Erkki Liikanen: Comment to Prof Gérard Roland: After enlargement - institutional achievements and prospects in the new member states

Comment by Mr Erkki Liikanen, Governor of the Bank of Finland, to Prof Gérard Roland: After enlargement - institutional achievements and prospects in the new member states, at the Central Banking Conference, Frankfurt, 21 October 2004.

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1. Introductory remarks

Professor Roland's paper raises some essential issues regarding institutional development of the new member states and prospects as to how enlarged European Union will work. The paper looks at various institutional indicators compiled by ERBD and the World Bank. By the use of these indicators, the paper aims at answering the following specific questions i) Have new member states achieved their institutional transition in a stable and satisfactory way, ii) Has EU played a positive role in this process, iii) Is there anything that EU can learn for its needed structural reforms in labor markets, pension and welfare reform and iv) How will EU work with 25 members.

2. Summing up the main results of the paper

The paper provides some tentative answers regarding the first two questions. It argues that institutional problems in the future are not going to be essentially worse than those facing existing EU-member countries. Furthermore, the paper argues that EU has been playing "fundamentally positive role in anchoring the institutions of the new member states to sound market system". As a general message, the paper suggests that fundamental market institutions and the basics of market institutions are well established and solid.

The last two questions get understandably less attention in the paper, given the wide scope of the paper.

First I want to comment two questions;

1. Hypothesis on external anchor and enforcement powers vis a vis the governments of Member states
2. Stable and satisfactory institutional transition

3. External anchor and enforcement powers

Regarding the first point, Prof. Roland argues that prospects on EU membership has enforced an institutional reform, but that once inside, incentives to fulfil future reforms will be weaker. The paper builds analogy to weak implementation of the Stability and Growth Pact (SGP) and argues that EU does not have appropriate (very strong) enforcement powers.

While to some extent it is rather easy to agree with this point, one may also recognize that SGP - similarly to Maastricht criteria - has improved fiscal prudence within the EU markedly over the last decade. And this in spite of all the difficulties.

On the other hand the SPG is still a relatively new instrument. The Commission has even stronger powers in the field of the internal market and competition policy. And there is a long tradition and case law. By these tools the commission has accelerated the liberalisation in member states, controlled the state aids and promoted competition. I am sure the commission will not hesitate to use these competencies in the new member states.

And there are two more incentives:

Most of the new member countries are working towards joining the European Monetary Union (EMU). Maastricht criteria and associated institutional reforms required will certainly foster future reforms, and not just those required in Maastricht criteria explicitly. For instance, some studies show that structural reforms in the labour markets may be associated with implementation of new monetary regimes, such as inflation targeting.

And secondly there is and will be a lot of healthy competition between new member states about new foreign investments. A successful reform process will be an asset in this field.

4. Stable and satisfactory institutional transition

Regarding institutional transition, we need to define “stable” or “satisfactory” institutional transition.

The paper seems to take a view according to which “stable” institutional transition means a process that has evolved progressively without major disruptions or reversals. By looking how the number of interesting indicators that the paper has compiled has evolved, this indeed seems to be the case: most of the institutional indicators show a steady pattern of improvement. Yet, as can be observed from the same indicators, there are also rather large differences between the countries.

One may also want to assess stability and satisfaction of institutional transition by analyzing its consequences on economic, political and societal development.

One may use indicators such as fluctuations in inflation, public sector deficit, interest rates, exchange rates, different measures of political stability, number of strikes, etc to measure stability from this point of view.

Looking some important macro indicators to convergence, the economic stability has improved as regards to inflation. As an average in the new member countries, the harmonized index of inflation declined from close to 10 % in early 1997 to around 2 % in mid-2002, where it remained until early 2004.

On the contrary, progress with fiscal consolidation has generally been too slow and majority of countries have yet to achieve a situation which, in broader view, might be judged as sustainable in the medium term.

One may also assess the satisfactory element of an institutional transition by looking at some more indirect measures. For instance, extent to which there has been reversal or drastic changes in inflow of foreign direct investments gives rather good indication as to how foreign investors judge the institutional transition. There are indeed rather large changes as regards inflow of foreign direct investments in many of the new member countries.

In many countries high foreign direct investments have supported high output and investment growth rates. However, maintaining a steady inflow of FDIs will constitute a major challenge in the future because FDI inflows have tended to decrease in many new member states partly linked to reduced privatisation activity. The decrease in FDI inflows have accompanied by a net outflow of portfolio investments, with loans and trade credits becoming the main source of financing of the current accounts.

All in all institutions has developed to right direction during the last decade and as paper argues, they are mostly compatible with market driven economy. Of course, institutions as such are not important but they provide necessary conditions for creating environment for future growth and prosperity. But reforms are needed, in particularly as regards to corruption and legal system.

Professor Roland also raises a question: What can we learn from reforms in labour markets, pension and welfare reform? Not much, is his conclusion.

I would like to put the question differently: What will the impact of the new member states on the regulatory development in the EU of 25?

I think that the new member states will be very sensitive with new regulation which will add costs on European. They compete directly with Asian countries about FDI’s. They don’t want to weaken there position. There will be less new regulation.

5. How will EU work with 25?

Let me finally, turn to the most important and topical issues on How will EU work with 25?

I agree with Professor Roland that the new member states will be active and enthusiastic members. They have not come to use a veto. And the larger is the Union, the more difficult it is to prevent a decision by one veto.

I would like to discuss also on growth and productivity prospects of European economies during the years to come. As already argued, for Europe to work as a stable political entity, and build room for enlarged EMU it is necessary to close the income gap between the new and the old member countries. Probably the best way to achieve this is to facilitate competition and thus enhance productivity growth in all the sectors of the economies.

The rationale for, and success of, the single market is that it reinforces a principle of market economy of the European economies. The market economy is reinforced by subjecting otherwise closed sectors to greater competition and by the prospect of wide range of cross-border exchanges of goods and know how. In doing so, it improves resource allocation and provides both dynamic and static efficiency gains that, in turn, offer the promise of improved economic performance.

As for the new member states, many of above mentioned positive features have already been felt as can be seen from faster economic growth and productivity in all of the new member countries.

The new member countries will in the future benefit also from greater markets for their products [and thus scale economies], while the old member countries are facing stiffer competition in many industrial sectors. Stiffer competition is likely to enhance productivity in Europe as a whole.

Large part of the productivity growth in the new member countries has been associated with inflows of foreign direct investments as well as restructuring of the domestic companies.

In this process, large internationally operating companies have been playing an important role by importing capital, but also by transferring business management skills and know how and thus decreasing the knowledge gap to rest of the Europe. Indeed, a large proportion of trade is intra-industry and intra-company trade where a significant proportion of global trade runs through international production and distribution networks.

Increases in intra-industry and intra-company trade reflects the motives of large companies for diversifying their supply chain and deepening economies of scope in the world market, rather than just reflecting the differences in costs of inputs at different locations. Moreover, due to stiffer competition and complexity of the products, companies concentrate on their core competencies.

This has a tendency to reinforce the development of a more concentrated, but spatially diverse economy. In the short run, there can be significant employment losses and unbalanced regional development, yet in the medium term European economies will be more efficient. Nevertheless, spatial agglomeration across territorial boundaries is a real challenge for Europe, as there is a need to find a right balance between strengthening the European most productive areas and their competitiveness globally, yet to develop policies that minimize a risk of excessive regional diversification. Policies that enhance exchange of know-how across borders are of crucial importance to minimize such a risk.

Especially for small new member countries, key to success is to be attractive and adaptive. In the medium term, this requires further strengthening of those business areas with comparative advantage and aiming at attracting foreign direct investment to those areas. This requires also continuing with institutional and legal reforms that strengthen ownership rights, reduce corruption and provide with favourable business environment in general. Otherwise, there is a risk that some countries lock-in to low-wage/low productivity production. This would lead into rapidly widening income differences between the EU countries.

In the longer term, know how, business management skills, and capital imported through FDI need to be “rooted” in the societies such as to build up domestic capacity and ability for further increases in productivity. As static comparative advantages based on lower labour costs has been deployed, the new member countries need to base longer term industrial strategy on dynamic comparative advantage and policies that enhance productivity through innovative activities of the firms. Once more, competition combined with appropriate renewal of institutions would be essential.