth**

March 13, 1938

**Present Position**

– Spokesman for the Board of Managing Directors at Bayerische Hypo- und Vereinsbank AG (before 1998: Bayerische Vereinsbank AG), Munich, since 1990

**Professional Experience**

– Bayerische Vereinsbank AG, Mortgage Department, from 1967 to 1973
– Member of the Board of Managing Directors at Nürnberger Hypothekenbank AG from 1973 to 1979
– Member of the Board of Managing Directors at Bayerische Vereinsbank AG, Munich, from 1979 to 1990

**Education**

– Law studies in Tübingen and Munich (1st and 2nd State Bar Exam, Munich)
– Doctorate in law from the University of Munich (Dr. jur.)
– Dr. oec. h.c. (University of Munich, 2002)

**Other Activities**

– Major Supervisory Board Mandates
  – Bank Austria Creditanstalt Aktiengesellschaft, Vienna (Chairman)
  – Münchener Rückversicherungs-Gesellschaft AG, Munich
  – Siemens Aktiengesellschaft
  – HVB Real Estat Bank AG (Chairman)
– Selected Mandates
  – Max-Planck-Gesellschaft München (Member of Senate)
  – Ludwig-Maximilians-Universität München (Member of University Council)

**Selected Publications**

Various publications on financial and economic matters

## Wolfgang Schüssel

**Date of Birth**

June 7, 1945

**Present Position**

– Federal Chancellor since February 4, 2000

**Professional Experience**

– Secretary of the Parliamentary Caucus of the Austrian Peoples Party (ÖVP) from 1968 to 1975
– Secretary general of the Austrian Business Federation, one of the three branches of the Austrian People's Party from 1975 to 1991
– Minister for Economic Affairs in the Austrian Federal Government (coalition government formed by the Social Democratic Party of Austria and the Austrian People's Party) from 1989 to 1995
– Minister for Foreign Affairs and Vice-Chancellor with the fourth and the fifth Federal Government Cabinet formed by Chancellor Franz Vranitzky and with the first Government Cabinet of Chancellor Viktor Klima) from 1995 to 2000

**Education**

– Law Studies at the University of Vienna (Dr. jur.)

**Other Activities**

– Elected chairman of the Austrian People's Party at the 30th Party Congress in 1995
– President Julius Raab Foundation

**Selected Publications**

– Mehr Privat – weniger Staat. (With J. Hawlik), 1983
– Staat laß nach. (With J. Hawlik), 1985
– Ideen die geh'n. Mitarbeiterbeteiligung. 1985
– Das rot-weiß-rote Weltkugelbuch. (With A. Komarek), 1998
– Im Namen der Zukunft. 1999

## Gerhard Schwödiauer

**Date of Birth**

May 12, 1943

**Present Position**

– Professor of economics at the Otto von Guericke University of Magdeburg, Germany, since 1993

**Professional Experience**

– Post-graduate fellowship and assistantship at the Institute for Advanced Studies in Vienna from 1966 to 1970
– Research associate at New York University (with Oskar Morgenstern) during 1971
– Managing editor of the then founded International Journal of Game Theory from 1971 to 1979
– Director of the Institute for Advanced Studies in Vienna from 1973 to 1979
– Appointed to a Chair in Economics at the University of Bielefeld, Germany, in 1979
– Member of the Graduate Center in Mathematical Economics
– Several visiting professorships at New York University and the University of Siena, Italy

**Research Interests**

– Game theory
– General equilibrium theory
– Strategic interaction of monetary and fiscal policy, population economics
– Transition economics

**Education**

– Graduated from the Vienna Business School in 1965
– Doctor's degree in economics from the University of Vienna in 1970

**Other Activities**

– Scientific coordinator of the newly established German-Russian Center of Economics in Moscow

**Selected Publications**

– Über die zeitliche Nutzung der Natur. (With B. Frey), in: Schmollers Jahrbuch 91, 1971

- Competition and Collusion in Bilateral Markets. (With O. Morgenstern), in: Zeitschrift für Nationalökonomie 36, 1976
- Economics and the Theory of Games: A Survey. (With A. Schotter), in: Journal of Economic Literature 18, 1980
- The Impact of Taxation on the Distribution of Wealth in an Economy with Changing Population. (With A. Wenig), in: Journal of Population Economics 3, 1990
- Restructuring Ukrainean Enterprises After Privatization: Does Ownership Matter? (With I. Akimova), in: Atlantic Economic Journal 28, 2000

## Hans-Werner Sinn

**Date of Birth**

March 7, 1948

**Present Positions**

- President of Ifo Institute for Economic Research since 1999
- CEO of CESifo Inc. since 1999
- Professor of Economics and Public Finance, University of Munich since 1984
- Director of CES – Center for Economic Studies, University of Munich since 1991

**Professional Experience**

- Associate/Full Professor, Department of Economics, University of Western Ontario, Canada from 1978 to 1979, and from 1984 to 1985
- Associate Professor (C2), University of Mannheim in 1983
- Lecturer/Senior Lecturer, Department of Economics and Statistics, University of Mannheim from 1974 to 1983
- Lecturer, Institute of Public Economics, University of Münster from 1972 to 1974

**Research Interests**

- Fiscal policies
- Taxation and resource allocation
- Systems Competition

**Education**

- Habilitation and venia legendi in economics at the University of Mannheim in 1983
- Dr.rer.pol. at the University of Mannheim in 1978
- Diplom Volkswirt at the University of Münster in 1972

**Other Activities**

- Supervisory Board, HVB Group since January 2000
- Vice president of the International Institute of Public Finance since 2000
- Chairman of the Verein für Socialpolitik (German Economic Association) from 1997 to 2000
- Scientific Advisory Council of the Institute for Advanced Studies, Vienna since 2002
- European Economic Advisory Group at CESifo since 2001
- Northrhine-Westfalian Academy of Sciences since 2001

**Selected Publications**

13 books with 22 editions in 6 languages (without edited books) and more than 180 published articles. More than 60 articles have appeared in refereed scientific journals

- The New Systems Competition. Yrjö Jahnsson Lectures, Basil Blackwell, Oxford, forthcoming 2002
- Jumpstart. The Economic Unification of Germany. (With G. Sinn), MIT Press: Cambridge, Mass. etc. 1992. (Second English edition 1993; German editions: Kaltstart, Mohr, Tübingen 1991, 1992, and DTV, Munich, 1993; Korean, French and Russian editions 1994)
- Capital Income Taxation and Resource Allocation. North Holland, Amsterdam etc. 1987. (German edition: Kapitaleinkommensbesteuerung, Mohr, Tübingen 1985)
- Economic Decisions under Uncertainty. North Holland, Amsterdam etc. 1983. (German edition: Ökono-

mische Entscheidungen bei Ungewißheit, Mohr, Tübingen 1980, second English edition: Physica, Heidelberg 1989)

## Jean-Claude Trichet

**Date of Birth**

December 20, 1942

**Present Positions**

- Governor of the Banque de France since 1993
- Member of the Governing Council of the European Central Bank
- Alternate governor for the International Monetary Fund
- Member of the Board of the Bank for International Settlements

**Professional Experience**

- Various posts at the Ministry of Finance in the General Inspectorate of Finance and later in the Treasury Department
- Secretary General of the Interministerial Committee for Improving Industrial Structures in 1976
- Adviser to the cabinet of the Minister for Economic Affairs (René Monory) in 1978
- Adviser to the President of the Republic (Valery-Giscard d'Estaing) in 1978
- Deputy head of Bilateral Affairs at the Treasury Department from 1981 to 1984
- Head of International Affairs at the Treasury Department
- Chairman of the Paris Club (sovereign debt rescheduling) from 1985 to 1993
- Head of the Treasury Department in 1987
- Censor of the General Council of the Banque de France and deputy governor of the IMF and the World Bank
- Chairman of the European Monetary Committee from 1992 to 1993
- Member of the board of the European Monetary Institute from 1994 to 1998

**Education**

- Ingénieur Civil des Mines
- Master's in economics at the Institut d'Études Politiques de Paris
- École Nationale d'Administration in 1969

**Other Activities**

- Chairman of the Monetary Policy Council of the Banque de France since 1994
- Member of the Governing Council of the European Central Bank since 1998

**Selected Publications**

Author of numerous publications and articles in the areas of monetary policy and economics

## Gertrude Tumpel-Gugerell

**Date of Birth**

November 11, 1952

**Present Positions**

- Vice governor of the Oesterreichische Nationalbank since September 1998
- Chief executive director of the Economics and Financial Markets Department since 1997

**Professional Experience**

- Economics Department of the Oesterreichische Nationalbank from 1975 to 1980
- Financial Analysis and Policy Training Program of the International Monetary Fund in 1980
- Economic policy advisor to the Minister of Finance from 1981 to 1984
- Member of the Supervisory Board of Österreichische Länderbank AG from 1981 to 1984
- Deputy head of the Economics Division of the Oesterreichische Nationalbank from 1985 to 1986
- Comptroller general at the Oesterreichische Nationalbank from 1986 to 1992
- Director of the Area Corporate Planning and Management at the Oesterreichische Nationalbank from 1992 to 1997

**Research Interests**

- Financial supervision
- Monetary economics

**Education**
- Graduated with honors from the University of Vienna with a master's degree in economics and social sciences
- Doctorate of economics and social sciences in 1981

**Other Activities**
- Member of the Council for the Foundation of Fachhochschulen (specialized institutions of higher education) in Austria
- Member of the International Relations Committee and the Banking Supervision Committee of the ECB
- Member of the Economic and Financial Committee
- Chair of the Banking Advisory Committee

**Selected Publications**
Author of numerous publications and articles in the areas of monetary policy and economics
- Completing Transition: The Main Challenges. (Edited with L. Wolfe, and P. Mooslechner), Berlin/Heidelberg, 2001

## Axel A. Weber

**Date of Birth**
March 8, 1957

**Present Positions**
- Professor for International Economics at the University of Cologne
- Member of the German Council of Economic Experts
- Member of the Research Advisory Board of the Deutsche Bundesbank

**Professional Experience**
- Director of the Center for Financial Studies in Frankfurt/Main from 1998 to 2002
- Professor for Monetary Economics at the Frankfurt's Johann Wolfgang Goethe University from 1998 to 2002
- Professor for Economic Theory at the University of Bonn from 1994 to 1998

**Research Interests**
- International finance
- Monetary economics
- Central banking

**Education**
- Diploma in economics (Diplom Volkswirt) from the University of Konstanz, Germany
- Doctorate in economics from the University of Siegen
- University teaching qualification (Habilitation) from the University of Siegen in 1994

**Other Activities**
- Research fellow of the Centre for Economic Policy Research in London
- Council member of the Société Universitaire Européenne de Recherches Financiéres
- Member of the Geldtheoretischer Ausschuss of the Verein für Socialpolitik
- Referee for substantial economic journals

**Selected Publications**
- Reputation and Credibility in the European Monetary System. In: Economic Policy 12, 1991
- The Role of Policymakers' Reputation in the EMS Disinflations: An Empirical Evaluation. In: European Economic Review 36, 1992
- Long Run Neutrality and the Lucas-Critique: Empirical Evidence for the United States and Europe. In: Carnegie Rochester Conference Series on Public Policy 41, 1994
- Germany Before and After Unification: The Determinants of Business Cycles and Long-Term Growth. In: Economic Modelling 13, 1996
- Sources of Purchasing Power Disparity Between the G3-Economies. In: Journal of Japanese and International Economics

## Arnout H.E.M. Wellink

**Date of Birth**

August 27, 1943

**Present Positions**

- President of De Nederlandsche Bank N.V. since July 1, 1997
- Executive director of De Nederlandsche Bank N.V. since January 1, 1982

**Professional Experience**

- Leyden University (teaching assistant and staff member, teaching economics; from 1965 to 1970)
- Ministry of Finance
  - Staff member from 1970 to 1975
  - Head of Directorate General for Financial and Economic Policy from 1975 to 1977
  - Treasurer general from 1977 to 1981

**Education**

- Studied Dutch law at Leyden University
- Ph.D. in Economics from the University of Rotterdam in 1975

**Other Activities**

- Chairman Board of Directors of the Bank for International Settlements, Basle
- President Bank for International Settlements, Basle
- Member Group of Ten Governors, Basle
- Governor International Monetary Fund, Washington
- Member Governing Council and General Council of the European Central Bank, Frankfurt

**Selected Publications**

Author of numerous publications and articles in the areas of monetary policy and economics

## Stefan K. Zapotocky

**Date of Birth**

December 3, 1952

**Present Position**

- Member of the Executive Board of Wiener Börse AG, Joint CEO, since 2000

**Professional Experience**

- Erste Österreichische Spar-Casse-Bank
  - Assistant to the Head of Personnel from 1976 to 1980
  - Head of Strategic Planning from 1980 to 1985
  - Head of the New Issues Department from 1985 to 1988
- Securities Division/New Issues at Österreichische Länderbank AG as of 1988
- Managing director of LB-Capital Markets as of 1989
- Senior general manager and head of the Securities Division and Asset Management Division at Bank Austria Aktiengesellschaft as of 1991

**Research Interests**

- Stock exchanges, Austrian capital market

**Education**

- Awarded degree in engineering (mathematics for economics and planning) from the Vienna Technical University in 1975
- Awarded doctorate in 1981

**Former Activities**

- Chairman of the Supervisory Board: Capital Invest, and Asset Management Gesellschaft
- Member of the Managing Board: Notar & Treuhandbank, and Bank Austria Kunstforum
- Member of the Supervisory Board: Immotrust Anlagen Aktiengesellschaft, Ringturm Kapitalanlagegesellschaft m.b.H., BA-Industrieholding Gesellschaft m.b.H., and Union Versicherungs-AG
- Lecturer at the Vienna University of Management and Business Administration

**Selected Publications**

- Portfolio Management. In: Bankarchiv, 63, 1987
- Aktienemission. In: Bankarchiv, 65, 1988

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