

Deutsch-Französisches Wirtschaftspolitisches Forum

**Working Paper**

## Financial Supervision and Policy Coordination in The EMU

ZEI Working Paper, No. B 07-2000

**Provided in Cooperation with:**

ZEI - Center for European Integration Studies, University of Bonn

*Suggested Citation:* Deutsch-Französisches Wirtschaftspolitisches Forum (2000) : Financial Supervision and Policy Coordination in The EMU, ZEI Working Paper, No. B 07-2000, Rheinische Friedrich-Wilhelms-Universität Bonn, Zentrum für Europäische Integrationsforschung (ZEI), Bonn

This Version is available at:

<https://hdl.handle.net/10419/39627>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

Zentrum für Europäische Integrationsforschung  
Center for European Integration Studies  
Rheinische Friedrich-Wilhelms-Universität Bonn



Deutsch-Französisches Wirtschaftspoliti-  
sches Forum-Forum Economique Franco-  
Allemand

**Financial Supervision and  
Policy Coordination in The  
EMU**

**Working Paper**

**B 07  
2000**

## Contents

1. Forum Economique Franco-Allemand / Deutsch-Französisches Wirtschaftspolitisches Forum .....	1
2. The First Year of EMU .....	3
3. Economic Growth in Europe: Entering a New Era? .....	17
4. Sixth French-German Economic Forum Summary of the Proceedings .....	45

# **Forum Economique Franco-Allemand**

## **Deutsch-Französisches Wirtschaftspolitisches Forum**

Together with other members of the European Union, France and Germany embarked on an unprecedented cooperative venture. To be successful, Economic and Monetary Union requires a very high degree of mutual understanding among the policymakers of the participating countries. It also requires upgrading the dialogue between those who contribute to shaping the policy debates on both sides of the Rhine.

France and Germany have a long tradition of high-level dialogue and cooperation in the framework of bilateral and European institutions. But the dialogue between their civil societies does not match this spirit of cooperation. Economists and those involved in practical economic policy making from both countries in particular rarely talk to each other to find out why they may have differing visions of the functioning of Economic and Monetary Union and of the associated challenges, and even more rarely try to narrow the divergence of their views. This lack of dialogue contributes to keeping alive entrenched prejudices on the one on the other country's supposedly hidden policy agenda.

Yet, an Economic and Monetary Union in which policy debates with a bearing on European policy choices remain confined within national boundaries would be prone to instability, because disagreements about policies would tend to end up in dispute between countries. It is, therefore, of utmost importance to foster the emergence of a genuine *European* professional discussion on major economic policy issues.

The purpose of the *Deutsch-Französisches Wirtschaftspolitische Forum/Forum économique franco-allemand* is to contribute to this discussion through the organisation of a series of informal meetings between French and German economists.

The Forum assembles professional economists from academia, business and the public sector. As a non-partisan institution, the Forum brings together participants from all strands of thinking about economic policy with the aim of stimulating fruitful debate. Each meeting is devoted to one or two major policy issues. The Forum commissions papers to provide an informed basis for the discussion, but the focus will be on debate and the exchange of views, starting with reactions from discussants whose role will be to present alternative views and to frame the key issues for the debate.

The proceedings of each meeting are published in working paper format. With the present brochure, we present papers of the discussion from the Forum's sixth meeting on January 17-18, 2000. We hope that this will be a useful input into an emerging public debate on Europe's economic policies in our two countries and beyond.

Jürgen von Hagen

Jean Pisani-Ferry

# The First Year of EMU

Jürgen von Hagen  
Center for European Integration Studies, University of Bonn  
Indiana University, and CEPR

## I. Introduction

European politicians and financial market players hailed the start of the European Monetary Union (EMU) on 1 January 1999 with much applause for a prospective challenger of the US dollar in the international financial markets for the new European Central Bank (ECB), the guardian of a strong European macroeconomic performance based on price stability. At the end of the first year, we can look back and see what changes EMU has brought, which promises have been fulfilled, and what the future might hold.

A first point in our assessment regards the changeover procedure to the euro. The smooth changeover confirmed the soundness of the approach which was based on two important elements: The early announcement of the bilateral conversion rates among the participating currencies, and the maintenance of the wide exchange rate band, or the absence of any announced intervention requirement for the central banks prior to December 31. It will remain of relevance as a precedent for future entries of further member countries into the EMU, particularly of countries whose economies are large.

The second point we consider is the performance of the euro's exchange rate during the year. As it turns out, the euro has been much weaker than expected against the dollar. There remains a long way to go before it will be a real challenge to the US currency.

A third point is the initial performance of EMU money markets and credit markets. Initial money market developments have been smooth, too, although the ECB's operations can be improved. Euro-denominated bond issues have been booming. There is some evidence that government bond rates in the euro area incorporate premiums on fiscal vulnerability and liquidity. The latter indicates that national markets are not fully integrated.

The final point considered is the monetary policy strategy of the ECB, which determines the course of monetary policy in the EMU and its interpretation by the markets. In contrast, the ECB scores rather badly on the latter issue. Monetary policy decisions taken by the ECB Council have not been consistent with the monetary policy strategy announced by the Council

in October 1998. As a result, transparency of monetary policy is low and observers are left puzzled by the central banks' intentions and assessments of the monetary conditions in the EMU. Two explanations can be offered for this unsatisfactory performance. One, that the ESCB, despite its announcements and notwithstanding its legal mandate, aims at an activist, short-run oriented approach to monetary policy. In this explanation, the ESCB seeks to keep transparency low as a way to minimize accountability. Two, that the ESCB has been unable to develop a consistent view of monetary policy internally and that the Council is split between advocates of a more expansionary policy, responding to the demands of the more sluggish economies (Italy and Germany), and advocates of a more stability-oriented policy who focus the aggregate EMU economy. Obviously, neither explanation gives much reason to be unconcerned: The first implies that the ESCB's commitment to price stability is less than what Europeans have hoped for in the creation of the monetary union; the second warns that internal dissent will keep the ESCB from formulating a consistent and adequate monetary policy for the union.

We conclude our assessment with a reflection on the longer-term macro economic consequences of EMU.

## **II The Changeover to the euro: Review and Implications**

The changeover to the euro as a currency in its own right was subject to a number of stipulations from the Maastricht Treaty and subsequent European Council decisions that complicated the process. First, conversion rates between the constituent currencies and the euro could only be chosen on 31 December 1998; second, the external value of the ECU could not change due to the conversion; third, the ECU had to be converted to the euro at a rate of one for one. These three rules, together with the fact that some currencies contained in the ECU were not included in the euro, implied that the conversion rates of the EMU member states' currencies had to be based on the market exchange rates of the last trading day before the start of EMU. As a result, there was a considerable potential for uncertainty about the conversion rates until 31 December 1998.<sup>1</sup>

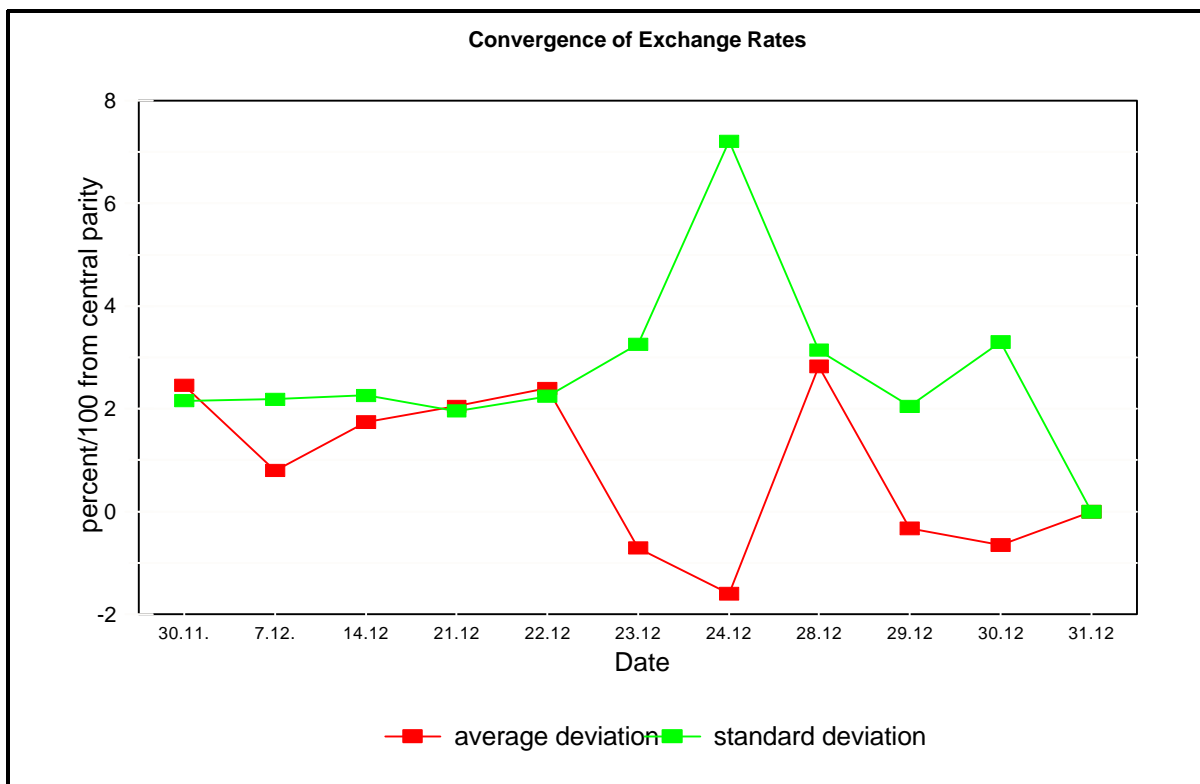
The conversion procedure adopted by the governments of the EMU member states aimed at reducing this uncertainty to the largest possible degree.<sup>2</sup> It rested on two elements: First, the

---

<sup>1</sup>For a detailed discussion of the difficulties implied by these rules see Jürgen von Hagen, Francesco Giavazzi, Charles Wyplosz, and David Begg, *EMU: Getting the End-Game Right*. London: CEPR 1997.

<sup>2</sup>The procedure was first proposed by von Hagen et al. (1997).

pre-announcement of the *bilateral* conversion rates between the EMU member currencies long before the start of EMU served to anchor bilateral exchange rate expectations the event and to exclude any last-minute political haggling over national advantages and disadvantages in setting the conversion rates. Advance agreement on the bilateral conversion rates was facilitated by the happy circumstance that the bilateral central parities prevailing in the ERM were consistent with reasonable estimates of the bilateral equilibrium real exchange rates, witness the absence of any serious relative price distortions on the basis of these parities. This also contributed to the credibility of the announcement.



**Figure 1**

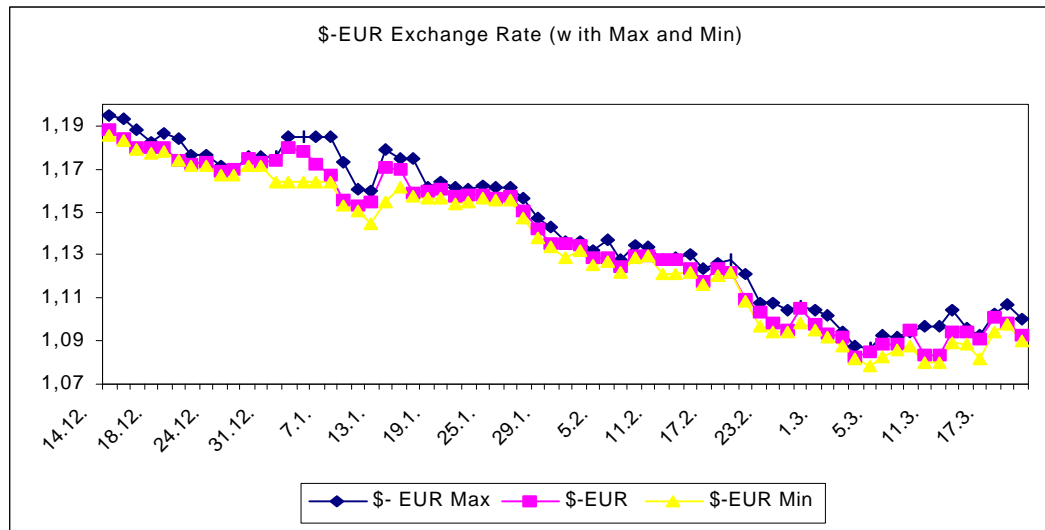
Second, the absence of any attempts to narrow the existing exchange rate bands around these central parities or to commit the central banks to large-scale interventions in the run-up to EMU. Narrowing these bands might have invited speculative attacks on the announced conversion rates, as the obligation for central banks to intervene offers one-sided bets to speculators. This might have created unnecessary and damaging exchange rate variability in the very last period before exchange rates were to be fixed forever.

Figure 1 gives an impression of the convergence process to the start of EMU. Specifically, it shows the average standard deviation of daily spot DM exchange rates of the 10 non-DM currencies in the EMU from their central parities to the DM in the ERM. The weights are



based on relative population size of the member states. The average deviation was close to 0.02 percent at the beginning of December and practically zero in the last trading days. The standard deviation hovered around 0.02 percent throughout the month, with a short blip on December 24. The figure clearly demonstrates that markets anticipated the use of the central parities as conversion rates.

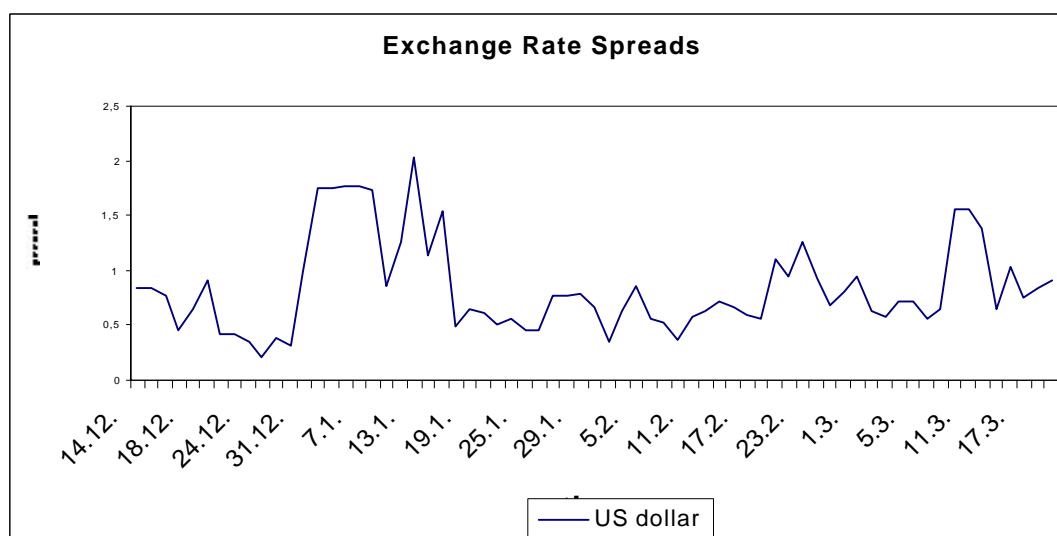
Figure 2 documents the smooth changeover in terms of the dollar exchange rate. Here, we



**Figure 2**

plot the mid-point closing rate of the day together with the highest and lowest rates during the last two weeks prior to EMU and the first 100 days. While the mid-point closing rate reflects average market conditions, the spread between the minimum and maximum rates reflects the range of perceptions market participants hold about the future course of the exchange rate and gives an indication of market uncertainty. Figure 2 indicates that the introduction of the euro came in a period when the dollar was already strengthening against European currencies. The immediate introduction interrupted this trend for a short period, but resumed in the second week of January. Another blip upwards occurred around the resignation of German Finance Minister Lafontaine on 12 March, but the trend resumed soon afterwards.

Figure 3 plots the percentage difference between the largest and the smallest exchange rate quotation in the dollar market each day. This spread can be taken as an indication of market uncertainty about the new currency. The figure shows that both spreads increased strongly upon the introduction of the euro and stayed high and volatile during the first few trading days. Over time, however, the spread came down to levels prevailing before January 1. This is true particularly for the US dollar. This indicates that market uncertainty receded fairly quickly after the start of EMU.



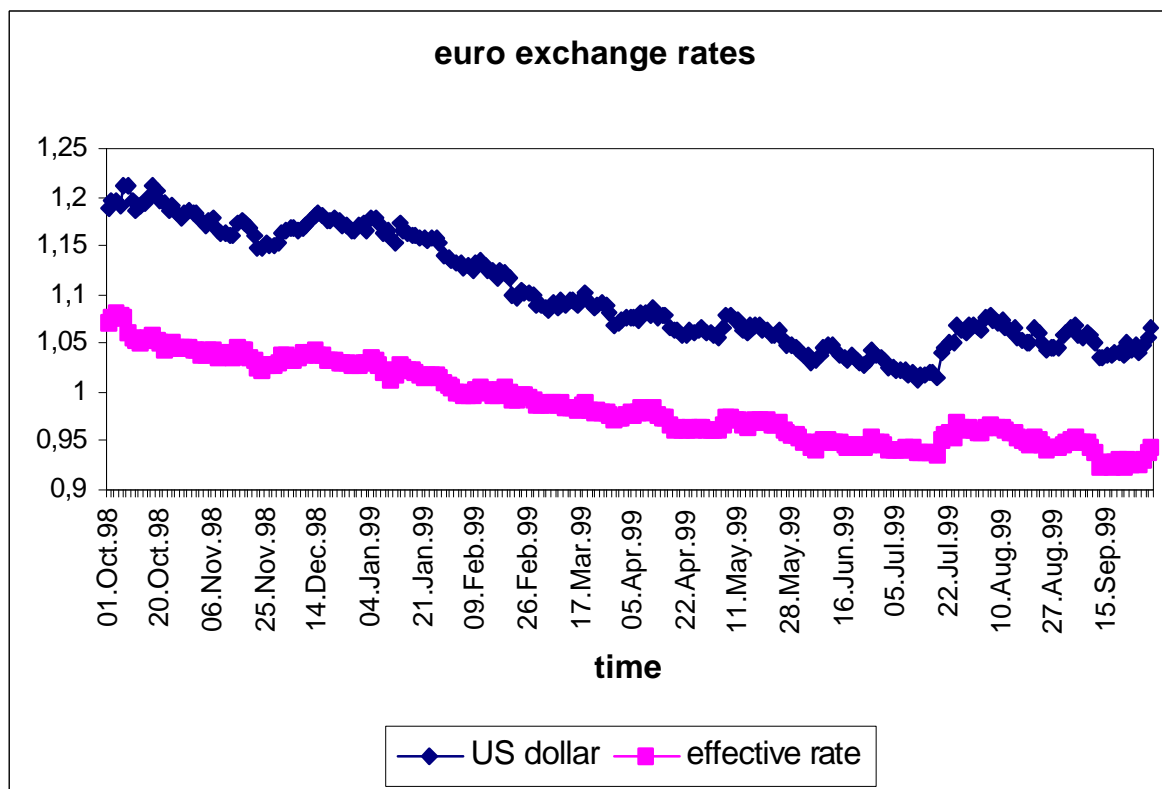
**Figure 3**

Overall, the data support the adequacy of the conversion procedure chosen by the member governments. The policy implication is that similar procedures should be used to usher in future members of the EMU. Then again, the important elements will be to pre-announce credible entry rates and to refrain from any compulsory exchange rate interventions. The new EMS certainly provides the basis for such an approach. A more delicate issue is how to handle the British entry into EMU, given the firm commitment of the British government not to join the ERM. Does this make a smooth entry of the pound more difficult? The experience that one can draw from the start of the EMU suggests that the answer is no. What matters for the British entry is the pre-announcement of a credible conversion rate significantly ahead (say 18 months) of the entry date. Such an announcement can be made unilaterally. Its credibility must be based on economic reasoning and a firm political commitment, which might be created if the announcement were delivered in the context of a Council decision. In addition, there should be no obligation neither for the Bank of England nor for the ECB to intervene in support of the pound nor the euro. Such an agreement would fit the British antipathy for fixed exchange rates, anyway.

### **III The Euro: A Strong International Currency?**

The high hopes of some European politicians and financial market players, that the euro would immediately challenge the dollar's position as the leading international currency, have not materialized during this year. Instead, the political uncertainties fueled by the Yugoslav crisis, the fall of the European Commission, and the weakness of the new German

government seem to have affirmed the dollars position. In a more long-term perspective, the dollar-euro rate is now slightly lower than its equivalent (the dollar-ECU rate) between late



**Figure 4**

1997 and mid-1998. From this point of view, the weakening of the dollar in the months prior to the start of EMU may have reflected euro-optimism more than the economic fundamentals, to which the market has now returned, most importantly, the weak performance of the EMU economies and the resistance of their governments against long-needed economic reforms.

Figure 4 shows the developments of the dollar-euro rate and the effective (trade weighted) exchange rate of the euro since the last quarter of 1998. Comparing the dollar with the effective exchange rate demonstrates that the euro's weakness is not simply a dollar-phenomenon. Both rates show continuous decline over this period. As indicated above, this decline was stopped temporarily at the start of EMU. Both rates reached their lows in end-July, when the ECB made visible efforts to "talk to the euro up." But the picture shows that this, like the start of EMU, could only bring about a shift upwards of the trend line, without really changing the slope.

Several reasons can be found for the continued weakness of the euro. One is plain fundamentals. The US economy continues to grow rapidly and with no strong indications of inflationary pressures. In contrast, the larger EMU economies, while coming out of the

recession, do not promise to reach growth rates much higher than 2.5 percent in 2000. As the US remains attractive for European investors, much of the credit expansion during 1999 has been used to purchase assets outside the EMU. Another factor, discussed in more detail below, is the strong activity in the growing euro bond market. With a large volume of new issues predominantly of corporate bonds during 1999, the supply of euro-denominated securities has increased rapidly, keeping the euro's exchange rate low.<sup>3</sup>

During the course of this year, the European Central Bank has not shown itself to be worried about the euro's exchange rate. Despite public criticism about the weakening of the new currency, the ECB was ready to lower interest rates in the Spring, a move that could only contribute to the euro's weakening. As indicated above, ECB Council members were heard talking about exchange rates in the Summer, but the Bank did not seem to be ready to put action behind these talks. The picture that is emerging is that the ECB, like the Fed, will not put much emphasis on the exchange rate in the formulation and implementation of its monetary policy. This picture is, of course, consistent with the fact that external trade with non-EMU countries is only about 20 percent of EMU GDP, which makes EMU comparable with the US. In the longer run, such a policy orientation would imply a higher volatility of the euro's exchange rate compared to the volatility of its constituent currencies in the past.

It is interesting to note at this point that daily observations from January through end-September 1999 are consistent with the hypothesis that the dollar-euro rate behaves as a random walk, i.e., the daily percentage changes are uncorrelated. This is consistent with the notion that the euro-dollar foreign exchange market is an efficient market and that today's exchange rate is the best predictor of tomorrow's rate.<sup>4</sup> These are well-known properties of exchange markets. Finding them here suggests that the introduction of the new currency did not create any special information inefficiencies or unusual arbitrage opportunities.<sup>5</sup>

Furthermore, many foreign exchange markets exhibit conditional heteroskedasticity, i.e., clustering of periods of high and periods of low volatility. Empirically, this has been tested and estimated by showing that squared relative changes in exchange rates are auto-correlated. Daily data of the dollar-euro rate do not show that property in 1999, although the rates of all

---

<sup>3</sup>See Robert McCauley, "The euro and the dollar - 1999," *Open Economies Review* 10, 1999

<sup>4</sup>A similar result holds for the euro-pound market.

<sup>5</sup>Interestingly, however, the euro-dollar exchange rate does not so far exhibit conditional heteroskedasticity, which is otherwise typical for foreign exchange markets. Conditional heteroskedasticity, or fat-tailness, means that large exchange rate surprises tend to cluster over time.

constituent currencies did before 1999.

Another interesting observation regards the development of bid-ask spreads in the euro-dollar market, which have declined substantially since trading started in January. This indicates a significant reduction in transactions cost due to the much larger size of the new market. The reduced transaction cost constitutes an immediate economic benefit of EMU.

#### IV Money and Financial Market Developments

The beginning of EMU was marked by the start of the EMU-wide clearing system, TARGET, and, with it, the creation of an EMU-wide money market. ECB operations to provide banks with reserves are based primarily on REPOs.<sup>6</sup> The ECB placed its first REPO at a rate of three percent on January 5 with a volume of euro 75 billions, which served to replace the volume of pre-EMU REPOs expiring that week. Initially, the market rate moved rather close to the marginal lending rate of 3.25 percent, suggesting that there was some under provision of liquidity to the system.

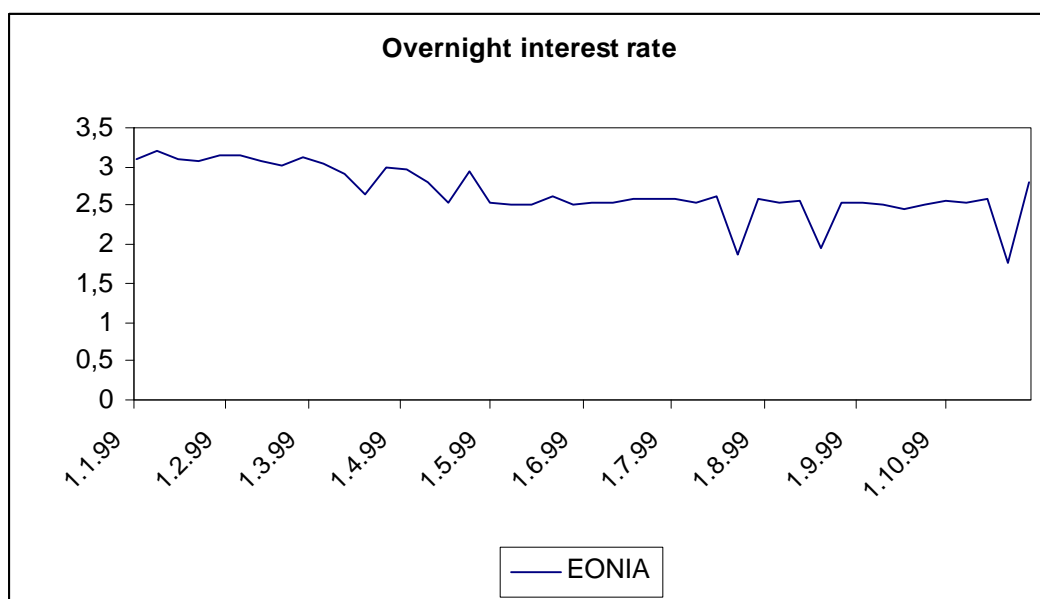


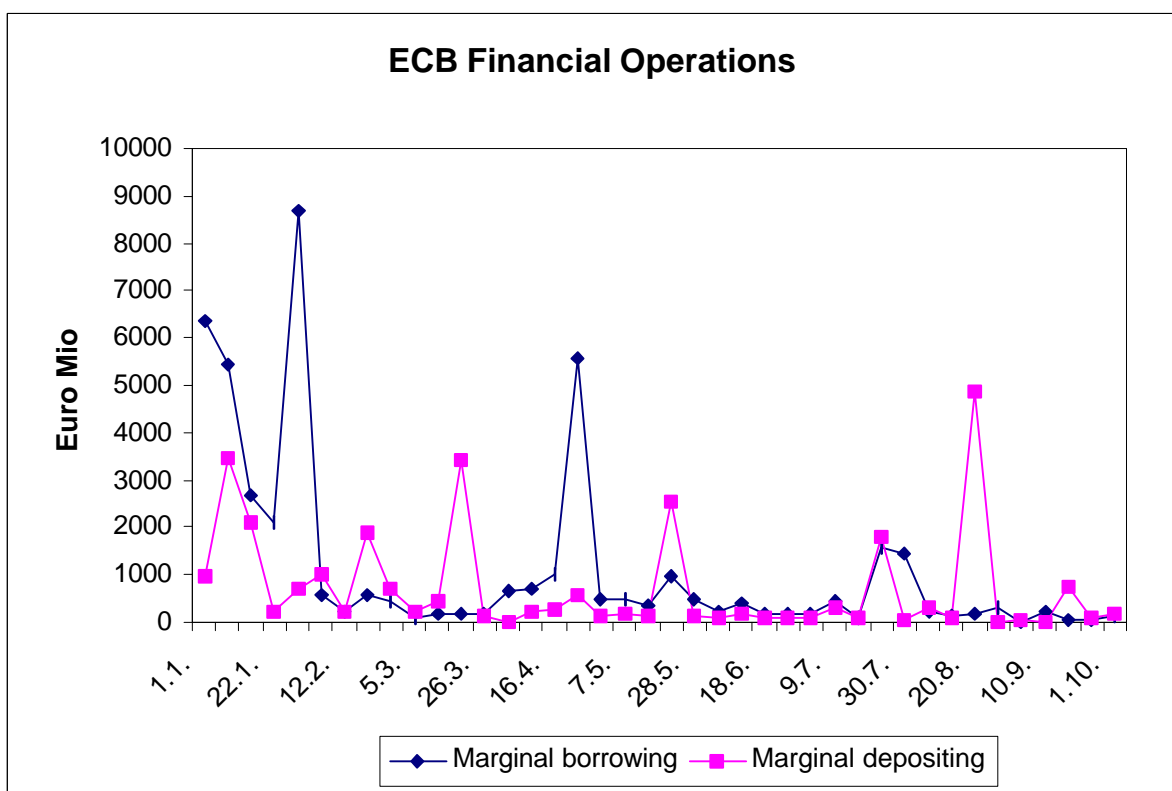
Figure 5

During the initial period, TARGET seems to have met some technical problems. Trading time had to be extended occasionally to ensure the processing of all payments, on one day, the ECB was unable to deliver liquidity before midday. Interest rate spreads reported between

---

<sup>6</sup>REPOs can be reversible credit operations with banks collateralized by eligible assets or reversible open market operations with banks as counterparts.

EMU money market centers are another indication of some initial trading difficulties. Another indication for this is the observation that banks deposited and borrowed relatively large volumes of reserves at the ECB on the same day, and that borrowing from the ECB was quite volatile during the initial period; see figure 6. To assure that such difficulties would not result in large interest rate movements in the new money market, the ECB kept rates within a narrow corridor defined by the marginal deposit rate of 2.75 percent and the marginal lending rate. This corridor was widened in late January to 250 basis points (200 basis points since 9 April), to encourage banks to trade reserves among each other rather than turning to the central bank. Figure 6 shows that the volume of marginal borrowing and depositing at the ECB declined sharply from early February onwards.



**Figure 6**

Nevertheless, the EMU money markets seem to continue encountering some problems in coping with the distribution of liquidity across the system and the management of liquidity over time. Figure 6 indicates that periods in which marginal borrowing and lending move in the same direction continue to occur. This suggests that money market trading is still confined more to trading within national markets than one would expect in a fully integrated money market. The large spikes in figure 6 also suggest that banks in the euro area do not yet make full use of the intertemporal planning opportunities implied by the fact that reserves and reservable liabilities are computed from monthly averages. Figure 5 shows that overnight

rates have developed an almost seasonal patterns around the end of reserve maintenance periods. This, too, suggests that there are unused trading opportunities in the system. Furthermore, the ECB might have intervened in the money market to prevent the unnecessary interest rate moves.

A peculiarity of the ECB's current operations is the use of fixed-rate tenders, in which banks submit bids for a volume of central bank reserves for a given, pre-set borrowing rate. Since the total volume bid for regularly exceeds the volume desired by the ECB, the central bank allocates reserves to the banks according to the size of their bids. Thus, banks bidding for large volumes are allocated more, although the total volume is determined by the ECB. During 1999, the total volume allocated was often less than 10 percent of the total volume bid for. Furthermore, when the ECB, responding to complaints by some banks, weakened its collateral requirement during the Summer, from demanding collateral for all bids to demanding collateral only for funds allocated, the ratio of total bids to allocations almost doubled.

This procedure is obviously inefficient and ought to be changed. On the one hand, the ECB seems determined to set both the price and the volume of reserves rather than letting the market decide one of the two. This is motivated by the desire to reduce short-term interest rate fluctuations, but banks are thus forced to accept price-quantity combinations which are off their reserves demand curves. On the other hand, the procedure invites banks to submit

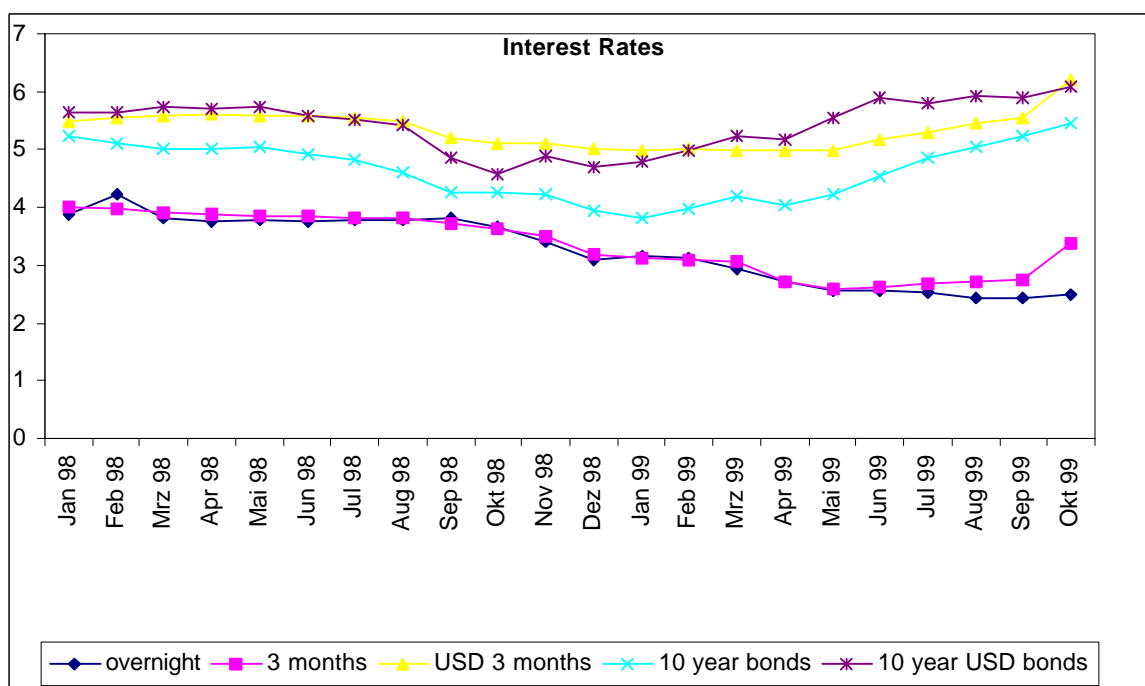


Figure 7

phony bids for much larger volumes than they actually demand simply to assure a favorable place in the queue. As all banks do that, the bids become relatively uninformative and the intention using a bidding process, namely to obtain information about the banking sector's liquidity position, is undermined. Finally, the ECB required banks to back up their bids with tier-I collateral. The implication is that banks which do not possess large volumes of such assets (Spanish banks, for example), are at a competitive disadvantage compared to banks with large volumes of eligible collateral (German banks currently), with the result that the latter obtain a windfall profit. Obviously, such a profit has no justification from a monetary policy nor from an efficient markets perspective.

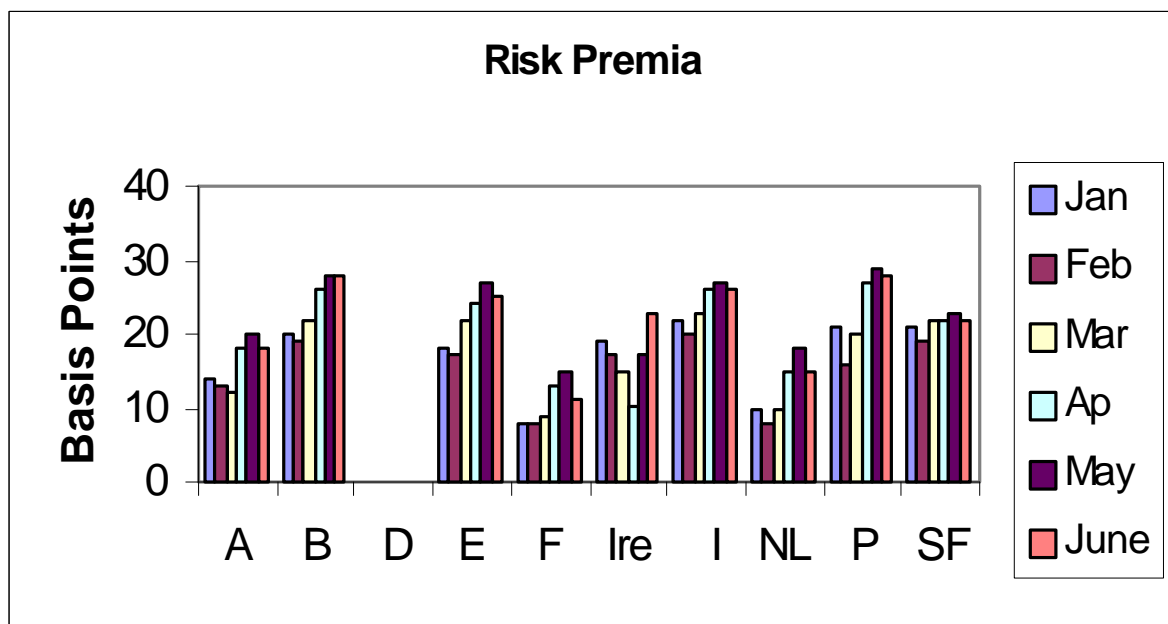
Figure 7 reviews the development of interest rates in the euro area since 1998. Long term rates fell in anticipation of the start of EMU, and were flat through the first quarter of 1999. But after the ECB's move to lower short term rates in April, long term rates began to drift upwards again. This probably reflects some increase in long term inflation expectations. While overnight rates remained flat, increasing interest rate expectations drove the less central bank controlled 3-months rate up starting in July. This movement reflects the market's response to increasing rumors from within the ECB, that the central bank would move interest rates up in the near future. Thus, when the Bank did move its rates up by 50 basis points in November, this had already been built into market rates over the previous months, with a marked jump in September.

Bond market activities have been particularly strong during 1999. The BIS reports an unprecedented volume of corporate issues in the EMU, driven by three main factors. The common currency has eliminated restrictions on foreign investments by institutional borrowers, who can now invest in bonds issued by foreign borrowers without incurring exchange rate risk. Furthermore, the low rates of return on more traditional investments such as government bonds has induced investors to look for higher returns in corporate bond markets. Investors show a greater willingness to incur credit risk, as exchange rate risk has been eliminated. Finally, the larger market size has allowed corporate investors to design much larger transactions to finance mergers than the previous, national markets might have allowed.

To illustrate the structural changes in the corporate debt market, one may note that international debt securities issues in euro-area currencies were 41 percent of dollar issues 1997, 54 percent in 1998, but 79 percent in the first and 88 percent in the second quarter of 1999. About two thirds of the euro-denominated issues of international bonds and notes came from euro-area borrowers. This is only slightly higher than the share of North American



borrowers in dollar-denominated issues in 1999. The volume of euro-denominated, international money market instruments outstanding increased by almost 60 percent in the first two quarters of 1999, while the volume of similar, dollar-denominated instruments - though still double in volume - increased by a mere four percent. Among international bonds and notes, the amount of dollar-denominated floating rate paper outstanding increased by about 10 percent in the first two quarters of 1999, compared to one third for euro-denominated instruments. Yet, dollar-denominated amounts of straight fixed-rate securities and equity-related instruments grew faster than euro-denominated securities.



**Figure 8**

One particular concern in the design of the EMU has been the fear that financial markets would not price credit risk of sovereign borrowers appropriately. The first few months of this year give us an opportunity to assess this question. We do this by computing interest rate premia over German government bond rates for the EMU governments with the exception of Luxembourg for the first six months of 1999. These premia are measured in percent. Figure 8 shows the variation of risk premia across EMU countries.

To measure fiscal risk as a determinant of these premia, we need a variable indicating the exposure of a government to revenue shocks and interest rate shocks diminishing its ability to serve its debt. For this purpose, we use the ratio of interest payments to total current revenues. Countries with a large ratio have a large part of their revenues committed to debt service, and, therefore, have less room to adjust to changes in financial market conditions or sudden changes in tax revenues.

A preliminary test of this relation shows that it explains a significant part of the variation in interest premia. But in a bivariate relation, the smaller EMU countries would seem to pay an excessive interest rate. A suggestive explanation is that EMU government bond markets incorporate liquidity premia in interest rates, to the detriment of smaller countries. Thus, we add a variable measuring the relative market size of the national debt markets. We do this by computing the ratio of total government debt in euros of each country to total government debt of all EMU countries. We can then estimate the following regression equation:

$$P_{it} = -22 + \frac{20}{1.2} \ln(Risk)_{it} - \frac{33}{2.0} Share_{it}$$

$$R^2 = 0.45, N=60$$

where P is the premium, Risk our measure of fiscal risk, and Share the relative market size. The coefficients are significant at the one percent (Risk) and five-percent (Share) level.<sup>7</sup> The results indicate that a country whose ratio of interest payments to current revenues increases by 10 percent faces an increase in its interest rate by 2 basis points. Thus, Italy's bond rate would fall by 16 basis points, if it reduced this ratio to the level of Germany. At the same time, small countries in the EMU pay significant premia for the small volumes of their bond markets. This indicates that EMU debt markets are still not well integrated.

Figure 9 illustrates money and credit developments during 1999. Money growth, measures in terms of M3 started at an annual rate of 5.4 percent in January, to slow down to five percent in February. Since then, money growth picked up again and continued to accelerate throughout the year, to reach seven percent at year-end. The growth rate of the narrower money stock M1 has been much higher during 1999, fluctuating between 12 and 14 percent on an annual basis. Likewise, credit to the private sector has grown faster than M3, its growth rate hovering around eight percent during the year.

Measuring money growth in the EMU, however, is not uncontroversial. The numbers for M3 discussed so far are derived from comparing levels of cash holdings and monetary assets in the euro area. The ECB, in contrast, reports money growth from adjusted flow data, i.e., monthly changes in levels of monetary assets corrected for changes in exchange rates and financial market prices. The ECB's concept of M3 includes non-euro denominated assets and some very short-term paper traded in secondary markets. Changes in the levels of these assets (the euro-equivalents for non-euro denominated assets) due to changes in the euro's

---

<sup>7</sup>Note that Risk and Share are annual data for 1999. The estimator accounts for the fact that the explanatory variables are annual while the dependent variable is monthly data.

exchange rate or in the market prices of such assets are subtracted from the data, supposedly with the aim of getting closer to those changes in levels which are produced by net transactions during the period under consideration.

It is quite obvious that such a procedure is not well grounded in economic reasoning. If money stock measures are meant to gauge the liquidity available in the economy, assets should be valued at their current market prices since they can be liquidated at these prices. Note also that the ECB procedure embeds a basic inconsistency in that flow-based changes in the levels do not add up consistently to the level data reported by the ECB.

Figure 9 illustrates the problem by comparing flow and stock-based growth rates of M3 and domestic credit. Money growth is increasingly underestimated in the euro-area if flow-based data are considered. The reason is that the flow data do not take into account the increase in value of non-euro denominated assets due to the euro's depreciation since January 1999. Credit growth, in contrast, is overestimated to an extent of 1-2 percent.

# Economic Growth in Europe: Entering a New Era?\*

Dominique Guellec  
OECD, Directorate for science, Technology and Industry

## 1. Introduction:

The economic performance of the US for the past ten years has raised many questions in Europe, which was facing big problems. Growth and innovation on the West side of the Atlantic, stagnation and unemployment on the East side: that is the picture many had in mind not long ago. And there was much truth in it. Things have been changing recently, as European economies were regaining momentum. Much remains to be done however before the performance of European economies can compare with the US. What happened on the two sides of the Ocean? The dominant view of American growth in America (see Alan Greenspan lectures) gives a large role to the ability of US companies to generate and use information and communication technology (ICT) –the extreme version being the “new economy” view (end-less growth and price stability thanks to ICT). Conversely, many European economists (e.g. Brender and Pisani, 1999) tend to underline macro-economic factors, notably monetary and budgetary policies –the extreme macro-economic interpretation emphasising the “bubble economy” on which American growth is built. The two views (except for the “bubble” interpretation of macro-economic factors) emphasise that Europe has something to learn from the US, and that a potential for growth does exist that can be captured by Europe.

There is no doubt that monetary policy was helpful in restoring and maintaining the conditions for growth in the US. It is the purpose of this paper however to emphasise more structural aspects, that relate directly to productivity growth and technological change. The way resources are allocated, the intensity of competition, the economic aspects of innovation, the importance of external (foreign) linkages, all these structural features of the economy have experienced tremendous change in the past years, especially in the US. No need to support the “new economy” view to reckon these evolutions and their positive effects on potential growth. It is the purpose of this paper to explore these features and examine their impact on economic growth.

---

\* This study is based on work for a project of the OECD on the sources of cross country differentials in economic growth. All opinions expressed herein are those of the author, and do not reflect necessarily the views of the OECD or its member countries.

More precisely, this paper will address the following questions:

- Is there currently a surge in structural growth going on, notably in the US?
- If yes, what is its background?
- What are the conditions for Europe to catch the train?
- Which policy implications?

## **2. Growth and productivity in the 1990s:**

The 1990s have been a dismal decade for the economy in Europe, especially when compared with the US success. This is partly the picture that emerges when looking at GDP growth over the decade (Table 1). Over the whole decade (1990-98), the European Union has grown by 2% a year, which is substantially less than the US (2.6%). Over the more recent period (since 1995), the US economy has accelerated (3.7% a year in 1995-98), as did Europe but to a much lesser extent (2.3%). The performance of Japan was even worse (1.2% a year over the decade). The very end of the decade has seen more optimistic prospects emerging for Europe: The recovery seems now to be spreading all over Europe, although it still lacks momentum in a few big countries. In the meantime there are no signs of a coming slowdown in the US economy.

The picture within Europe is quite contrasted however (a detailed examination is made in OECD 1999). Over most of the decade, a few smaller countries such as Ireland, Denmark, the Netherlands or Finland experienced higher growth than others, especially the big continental countries (France, Germany, Italy). The UK is in a medium position. Then, although there are Europe-wide factors for the slow growth, a few countries managed to thwart these factors.

On the employment side, the performance of Europe is still weaker (OECD 1999b). The number of persons employed grew by 1.3% a year in the US, a level that is matched only by the Netherlands and Ireland among European countries; some, such as France and Germany, basically did not create jobs in the decade. This is reflected also in unemployment, that is much higher in Europe (9.4%, end of 1999) as in the US (4.2%) except for Denmark and the Netherlands.

Hence the image of a fast growing and job creating US economy, opposed to sluggish Europe. Economic growth in the US has been impressive not only by its rhythm: it has also displayed features that make it difficult to understand with the standard macro-economic analysis that applied to the 1970s and 1980s. It is to become the longest growth cycle ever (reaching a ten years length soon); it has accelerated sharply late in the cycle (since 1995)

and gives currently no sign of running out of steam; this performance has not triggered inflation pressure (even booming oil prices in the past year have not had important effects on consumer prices); and GDP growth is now pulled by accelerating productivity growth.

We will focus now on productivity. The US records in productivity had not been high over the past decades, including the last one, as compared with other developed countries. As the most advanced country, the US did not benefit much from other countries' technology, whereas these countries were catching up to the US productivity level, hence experiencing high gains. However, things have changed since 1995-1996, with a sharp acceleration in some indicators of productivity in the US. Figure 1 shows the output per hour worked, in the US business non financial sector. For the past 3 years, the US have experienced productivity gains that had not been seen since the 1960s. Hence the claim of an acceleration in technical change, which is the major driving force of productivity. Measuring productivity is not so simple, and various existing measures give somewhat different pictures (see box 1). When looking at total factor productivity (TFP) for instance, the most recent data available (up to 1997) show only that the US is now experiencing gains of the order of 1% a year, which is less than in the 1960s and similar to European countries. However, at this stage of the cycle (where capacity utilisation must be high and non increasing) this is significantly better than it has been since the early 1970s. Hence, although the figures may differ, all indicators tend to show a recent acceleration of productivity in the US.

Does this acceleration in productivity signals an acceleration in technical change? As technical change is not measurable, we are left as usual at examining alternative explanations (technology is the residual explanation, that may be considered only if others don't hold), and at looking at anecdotal evidence regarding technology. There are two alternative explanations in this case: physical investment and regulatory reform. These two explanations are very consistent with the technological vision. Investment is driven notably by technological opportunities, and as it embodies new technology it is a source of productivity growth (even of TFP, as the price of equipment may not capture all of the quality improvement they embody). A recent study of the factors of labour productivity growth in the U.S. (Macroeconomic Advisers 1999) shows that more than half of the contribution of capital deepening to productivity growth in 1998-1999 is due to ICT equipment (0.65% for ICT, 1.19 for total capital deepening). The steady growth of the contribution of ICT through this channel since 1994 is due to the price drop it experienced, which created incentives both to substitution to other equipment and to an increase in total investment. The role of regulatory reform will be examined later; suffice it to say at this stage that its effects are not static only, but also dynamic: resources are better allocated to productive, but also innovative activities,

hence generating more technological change for the economy. Then, far from excluding technology, both investment and regulatory reform give rationales for the observed surge in technical change.

Anecdotal evidence and partial statistics show booming investment in ICT equipment and large productivity gains experienced by companies. Technical change in the ICT producing industries is well known (the “Moore’s law” recognises a doubling of the power of computers every 18 months), and it is confirmed by available statistics (e.g. hedonic price indices for computers). As a result of this technological progress, ICT equipment is rapidly substituting to older, non computerised generations of equipment.

The share of ICT equipment in non-residential investment has been increasing consistently in all OECD countries, and it is higher in the US than in most other countries (table 2): it was 20% in 1996. This figure does not take into account investment in software, which is estimated at around 10% of non residential investment in the US (6% on average in OECD countries), and would boost the share of ICT in total investment to about 30% in the US. There is plenty of anecdotal evidence of the productivity gains and new services allowed by new technology. Examples include: a reduction in the cost of share trading thanks to online trading (Charles Schwab&Co); Internet platform for moving procurement online (Ford, GM, Boeing with Oracle – replacing EDI based systems), allows a more efficient management of the supply chain, which translates in reductions in procurement, inventory, sales execution and distribution cost; direct management of the consumers base allows companies to better identify and forecast demand at the very micro level; in the transportation industry, new technological systems (integrating GPS, portable phones, computers) allows to manage more efficiently flows of freight. In most industries and especially in the services, ICT is changing the way business is done.

Little doubt that rapid technical change has been at work in the US in recent years, and that it is part of the growth record achieved by this economy. The growth rates of the 1950s and 1960s, in the order of 4-5% a year, are probably not achievable in the foreseeable future in a sustainable way. The reason is that in these decades the US was catching up its potential GDP after the losses due to the 1930s crisis and the Second world war (i.e. implementing and realising the full potential of technologies initiated in these troubled times). Growth in the after war period was even higher in European countries and especially in Japan, which were catching up the US itself, implementing US technology. By definition catching up cannot last: when economies have reached the “technological frontier”, meaning that they are using the full potential of existing technological knowledge, the only way of continuing growth is to push forward the frontier. The waning of the catch up forces triggered a period of crisis, starting in the late 1960s in the US, the mid 1970s in Europe, the late 1980s in Japan:

actually, developed economies had to adapt to the new conditions. They should now generate more technical change, which involves different economic mechanisms than just accumulating physical capital for catching up a known technological frontier. It takes time to change economic and institutional structures, hence the poor growth records of the past decades. The current technological revival reflects the fact that economies are getting back to steady state regime of growth -but some have been quicker than others to do so. Hence, future growth will not benefit from a premium due to inherited output gap, and will be at a more moderate pace than the “golden 60s”, although it will be higher than in the 1980s for the US, the 1990s for Europe and Japan.

Why did this technological wave start in the US? and to which extent is Europe able to surf it? Answering these questions requires the perspective to be broadened –which is attempted in the next paragraphs.

In the 1990s Europe performed better than the US in terms of productivity. As mentioned before, thanks to catching up since World war 2, this is not new and does not go against the above arguments. In addition, two new elements are to be noticed. First, productivity growth in most European countries was enhanced by rising unemployment (lower productivity jobs are suppressed first, resulting in a higher average productivity level for the remaining ones). Second, the US has outperformed Europe since 1995, for the first time since 1945. The good news for Europe is that, in some countries (e.g. Netherlands, recently France), this is due partly to a more “job intensive” growth process (the reverse mechanism as the one which worked in the first half of the decade). The bad news is that the technological wave has been late in reaching Europe.

### **3. The new economic regime: innovation and competition**

#### **3.1. Trends that underlie the new economic landscape**

Three broad, basic trends (interrelated and partly endogenous, but still basic), which emergence has contributed to shape economic patterns in the 1990s and will be still more important in the future:

- *Emergence of the knowledge-based economy (KBE)*. It comes from the size of the stock of knowledge (accumulated in the past) and the progress of ICT, which together entailed a surge in the return to investment in knowledge, triggering in turn a virtuous, endogenous growth type, circle of economic expansion. In this context all knowledge related activities are expanding rapidly: research and development, technological innovation, higher education,



supply and demand for ICT, software. Total investment in knowledge now overtakes investment in equipment in most OECD countries (see figure 2).

- *Globalisation*: It is also a long term trend, which has reached now such a level that it changes in many respects the way economies work. It boosts competition (lowering of national boundaries, end of protected markets), it increases the scale of activities (world-wide markets), and the circulation of knowledge (technology crosses borders). Along with the development of formerly poor countries, globalisation impacts particularly on knowledge intensive activities: with emerging economies overtaking markets in low tech goods, resources are freed in developed economies for the production of high tech goods (similarly: the increase in the world-wide supply of low skill labour triggers higher demand for high skilled labour). Moreover economic development enlarges the world market for high technology goods produced by developed economies, then stimulating supply. Hence globalisation reinforces the KBE in developed economies.

- *Deregulation, privatisation*: During the after-war period, an administered, regulated institutional framework dominated, which was consistent with the then economic, social and political conditions (catching-up, cold war). Since the late 1970s, the market mechanism (competition, co-ordination through prices) has been extending its area of dominance (at the expense of the government, and to some extent of non-monetary motivated activity), and on existing markets competition is getting fiercer than it used to be (markets are more contestable, as regulatory barriers are removed, customers are better informed etc.). This still ongoing process concerns markets for goods and services as well as for capital and labour.

These broad trends underlie an in-depth change in the micro-economic conditions and the institutional conditions that underpin economic growth.

### 3.2. A new micro-economy:

Innovation and competition are the master words for firms, reshaping the business environment and strategy :

Innovation has become the highest priority for many businesses. In industries such as ICT or pharmaceuticals, the strategy of firms is entirely determined by their innovation goals and achievements. Industries that used not to innovate much, especially in the services, have experienced a surge in innovation, often related to the processing of information (e.g. the transportation industry, that increasingly uses integrated systems with GPS, mobile phones and the internet for monitoring flows of freight). The basic rationale is that innovation

provides high returns, whereas non innovating leads to losses as competitors are innovating. The profits and market share of firms is increasingly dependant on their availability to launch new products and services and to improve their production processes: and in this process, technology plays a key role.

The surge in innovation is illustrated by the surge in patenting (see graph). Since the mid-1980s, the number of patents granted by the USPTO has experienced steady growth that is higher to the one of the 1950s and 1960s. Moreover in these decades GDP growth was higher, indicating that other sources of growth (e.g. catching up) were stronger than they are now, which emphasises the current role of technical change. This growth in patenting is partly explained by changes in the law (e.g. software became patentable), but patent offices in other countries and regions (e.g. the EPO in Europe) have also been faced, later than the USPTO, with a similar surge. Moreover, although a major contribution was made by ICT and biotech, most technology fields also grew rapidly (Kortum and Lerner, 1998). There is a strong presumption then that technological innovation has experienced an acceleration since the mid 1980s after a through since the early 1970s.

Technological innovation in many fields makes more intensive use of scientific knowledge than before. Actually, in ICT or biotech, the frontier between science and technology is blurring, as fundamental discoveries can lead both to scientific publication and commercial success. A series of studies on the biotech industry (Darby et al. 1999) showed that the commercial success of companies in this industry is closely linked to their connections with the scientific community (e.g. participation of renown scientists in the board). A study of scientific publications in the UK (Hicks and Katz 1997) shows that the proportion of articles authored by industry scientists with co-author from university rose from 20% in 1981 to 40% in 1991. Similar trends are occurring in the US (NSF 1998, p. 5-38). A recent study (Narin, Hamilton and Olivastro 1997) shows that 73% of references made in patents to published articles were to "public" science - academic, governmental and other public institutions. The number of references to public science had nearly tripled during the six year period studies.

Most OECD countries, with the exception or large European ones and Japan, have experienced high growth of their business funded R&D expenditure in the 1990s (see graph). This is the case especially of Australia, Ireland, Nordic countries and the US. Stagnation in a few countries was caused mainly by economic slowdown and a reduction in government spending (OECD 1998): business funded R&D has started recently to pick up in most of those countries.

At the same time, the organisation of R&D has changed markedly. Firms are doing less basic research in-house, contracting it out, instead, to universities (OECD 1998).

Increasingly in large firms, central laboratories have less resources, which are allocated instead to departments and affiliates laboratories which perform more applied research. The point is that universities have a comparative advantage in basic research: the circulation of knowledge (through publications, conferences) that is key to the advancement of basic knowledge is better organised, peer review allows quality check and the incentive system is more adapted (Dasgupta and David, 1994). Hence the development of links between universities and business, which take various forms: research contract, research co-operation, patent deals (sales or licences), mobility of researchers, consulting. the increasing share of university research which is funded by business (see table 1) in most countries, including the largest spenders (US, Japan, Germany). Largest increases are met in Finland, the Netherlands and the US. Largest countries where business funding of higher education R&D dropped are the UK (where it is relatively high) and France.

The new economic environment, shaped by innovation and competition, is triggering large changes in the organisation of industry.

- As markets become world-wide and the cost of innovation increases in many industries (pharmaceuticals, chemicals, automobile), the minimal size for firms to be competitive has increased in these industries, leading to a wave of mergers and acquisitions (M&A) which reached US\$ 3,430bn in 1999, against US\$2,520 bn in 1998 which was already a record year (Source: TFSD) -1999 is actually the 7<sup>th</sup> consecutive record year. Most of these M&A aim at reinforcing the core business of firms -they are mergers of firms in the same business (all the 10 biggest M&A in 1999 were between firms in the same industry). This is to be contrasted with the 1980s, when M&A between different fields of business were more common (UNCTAD 1998). The global basis for business restructuring is demonstrated by the increasing share of cross-border deals, which reached 28% in 1999 against 22% in 1998. Actually, the amount of cross border M&A has grown more than tenfold between 1991 and 1999 (sources: KPMG and TFSD).

- At the same time, many firms have been contracting out activities that they used to do themselves, or have split up into new entities that are more specialised in one business (e.g. AT&T in 1994, that gave birth to AT&T, Lucent and a company in the software services). In the automobile industry, a growing role is left to suppliers, that design and produce now entire parts of the cars instead of providing small pieces later assembled by the motorcar firm. Such specialised suppliers are getting bigger and their number is decreasing. This allows to limit the size of firms in a context of large M&A, hence preserving their reactivity and limiting the costs of bureaucracy generated by size. Both moves, M&A and split up/contracting out, aim at creating large, focused firms and reactive firms.

- The pressure of financial markets in these moves is overwhelming, as more profits are expected from the new corporate entities. This is at odds with the hitherto prevailing tendency of firms to diversify, that was supported by management and banks (in search of insuring themselves against industry specific shocks: now diversification is made by investors, not by companies). In a context of deregulation of financial markets since the 1980s, firms have increasingly access to direct finance through emission of shares and bonds, shortcutting banks, which have weakened the position of banks and strengthened the position of shareholders.

- An alternative way to M&A for capturing economies of scale due to knowledge is networking. Moreover, it gives to the firm access to complementary knowledge, that is outside its own business but may help it. There is abundant evidence of increasing networking by firms, with universities and other public bodies, but also with other firms, be they in the same line of business or in other ones. It is also shown that firms with more connections are also more successful in innovating. Networking can take many forms: research joint ventures, research contracts, cross-licensing agreements. The number of technological alliances between firms was 136 in 1980, 287 in 1990, 483 in 1996 (source: CATI, MERIT). Networking develops at an international scale, since firms have to find the best partners wherever they stand. This is reflected in the increasing share of patents with inventors from different countries, which has doubled between the mid-1980s and the mid-1990s (from 2.5% to almost 5%).

- At the same time, a wave of new, small, innovative firms has risen. Creation of new business is very active, especially in new technology industries. Does it contradict the trend towards world-wide concentration? No. First, many new firms do not stay small for long. Either they get big (Microsoft), or they are purchased by bigger firms, or they fail. Second, many are highly specialised, e.g. in a special type of software or genetic experiment, so that they are big on their own market (which is small). Third, these start-ups fulfil a special role that is less accessible to large firms: they are at the forefront of building entirely new industries (e-commerce, genetic engineering), which is a very risky endeavour, that requires both flexibility and strong incentives that are more easily achieved in small businesses than large ones, and also a business approach that is somewhat different from established industries where big firms come from. There is a strong complementarity between small and large firms, as the latter purchase the successful ones among the former (e.g. Alcatel and Cisco go shopping to Silicon valley; in 1999 Microsoft acquired shares in 44 firms for US\$ 13bn, Intel 35 firms for US\$ 5bn), leaving in a way to the market the role of selecting successful innovations before integrating them in their own portfolio.

### 3.3. Economy-wide aspects:

An efficient functioning of this innovative/competitive system requires some conditions to be met in the environment, especially at the country level:

- Countries must have a *strong knowledge base*, where firms can tap in. Government and university research must be strong and opened to industry. Knowledge has a public good component that makes public funding necessary to its progress. At the same time, knowledge does not flow automatically from the university lab to the firm: certain conditions must be fulfilled for knowledge to circulate, such as the mobility of researchers themselves, or an involvement of the user at the research stage (that allows early learning). The institutional and incentives structures must be adapted accordingly. Countries benefit from a large endowment in *human capital* (coming from education or immigration), that provides the labour force needed by business and enhances the demand for knowledge intensive goods (that require skills from the consumer). The public schooling system and universities have a key role there, provided that they take into account the evolutions of demand.

- *Market forces should work efficiently*, generating a strong competitive pressure on firms (markets for goods) and the permanent reallocation of resources (capital, labour) required by the innovative economy. Creative destruction is the result of competition and innovation, and competition is a major factor of innovation. Trying to thwart competition or its consequences (creative destruction) is detrimental to innovation. At the same time, co-operation between businesses, and between businesses and public institutions should be encouraged, provided that competition is not distorted. The institutional framework, especially financial institutions, should allow the allocation of resources to risky activities conducted mainly in start-ups (venture capital, stock options).

- *Size matters*: either a country must be large or it must be opened (or both), so that firms have access to a large pool of customers, to a large pool of capital and to the specialised labour force they need. In the case of small countries openness and specialisation were necessary for long as globalisation is nothing new: it is becoming the case increasingly for medium sized countries (especially the large European countries) as the critical mass in many industries is growing.

- *Distribution of income*: there is a need for strong (mainly financial) incentives for innovators, entrepreneurs, etc. that favour initiative and risk taking; this conveys the danger of increased income inequality, resulting both from the working of market forces (that favour the skilled and powerful more than do an administered, regulated, redistributive economy), and from the KBE (increased demand for skills). Increased risk and creative destruction

imply that market forces will leave losers as well as winners: those who fail in their entrepreneurial activity, those who work in firms or industries that are destroyed by competition need some support, otherwise they will resist change -to the detriment of economic growth.

#### 3.4. The diverse fates of countries:

These new conditions for economic growth are fulfilled to a differing degree by countries. This diversity in turn explains most of the growth differentials in the 1990s. Economies which have been in a favourable initial position (by their factors endowment), or have implemented the relevant institutional changes to live in this new model have experienced higher growth than others. Overall, more favourable conditions were met or built in the US and in some small countries (e.g. Australia, Ireland, Denmark, Finland), rather adverse conditions in large European countries (but things are changing rapidly there) and, even more, in Japan.

##### United States:

- Large endowment in science and technology: The US is the largest spender in R&D, funded by business or by government; it has the best universities in the world, as illustrated by the number of Nobel laureates (many of them foreign born). Government R&D policy (with defence or civilian purpose) anticipated the ICT revolution. The regulatory framework encourages technology transfers from universities to business (Bayh-Dole act for patents). There is plenty of human capital available, at least in the upper tail, either produced by the world best universities or attracted from abroad (thanks to universities, income inequalities and business friendly environment).
- A deeper rooted tradition of competition made it easier than in other countries to adapt the institutional framework from the late 1970s on (deregulation of the labour market, break down of ATT, deregulation of air, road and rail transportation). A legal framework that favours risk taking: Pension funds have been allowed to finance venture capital since 1979; well functioning financial markets allow to channel funds to projects with rewards only far in the future (internet stocks). The patent system gives a strong protection to innovators.
- Size of the economy: The US is the largest economy in the world. Market size is key in industries such as software, e-commerce (a large base of known and relatively homogenous customers). Raising capital in the largest financial market in the world is easier than in smaller ones.

- Conclusion: the US was in the best position to lead and get the rewards (growth, productivity) coming from the KBE, as it is shown by the 1990s. Problems may be coming in the future from the weak educational system (except the upper tail) that could generate a shortage of intermediate level skills (technicians). When other developed countries recover, a possible reversal of migration streams may hit innovation and entrepreneurial capacities, and a similar reversal of financial capital streams may reduce investment. When macro-economic conditions deteriorate, with an increase in unemployment, income inequality may become a bigger social and economic problem as the social net has been substantially lightened in the 1990s.

Japan:

- Weak science base, due to a weak public research sector; good endowment in human capital, especially at the intermediate level (blue collar high skilled, technicians). The 1996 plan by the government to double public expenditure in basic research was good news.

- Highly rigid labour market, for the skilled at least (life long employment); highly regulated markets for goods and capital, resulting in weak entrepreneurial activity. *Keiretsu* linkages reduce the ability of firms to focus on core activities, and hamper competition. Except for a few, selected industries (automobile, consumer electronics), the country is quite insulated from the outside world.

- Conclusion: Recently, there have been signs of reform of the institutional framework and of openness (Nissan). Change is going on in Japan, but at a slow pace and it is just starting.

#### **4. Europe in the new economic conditions:**

It is common to dismiss Europe as a laggard on the technological scene, pointing out its weaknesses in ICT and biotech. Some go to say that this would be largely irreversible, as the the new industries are characterised by economies of scale that give a permanent advantage to the first mover (i.e. the United States). Although European weaknesses are real and big, they should not be overestimated, and there is no evidence of irreversibility in these industries that are still in their infancy and will change totally (in unknown directions) in the future.

First, there is huge diversity within Europe: Nordic countries are more advanced than the US in many respects (PC penetration in households, and even for the number of internet hosts per inhabitant - figure 5). A ranking of the best banks web sites in 1999 (with criteria such as: accessibility, navigability, customer service, content, technical performance and visual

expression), Interbrand found that the first was a US bank, followed by three Nordic banks. Actually, seven out of the first ten were European.

Second, things have been changing rapidly in Europe in the very recent past: investment in venture capital has trebled between 1995 and 1998 (as in the US); the penetration of equipment and the use of ICT are increasing more rapidly than in the US (starting from a much lower level).

Third in some high tech industries (not many) Europe is a frontrunner, not a laggard: this is the case in mobile phones, aircraft; Linux is a European invention, and European research contributed to the Internet (Mosaic, the first internet protocole was designed at the CERN in the early 1990s).

The bottom line is that Europe is actually weak in ICT and innovation, but its situation is far from desperate and it is improving rapidly. What are the factors underlying this position?

#### 4.1: The science base:

Most countries have a quite strong science base and a good educational system (although not as good, for the top end, as in the US). There are however a few problems:

- In most European countries, public research seems to be little reactive to changes in the distribution of scientific opportunities, with excessive rigidity in the allocation of resources by scientific fields. Entrenched in established fields with established research teams, public research was unable to catch the ICT revolution.

- In a way, the overall quality of European science is probably lower than the sum of its national components: still relatively weak cross border links between national research systems entail duplication, weak competition and weak networking. EC programs and country initiatives (such as the synchrotron "Projet Soleil" that the French Ministry of research wants to share with the British government and the Wellcome Trust) go in the right direction, which is more integration. Research by the OECD (1999c) shows that being a member of the EU does not increase the probability to co-invent with another member as compared with a non-member (when other aspects, such as technological similarity, a common language or geographical proximity are controlled for). Also the EU taken as a whole is not as open to foreign (non EU) S&T co-operation as the US is. In an era of globalising science and technology, this is probably a handicap.



#### 4.2. Institutions for technological change:

- Until recently, European economies were highly regulated, with a large government owned sector and very protected labour market. In the UK, as in the US, deregulation started earlier and was conducted bluntly, something more difficult to do in continental Europe where consensus has to be reached for broad reforms to be feasible. In smaller countries (Finland, Netherlands, Denmark) a strong social/political consensus (in the European tradition) was achieved in order to reshuffle the system, especially to make the labour market more flexible (higher incentives to work, lower costs of hiring and firing). In larger continental countries, reaching a consensus is obviously more complex and difficult, and it took some time to go ahead. Structural change is now under way, and well advanced in some countries.

- European integration also has put pressure on national governments for liberalising markets, pressure which is conveyed by the European Commission. Markets that used to be legal monopolies (telecoms, energy) have been progressively opened to competition. Government owned companies (e.g. banks, telecoms) are privatised, especially in Italy and France. Liberalising the economy results in dropping these firms and industries that are not competitive and allocating more resources to efficient activities, hence in higher specialisation (economies of scale) which is visible in Finland.

- Industrial restructuring: European M&A reached US\$ 1200bn in 1999, more than double their 1998 amount (US: US\$ 1750bn) (source: TFSD). In the first three quarters of 1999, EU companies made cross border M&A totalling US\$ 430bn (world: US\$ 608bn), compared with US\$ 203 in the same period of 1998. The EU accounts for 70% of the total value of cross border deals completed, with the UK for 33%. Excluding the UK, EU made US\$ 228bn, a 45% increase over the same period in 1998 (US: US\$ 113bn, a 7% increase over 1998) (source: KPMG).

- Venture capital (see box 2) is weak yet, but it has been booming in recent years, thanks to new awareness of financial institutions of its potential return, thanks to government policies (creation of public VC funds, tax breaks), and to the establishment of secondary financial markets (Neuer Markt, Nouveau Marché, EASDAQ). The absence of pension funds, the major provider of capital to VC in the US, remains an obstacle in some countries.

#### 4.3. Size of the market:

No doubt that Europe is far from being a single, integrated economy as the US is. There are still national champions, language barriers, differences in regulation, in financial channels

etc. This has hampered innovation in larger countries, which were reluctant to let non competitive industries decline and specialise according to their comparative advantages. Small countries have been traditionally more opened, they used to specialise before and did not feel the pressure to specialise as anything new. Hence the success for instance of Nokia (more than half of the Helsinki Stock exchange capitalisation). The potential of innovation in Europe when internal barriers are removed or overcome is exemplified by the mobile phone (a common standard unified the demand side) and Airbus (pooling of resources boosted the supply side). For the mobile phone, four different standards have been competing in the US, resulting in weak demand that limited supply. Conversely, thanks to its single standard, Europe has the highest diffusion rate in the world and three of the four leading companies (Nokia, Ericsson and Alcatel). Airbus shows the ability of European technology to compete with the US when enough resources are pooled for a critical mass to be reached.

The launch of the Euro has contributed to mitigate this internal split, as it is shown by the wave of large national and cross-border M&A and industrial restructuring since early 1999 (see above). Whereas the UK's acquisitions have been focused on the US market, other European firms have been setting their sights on other European countries. Among the ten largest M&A involving French firms in 1999, 5 involved a foreign partner, including 4 from other European countries. (Source: TFSD). Some big and really European companies, beyond national frontiers, are now emerging: EADS from Matra-Aérospatiale and DASA, Aventis from Rhône-Poulenc and Hoechst, Framatome/Siemens. Vodafone bid on Mannesmann exemplifies this new situation. Only a deep financial market can provide capital for large operations (often funded by corporate bonds) that give birth to European industry giants.

- Conclusion: Europe has paid in the 1990s the price for the adaptation of its institutional framework to new growth conditions and for its integration. As both are under way, the current signs of a revival in growth reflect a structural shift in the right direction.

## **5. Policy implications:**

What can governments do for fostering growth in Europe, while not losing valuable aspects of the "European model" (especially its emphasis on social cohesion)? Following the above analysis, government should strengthen the knowledge base of European economies, foster competition on all markets, encourage innovation and push forward the integration of European economies. At the same time, governments should limit social disparities – an objective that may be difficult to make consistent with the preceding ones. While not setting up a catalogue of possible measures to take, a few examples may give substance to this

policy agenda. One will see then that European governments and the European Commission have started, sometimes long ago, in most cases more recently, to work in this direction, although following often a piecemeal approach. It is now at the top of the agenda of European policy makers to help promoting an innovative, high growth economy.

- Research policies must have a built-in European dimension (which does not exclude international co-operation beyond Europe). The goal is to create a really European field for science, as there is one in the US, generating both complementarity, competition and circulation of knowledge between now rather separate research communities. Examples of measures that go in this direction are: i) strengthening a few high level universities, world class research centres, by concentrating resources on a few selected “centers of excellence” (instead of trying to promote research in all regions, whatever their ability to do so, as do some EC programs); ii) encouraging the circulation of graduate students and researchers across the EU (“Erasmus program”). iii) Increasingly, large research equipment must be part of international programs (recent case of the British-French synchrotron), in order both to reduce cost and enhance quality of research. The CERN is of course the leading example.

- Innovation policies: contrary to tradition in some countries, innovation policies must be market friendly –help the market to work instead of substituting for it. Innovation policies should favour new and small firms, as they larger barriers than big firms (access to capital, to markets, to skills); university/industry relationships should be strengthened (commercialisation of results from public research, creation of networks involving public and business research); the diffusion of ICT should be encouraged among SMEs. There are a few examples in the past of such innovation policy programs, ANVAR in France, or Fraunhofer Institutes in Germany. But there are not many such examples, and in both countries, as in other European countries, an in-depth reshuffling of innovation policies is under way along the above lines. It is also important to encourage co-operation between firms from different countries (the EC framework programs already try to do that). Finally, creating a EU patent is necessary for simplifying intellectual property issues in Europe and reducing the cost of protection.

- Structural policies, for more unified and more flexible markets: privatisation of the remaining government owned industrial companies (e.g. power industry in France); promote competition (deregulation and anti-trust); encourage risk taking (bankruptcy law must be more friendly to the entrepreneur according to a recent EC report; taxes on stock options are very high in some countries). Capital should circulate more easily across borders within Europe: the Euro was a great achievement in this respect; further advances would include a more homogeneous tax system, more integrated financial markets (Neuer markt, Nouveau

Marché, Easdaq) that could raise funds at a European scale for innovation, and a European corporation status (in discussion for more than 20 years now) that would simplify the conditions for setting up large European firms.

- Education and training: one strength of most European countries (Vs the US) is a high quality of their primary and secondary schooling system, which provides relatively qualified workers for intermediate skills levels. While this must be kept, Europe must strengthen the high end of its university (tertiary) level, that is currently relatively weak. This should be done in co-ordination with research policy (see above).

- Most of these recommendations, if successfully implemented, lead directly or indirectly to higher income inequalities. The trend towards a more equal income distribution, started in the first half of this century, reversed in the US in the late 1970s and stopped in Europe in the early 1980s (it reversed in the UK at least). But increased unemployment in Europe has hidden potential wage inequalities, that will turn out as many low skilled are coming back to work. Why this reversal? Basically, growth based on competition and innovation goes hand in hand with inequalities, for many reasons (information rents for the decision makers, reward to risk taking); the knowledge based economy increases the demand for high skilled workers, reducing the price of low skilled labour. Inequalities as they have developed in the US are unacceptable in most European countries. They would lead to social disruption and would have counter-productive effects. It is necessary to ensure security and some income equality among citizens, through redistributive policies that: i) do not give incentives to keep out of work, and ii) do not penalise failure for citizens who take risk.

## **Conclusion**

Due to technical change, globalisation and more competitive markets, economic growth is gaining momentum again in Europe, in the steps of the US. There are macro-economic imbalances in the US, especially the low (actually negative) households saving rate and the related balance of payments deficit: part of investment is financed by foreign capital, as well as immigration of scientists allows partly free (but not sustainable) imports of human capital. The business cycle is not dead, and growth will slow down at some point in the future, even a recession may occur. This will not change however the fact that a more innovative and more competitive economic structure has been built in the US and some other countries, that is a basis for long term growth. Europe is now on the way to achieve a similar situation, with competition and innovation gaining momentum here too. In order to realise all the potential gains that the new economic context conveys, European countries must keep

embracing a policy aimed at accelerating European integration, strengthening their science base and allowing greater flexibility of markets while preserving social cohesion.

## References:

- Brender A. and Pisani F. (1999). *Le nouvel âge de l'économie américaine*. Economica. Paris.
- Darby Michael R., Qiao Liu, Lynne G. Zucker (1999), "Stakes and Stars: The Effect of Intellectual Human Capital on the Level and Variability of High-Tech Firms Market Values". *NBER Working Paper No. 7201*
- Dasgupta P. and P. David (1994), "Towards a New Economics of Science", *Research Policy* 23 (4): 487-521
- Kortum J. and J. Lerner (1998), "Stronger Protection or technological Revolution: What is behind the Recent Surge in Patenting?", *Carnegie-Rochester Conference Series on Public Policy*.
- Hicks D. and S. Katz (1997), "The Changing Shape of British Industrial research", *STEP Special Report No. 6*.
- Macroeconomic Advisers, LLC (1999), Productivity and Potential GDP in the "New" US Economy. Mimeo.
- Narin F., K. Hamilton and D. Olivastro (1997), "The Increasing Linkage between U.S. Technology and Public Science", *Research Policy* 26(3): 317-330.
- NSF (1998), *Science and Engineering Indicators*. Washington D.C.
- OECD (1998), *Technology, Productivity and Job Creation*. Paris.
- OECD (1999), Economic growth in the OECD area: Are the disparities growing?
- OECD (1999b), Implementing the OECD Jobs Strategy. Assessing Performance and Policy.
- OECD (1999c), Patents as indicators of internationalisation.
- UNCTAD (1998), *World Investment Report: Trends and Determinants*.

## Tables and graphs

	1995-98	1990-95	1990-98
Australia	4	2.7	3.3
Austria	2.6	1.7	2.1
Belgium	2.3	1.4	1.8
Canada	2.9	1.6	2.2
Denmark	3.1	2.4	2.7
Finland	4.6	-1.1	1.4
France	2.1	0.8	1.4
Germany	1.6	1.1	1.3
Greece	2.6	1.0	1.7
Ireland	8.7	4.1	6.1
Italy	1.2	1.2	1.2
Japan	1.2	1.4	1.3
Netherlands	3.1	2.0	2.5
N. Zealand	1.5	2.6	2.1
Norway	3.7	3.5	3.6
Portugal	3.2	1.6	2.3
Spain	3.3	1.2	2.1
Sweden	1.9	0.3	1
United King.	2.7	1.4	2
United Stat.	3.7	1.7	2.6

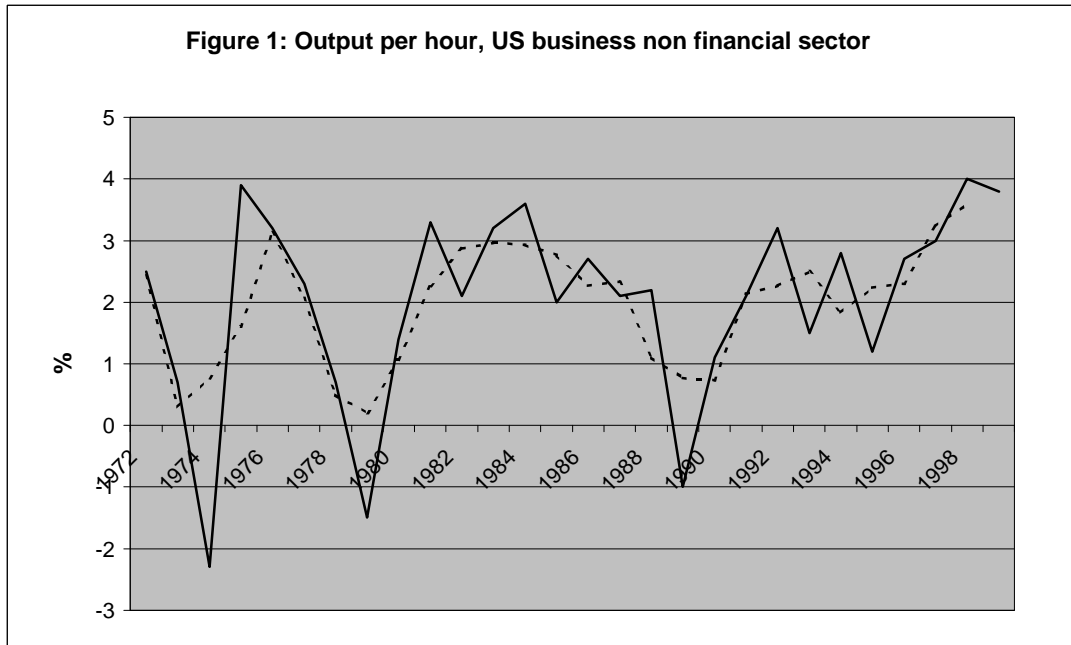
Source: OECD, Economic Outlook

	Canada	France	Germany	Italy	Japan	UK	US
IT							
1985	6.9	6.1	3.4	3.4	3.4	5.2	6.3
1990	7.3	5.0	3.5	4.1	3.8	7.5	8.7
1996	10.1	6.0	6.1	4.2	4.6	11.7	13.4
Communication							
1985	4.2	4.0	3.7	2.4	0.8	5.2	5.8
1990	5.3	3.8	3.7	3.6	1.5	5.8	7.0
1996	6.1	4.9	4.8	5.4	3.5	6.6	6.5

Source: OECD estimates.

Table 3: Share of business in Higher education R&D funding		
	1989	1999*
Australia	2.3	5.2
Belgium	12.6	10.6
Canada	6.3	10.8
Denmark	1.5	1.8
Finland	4.8	14.1
France	4.6	3.1
Germany	7.0	9.7
Italy	2.6	4.8
Japan	2.2	2.4
Netherlands	1.1	4.3
Norway	3.9	5.2
Spain	9.2	6.5
Sweden	7.9	4.5
UK	7.7	7.1
US	4.5	6.0

\* Or latest year available



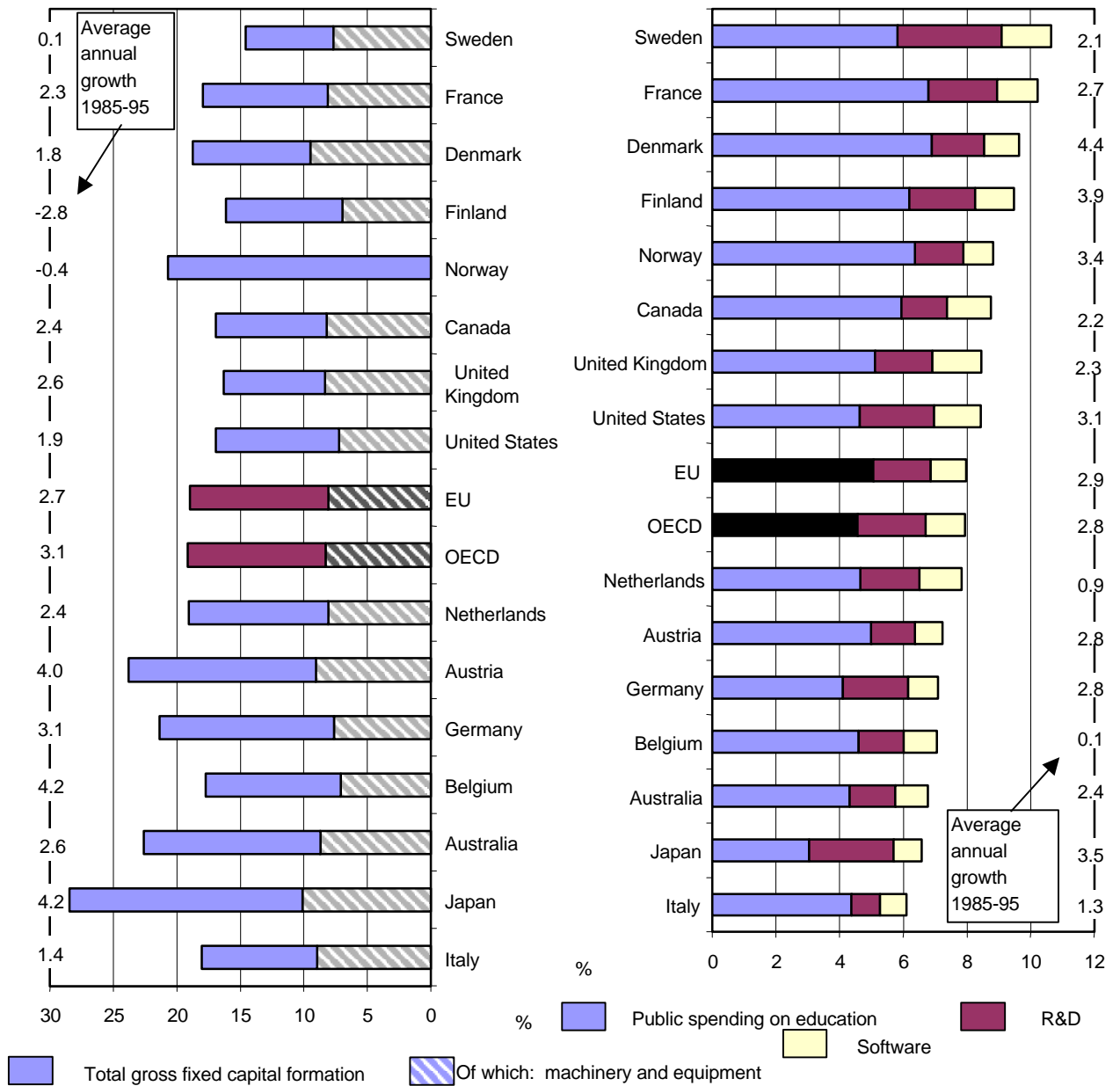
Source: BLS.



**Figure 2: Investment in tangibles and in knowledge**

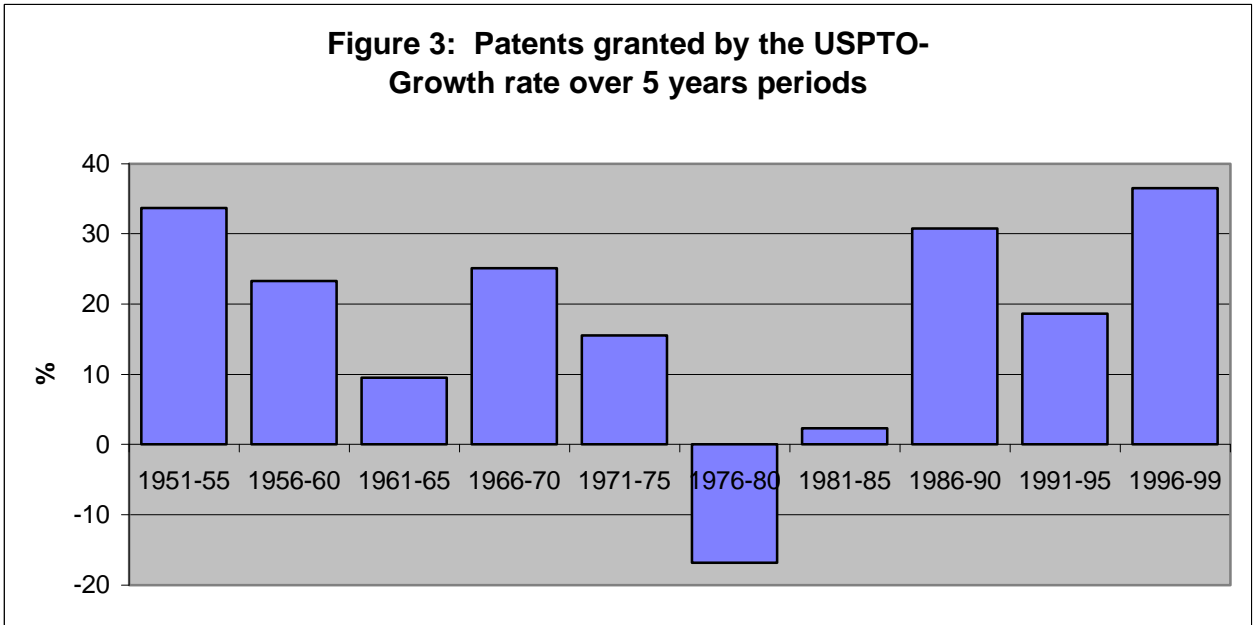
Physical investment as a percentage of GDP, 1995

Investments in knowledge as a percentage of GDP, 1995

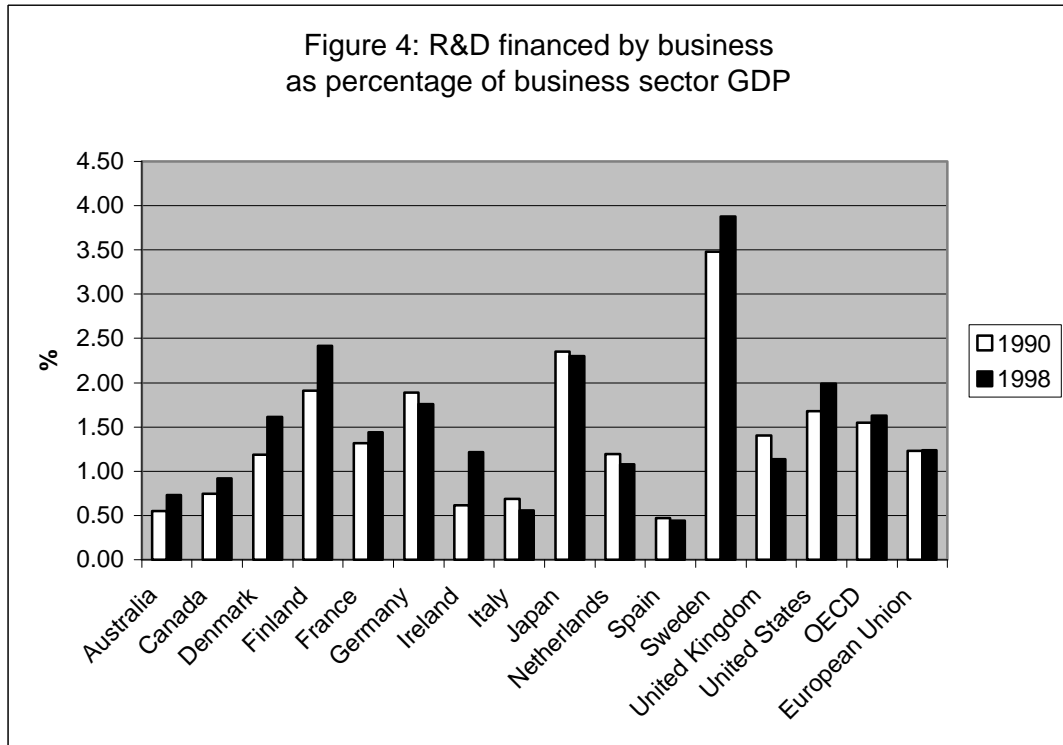


Source: OECD, Scoreboard of S&T indicators, 1999.

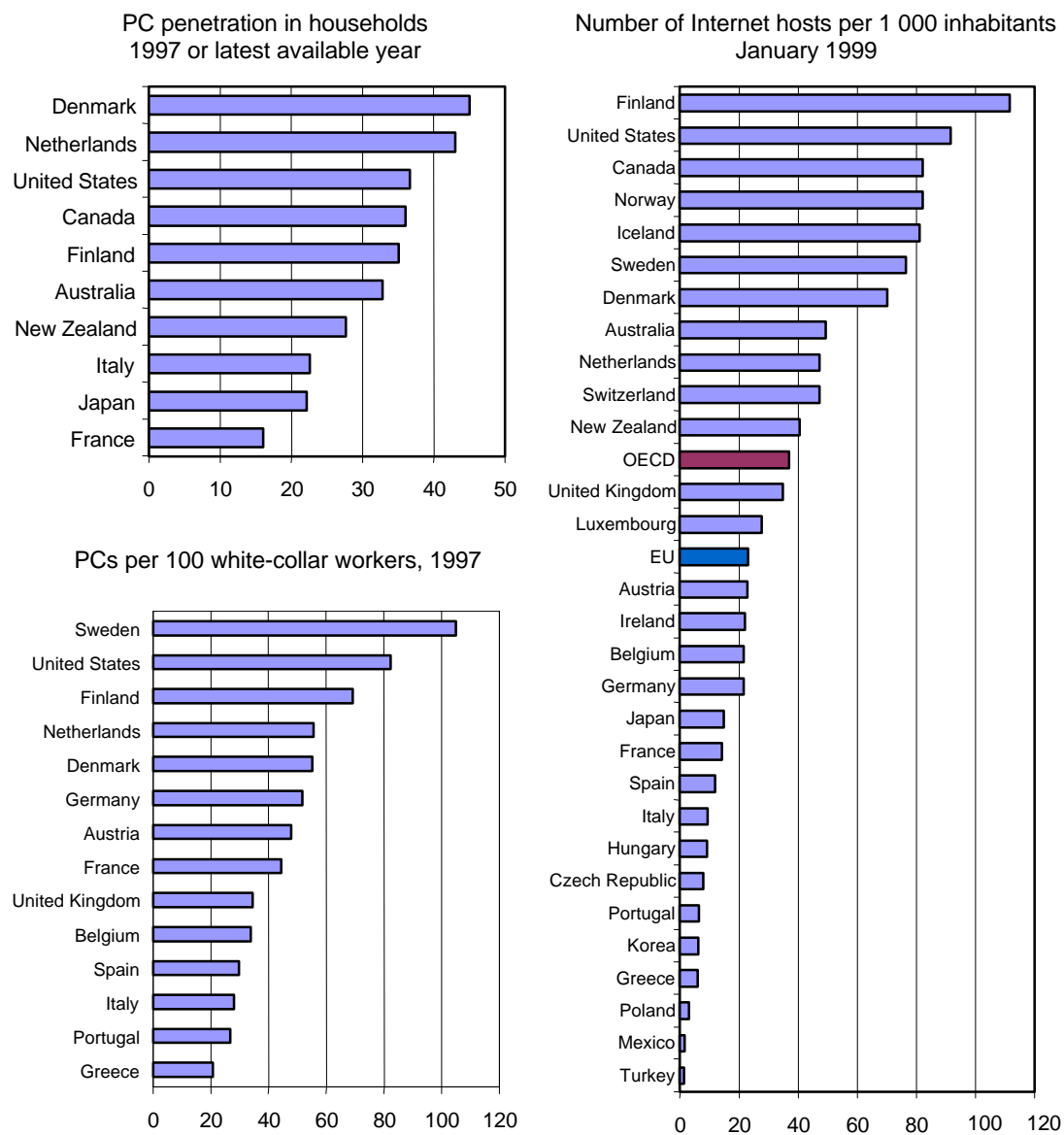
**Figure 3: Patents granted by the USPTO-  
Growth rate over 5 years periods**



**Figure 4: R&D financed by business  
as percentage of business sector GDP**



**Figure 5: Equipment in computers**



Source: OECD.

### **Box 1: Measurement of output and productivity**

Several measurement issues arise when time series of inputs, outputs and productivity are compared at the international level. Currently, the three most pertinent issues in output measurement are (i) the independence of output from input measures, (ii) the use of chained and fixed-weighted indices and (iii) the treatment of price indices of information technology products, in particular computers. Although it is not possible to draw overall conclusions about the extent of a bias in international comparison of growth rates of output, the following observations can be made:

(i) *Independence of output from input measures.* A vital point for the validity of productivity measures is that price and volume indices of inputs and outputs are constructed independently of each other. Dependence occurs, in particular, when output volume series are based on the extrapolation of input measures, for example when employment series are used to carry real output series backwards and forwards. The use of extrapolation methods, which occurs most frequently in industries that mainly comprise non-market producers (such as health or education), generates, in all probability, a downward bias within each country. It is difficult to make statements how extrapolation bears on cross-country comparisons of growth rates of output.

(ii) *Chained and fixed-weighted indices.* Economic theory and the 1993 System of National Accounts recommend the use of chain-weighted indices over the use of fixed base years for the analysis of time series of outputs, inputs and productivity. The main reason is that chain-weighted indices minimise the substitution bias implicit in fixed-weight price and volume indices that occurs in periods of rapid change of relative prices and quantities. To date, only a small number of OECD countries have introduced chain-weighted indices. Whether this reduces or increases comparability is difficult to assess. Comparability is reduced with respect to a (hypothetical) situation where every country employs fixed weight indices with the same base year. However, in practice, there have always been significant differences in the periodicity at which countries re-based fixed-weight index numbers and in the degree to which the new base was carried backwards. It is certain that international comparability is being improved between those countries that employ chain-weighted indices.

(iii) *Computer deflators.* Methods to construct price indices of computers and peripheral equipment varies between OECD countries. The use of hedonic methods in the deflation of computers tends to produce much more rapid price declines than other methods. Hence, the growth rate of volume output of those countries that do not use hedonic methods is likely to exhibit a downward bias. This is almost certainly true for volume output measures of the computer industry. Whether or not an industry-level bias carries over to aggregate measures of GDP depends on the size and delivery structure of the computer and ICT industry.

(Source: OECD 1999)

## Box 2: Venture capital:

### 1. Venture capital:

Venture capital (VC) can be defined as equity or equity-linked investments in young, privately held companies, where the investor is a financial intermediary, who is typically actively as a director, an advisor, or even a manager of the firm. Using a variety of mechanisms, VC are able to finance many risky early-stage projects with no tangible assets. First, business plans are intensively scrutinised: historically, only 1% of those firms that submit business plans to VC have been funded. The VC's decision to invest in a project is frequently made conditional on the identification of a syndication partner who agrees that the invest. Is attractive. Once the decision is taken, VC disburse funds by stages. To ensure that the money is not squandered, managers of VC backed firms are forced to return repeatedly to their financiers for additional capital. In addition, VC intensively monitor managers. These investors demand representation at the board of directors and preferred stocks with numerous restrictive covenants.

### 2. Recent developments in OECD countries:

The VC was traditionally a US industry, with some diffusion in Canada and to a lesser extent the UK. Since 1995 VC has been booming in all European countries, and the share of technology in VC has increased sharply. This is not the case yet in Japan.

Table A2: Amount invested by VC funds, US\$PPP billion.

	1995	1997	1998
Europe: total VC	2.6	4.1	6.0
Of which: technology	1.3	2.3	4.0
US: total VC	6.2	11.5	14.3
Of which: technology	3.6	7.8	10.5
Japan: total VC			0.4
Of which: high technology			0.1

Sources: PriceWaterhouse, EVCA, MITI.

*US:* First created in 1945, VC experienced a big push in the early 1980s, after pension were allowed to invest part of their assets in risky ventures. There have been a strong acceleration in the second half of the 1990s, which is going on in 1999 (more than 100% growth for the first three quarters over 1998). Most high tech firms created since the late 1970s in the US have been backed by VC. The recent surge of VC investment is fuelled mainly by internet related investment, that jumped from one quarter of VC in 1998 to one half in 1999 (amount multiplied by five). VC is very concentrated in a few areas (37% in Silicon Valley, 10% in New England/Massachusetts, 8% in New-York Metro, in Q3-1999).

*Europe:* The VC industry was traditionally small, except in the UK, and not focused on high tech segments and early stage funding. It has surged in all countries since 1995 (similar growth as in the US), especially in technology related fields. Why this surge?

- The US has shown the way to investors and government (the example was made visible by the press, its viability demonstrated by US economic growth, its recipes learned through European entrepreneurs established in the US and US VC funds crossing the Atlantic);
- Secondary financial markets were set up;
- Macro-economic conditions improved (in 1997), increasing the availability of funds;
- Deregulation in some industries opened new opportunities: telecoms;

- New policy in some countries: creation of government funds, fiscal measures etc. Creation of a more business friendly environment.

*Japan:* VC is very low as compared to other countries. This is related to the weak openness of some markets (telecoms), to the industry organisation (keiretsu, cross-shareholding limit the scope of entrepreneurial activity), to the job market (life long employment for the skilled reduces mobility and increases the risk of going to a small start-up firm), and to the absence of a secondary market where investors can exit. Japanese VC tend to invest small stakes in many firms (in 1998, the average size of a deal was US\$ 0.5 million in Japan, as compared to 4.7 in the US and to 1.1 in Europe), in order to diversify their risk. In FY1998, less than 2% of investment went to the creation of new firms, whereas more than 35% went to firms aged 20 years or more. VC funds do not get involved in the management of firms therefore not bringing expertise to the backed firms. Most funds ("VC associations") are affiliates of stock brokers, that make money by underwriting the floatation more than from their investment. The MITI is currently working on a new policy package aimed at fostering VC (that includes a government VC fund).

### **3. The contribution of VC to innovation and growth**

There is apparently only one quantitative study of the relationship between innovation and VC. Kortum and Lerner (1998) explore the experience of 20 US industries over a 30 years period. They find that, controlling for the amount of R&D, VC investment has a significant positive impact on patenting. VC, even though it is less than 3% of R&D, may be responsible for 15% of patenting in the 1990s. On a separate sample of firms, they show that not only VC backed firms patent more than similar, non VC backed firms, but also their patents are more cited and more aggressively litigated, which indicate a higher technological and economic value. Also, VC backed firms are more frequent litigators of trade secrets, which suggests that they are not simply patenting more in lieu of relying on trade secret protection.

Anecdotal evidence: Silicon valley has been boosted by VC. Most large high tech firms in recent decades have been the offspring of VC (Microsoft, Netscape, Compaq, Sun Microsystems, Intel, Apple, Digital Equipment Corp., Genentech, etc.). Over the last twenty-five years in the US, almost 3000 companies financed by venture funds have gone public

### **4. Policy aspects:**

VC is only one component of a broader system aimed at financing innovation in start-up firms. Its is one stage in the innovation chain that goes from investors (institutional, individuals) to entrepreneurs, and one stage in the financing process (from initial investors to IPO or acquisition). Therefore, a well functioning VC is important for the whole system, but it is not sufficient for giving momentum to innovation economy-wide. The experience of OECD countries suggest certain conditions that allow VC to play an active role in the broader innovation dynamics:

- Government VC funds may be useful in countries where VC is not yet developed, or for providing seed capital. Otherwise, government funds may crowd out private funds.
- Investment in VC funds by institutional investors (pension funds, life insurance funds, banks) should be allowed to the extent that it is compatible with prudential rules.
- Fiscal treatment of capital gains and revenues coming from investment in VC should be friendly, as the risk incurred by investors is higher than in other types of endeavours.

- Stock options should be allowed and taxed not too heavily: they are the only way for cash less firms to attract the human capital (technology and management skills) that must complement their financial capital.
- Secondary markets (NASDAQ type) should be created where they do not exist, so that investors can recoup liquidity securely.
- An entrepreneur friendly environment: simple conditions for the creation of firms, bankruptcy laws that protect to some extent the entrepreneur, encouragement for public and university research to be transferred to the business sector (incubators around universities).
- A general environment that support the openness of markets (e.g. telecoms, energy) and mobility of the labour force (especially for skilled workers)..

**Reference:**

Kortum S. and J. Lerner (1998), Does Venture Capital Spur Innovation? NBER Working Paper #6846.

# Sixth French-German Economic Forum

## Summary of the Proceedings

Bonn, 17-18 January 2000

The sixth French-German Economic Forum was held in Bonn on January 17-18, 2000. The meeting was co-organised by the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) and the Zentrum für Europäische Integrationsforschung (ZEI), and hosted by the latter. Two papers were presented. The first one was written by Jürgen von Hagen (ZEI) on "The European Central Bank: 1<sup>st</sup> Birthday". The second one was written by Dominique Guellec (OECD) on "Economic Growth in Europe: Entering a new Era?".

### ***Morning Session : The first year of EMU***

Jürgen von Hagen (ZEI) "The European Central Bank : 1<sup>st</sup> Birthday".

Three major points were presented: the process of introduction of the Euro, the external performance of the Euro, the integration of money and credit markets in the Euro zone and the monetary policy of the European Central Bank.

First, the smoothness of the transition process confirmed the soundness of the approach that was used: early announcing of the conversion rates combined with large bands. The lesson here was that any would-be member of the EMU should follow the same path, especially the UK which is reluctant to a tight exchange-rate commitment.

On the external front, the Euro weakened considerably during the year, against the Dollar, but also against other currencies, as witnessed by the similar depreciation of the effective exchange rate. Mr von Hagen explained this fact by the growth differential between the world and the Euro zone, and large Euro bond issues. The ECB did not seem worried by this outcome.

The EMU-wide money market was successfully implemented but some problems of liquidity management remained. Thanks to the introduction of the Euro, financial markets witnessed a large increase in bond market activities. However, two major points of worry remained: (i) the bidding procedure of the ECB, based on the use of fixed-rate tenders and a collateral requirement, was deemed inefficient as it encouraged banks to make phoney bids and excluded those short on reserve assets ; (ii) the parallel evolution of marginal borrowing and marginal lending in several instances proved the inefficiency of the inter-bank market ; (iii)



the persistence of risk premia (interest rate differentials) between EMU countries showed that the financial markets of the zone are still imperfectly integrated. These spreads could be explained by risk (interest payments as a share of GDP) and size factors.

Finally, the monetary policy strategy of the ECB aiming at medium-run price stability was judged confused by Mr von Hagen. According to him, the two pillars on which this strategy was officially based, M3 targeting and inflation targeting, were both trampled during the first year. Decisions on interest rates largely disregarded the variables that allegedly were the basis for the ECB strategy. Combined with a lack of transparency in the decision making of the ECB and methodological errors in evaluating credit demand, these discrepancies added to the surrounding uncertainties. The persistence of growth differentials added to the risks of a short-term management of the monetary policy.

Discussant: Pierre Jaillet (Banque de France)

Mr Jaillet agreed with the author on the transition strategy. He however stressed that, as shown by the experience of the pound entering the EMS in 1990, the exchange rate level should not be unilaterally fixed. Concerning the exchange rate of the Euro, he reminded that even though it was not the central bank main objective, the ECB officials had still made many declarations on this subject showing they did not neglect this matter. He reminded that some of the liquidity management problems identified by Mr von Hagen (EONIA spikes) were not new and already present for example in Germany during stage II of EMU. He judged Mr von Hagen severe in his assessment of the ECB strategy. First of all, he underlined the difficulties associated with measuring M3: according to him, in 1999, the growth of M3 was closer to five than to six per cent. In addition, a reference value (as opposed to a target) for money growth does not imply automatic adjustment in reaction to discrepancies. With all this in mind, the strategy of the central bank was rather consistent with what was announced. However, the discussant reminded that one year is a very short time to take stock of the ECB's single monetary policy given the remaining uncertainties (e.g. how to deal with possible asymmetric shocks without federal fiscal transfers?).

Discussant Jens Weidmann (Sachverständigenrat)

Mr Weidmann confirmed that the integration of financial money markets was still far from complete. This was proved by still large differences in risk premia and bid-ask spreads for overnight interbank rates. The solution was to implement structural reforms in clearing and settlements procedures and to curb down the persisting protectionist trends of some countries. He however deemed the size factor to have no impact on the risk premium once a general assessment indicator (SP rating) was included. Concerning the ECB strategy, he

underlined the time varying relative importance given to the two pillars. This helped to better understanding of the ECB decisions. Mr Weidmann however blamed the ECB for its lack of transparency which could undermine credibility.

### General Discussion

The general discussion began by an evaluation of the remaining disparities in Europe: the imperfect integration of European markets combined with various stages in the business cycle were part of the difficulty of devising the optimal monetary policy for the whole Euro-zone. The discussion centred on the objectives of the ECB, the transparency of its strategy and the decision-making process of the bank.

The neglect of the ECB towards the external value of the Euro was criticised by some participants. It was questioned whether the DM had not entered EMU while being overvalued. However, the negative supply shock suffered by Germany at the end of 1998 led some to think it was not so. The question of whether the low value of the Euro was due to the business cycle, to the lack of perception by the outside of Euro-zone policies, or by structural problems, had to be answered to determine if the ECB was to intervene.

The medium run objective of price stability led to lively discussions about the interpretation of inflation data in the Euro-zone. It was noted that the inflation in asset prices was not taken into account by the ECB, which could prove problematic in the future. The higher than 2% observed inflation in periphery countries of the zone was said by some to be possibly a one-shot adjustment due to a catching-up process, so the lack of reaction of the ECB was not problematic. However the temporary nature of these figures was questioned, leading to fears of an upswing in inflation.

Many participants criticised the ECB for its lack of transparency in explaining its strategy, which added to the uncertainties of the economic context. The ECB could improve the way it conveyed information to the markets and learn from the Fed. However the expectation-shaping role of a central bank was deemed secondary by some. This commitment problem led to diverging views concerning the strategy to be publicised.

Some participants thought the ECB should clearly indicate the variables influencing its decisions. From this point of view, it was dangerous for the bank to focus one year on output gaps and the following year on wages increases. If the bank acted on monetary targeting as indicated by the first pillar, it should have reacted to the M3 figure, as the delays of reaction could prove costly in terms of inflation. The second pillar strategy (inflation targeting) was preferred by some participants, but judged dangerous by others who pointed out that it requires finding the correct model linking the different macro variables and monetary

aggregates. One participant pointed out the lack of transparency of the model used by the ECB for this second pillar.

Others stressed that delivering the goodies were more important than following rules. They reminded that the Bundesbank had not always respected its M3 growth target. Credibility of the ECB would be determined by its capacity to curb down inflation, not by having a M3 growth of 4,5% a year. The uncertainties surrounding the actual M3 growth necessitated taking into account other aggregates to forecast inflation. The ECB decision to base its policy on targeting an observed variable led to fewer interest rates changes. This policy was sound since targeting an expected variable like M3 would have entailed more volatility in the short run. The latter solution would maybe be ok for the UK as many variables were fully indexed on short-term rates, but not for the Euro-zone.

Apart from the general strategy of the ECB, there were some fears about the decision-making process of the bank: some participants thought that the board was not strong enough to stand up against national governors, and that the consensus principle was an error ; others worried about the future of the decision-making process when EMU is enlarged.

### ***Afternoon Session : Prospects for Economic Growth in Europe***

Dominique Guellec (OECD) "Economic Growth in Europe: Entering a New Era?"

The second paper tried to answer four questions: (i) how can US growth 1990s be explained? (ii) what was its background? (iii) after a rather dismal decade, what are the prospects for Europe in this light? (iv) what policies are needed to raise growth rates?

The strong performance of the US economy has given birth to various explanations. One is the "new economy" paradigm, also called the technological point of view, according to which a deep structural change driven by regulatory reforms and ICT industries has taken place in the US, enabling strong sustainable growth without inflation. Another explanation focuses on macroeconomic factors such as sensible monetary policies, short-term factors and the emergence of a possible bubble economy.

Whatever the reasons behind such changes, the macroeconomic consequences are numerous: a rise in inequalities during the first stage, followed by a recent decrease; numerous impacts on the labour markets; surge in investment.

According to Mr Guellec, the two views should not necessarily be opposed: both acknowledge the importance of structural reforms, globalisation and innovation.

In a world of increasing returns, Europe suffers from the still imperfect integration of its markets. Structural reforms such as deregulation and privatisation are needed to speed up the integration process and increase flexibility and competition, leading to the creation of European champions able to compete on the international scene. The same structural reforms are also necessary in the scientific and academic world to help promote innovation in Europe.

Discussant Anton Brender (CPR)

Mr Brender stressed the very strong macroeconomic implications of the extreme view of the new age economy: end of inflation and of business cycles, increase in growth and in corporate profits, very strong rise in stock prices. The soft version of this new paradigm led “only” to a rise in investment and productivity. So it is necessary to fully take into account the often neglected macro factors. The previous errors in forecasts (for example, how the short-term view of US firms was deemed to be an handicap compared to long-term planning Japanese firms in the 1980’s) reminds us of the need to fully understand the broad picture before implementing irreversible reforms. Concerning Europe, the pattern of job creations in the US, which took place at the two ends of the scale of qualification and pay, may not be acceptable.

Discussant Renate Hornung-Draus (Bundesvereinigung der Deutschen Arbeitgeberverbände)

Mrs Hornung-Draus stressed the importance of having better institutions in the actual economic context. Mentalities also need to evolve. She underlined that, despite the numerous break-up of barriers between European countries, goods and scientific markets were still very fragmented. She noted that there were many pre-requisites for successfully undergoing the change to this new Knowledge-Based Economy (KBE). Because of the present rigidities, she feared Europe did not meet those pre-requisites for the moment. There were still too little contact between industry and research. The education system needed to be improved; in particular, long-life continuous training and formation had to be developed to help an ageing population absorbing the increasingly quick technological change. She wondered whether the author’s proposal to develop scientific pools of excellence would not jeopardise general education in Europe. The microeconomic changes induced by the KBE needed to be fully understood so as to help reaching the optimal regulation and social bargaining process.

## General Discussion

The discussion focused on the reforms Europe needed to raise growth rates while limiting the rise in inequalities.

The deregulation solution was judged by some not to be a solution *per se*: even though there is a need for greater competition and efficiency gains in the Euro-zone, increasing returns to scale in some of the new high growth sectors could justify governments intervention. The example of a common standard for mobile phones in the EU supported this view.

The early start of the US economy had some wondering whether Europe would catch-up automatically, or if reforms were needed to fill the gap. It was however noted that catching-up was by no means systematic.

The data itself raised several questions: why did the break in the productivity trend in the US happened in 1995? Is this break temporary or permanent? It was noted that every technological revolution took a long time to bring benefits; it required organisational changes and it raised inequalities temporarily.

Two views conflicted on the impact of technical change on the labour markets: both views acknowledged that entering this “New Age economy“ raised inequalities in a first stage, but had different medium-run implications. Some participants thought that recent technology changes were biased against low-skilled labour, whereas others wondered whether capital deepening enabled more people to enter the labour market, which would explain the recent decrease of inequalities observed in the US. This brought the question of whether structural reforms were not needed very quickly so as to enable European economies to reach this stage of decreasing inequalities. Whatever the causes, there had been changes in the negotiation process in labour markets.

A very close study of macroeconomic factors was needed to understand the nature and the scope of the recent evolutions: a “New Economy”, or just business cycle as usual. Several participants worried about the ability of the ECB to perform as well as the Federal Reserve in monitoring a non-inflationary growth.

Jean-Louis Guérin  
CEPII

<b>2008</b>		
B01-08	<b>Euro-Diplomatie durch gemeinsame „Wirtschaftsregierung“</b>	<i>Martin Seidel</i>
<b>2007</b>		
B03-07	<b>Löhne und Steuern im Systemwettbewerb der Mitgliedstaaten der Europäischen Union</b>	<i>Martin Seidel</i>
B02-07	<b>Konsolidierung und Reform der Europäischen Union</b>	<i>Martin Seidel</i>
B01-07	<b>The Ratification of European Treaties - Legal and Constitutional Basis of a European Referendum.</b>	<i>Martin Seidel</i>
<b>2006</b>		
B03-06	<b>Financial Frictions, Capital Reallocation, and Aggregate Fluctuations</b>	<i>Jürgen von Hagen, Haiping Zhang</i>
B02-06	<b>Financial Openness and Macroeconomic Volatility</b>	<i>Jürgen von Hagen, Haiping Zhang</i>
B01-06	<b>A Welfare Analysis of Capital Account Liberalization</b>	<i>Jürgen von Hagen, Haiping Zhang</i>
<b>2005</b>		
B11-05	<b>Das Kompetenz- und Entscheidungssystem des Vertrages von Rom im Wandel seiner Funktion und Verfassung</b>	<i>Martin Seidel</i>
B10-05	<b>Die Schutzklauseln der Beitrittsverträge</b>	<i>Martin Seidel</i>
B09-05	<b>Measuring Tax Burdens in Europe</b>	<i>Guntram B. Wolff</i>
B08-05	<b>Remittances as Investment in the Absence of Altruism</b>	<i>Gabriel González-König</i>
B07-05	<b>Economic Integration in a Multicore World?</b>	<i>Christian Volpe Martincus, Jennifer Pédussel Wu</i>
B06-05	<b>Banking Sector (Under?)Development in Central and Eastern Europe</b>	<i>Jürgen von Hagen, Valeriya Dinger</i>
B05-05	<b>Regulatory Standards Can Lead to Predation</b>	<i>Stefan Lutz</i>
B04-05	<b>Währungspolitik als Sozialpolitik</b>	<i>Martin Seidel</i>
B03-05	<b>Public Education in an Integrated Europe: Studying to Migrate and Teaching to Stay?</b>	<i>Panu Poutvaara</i>
B02-05	<b>Voice of the Diaspora: An Analysis of Migrant Voting Behavior</b>	<i>Jan Fidrmuc, Orla Doyle</i>
B01-05	<b>Macroeconomic Adjustment in the New EU Member States</b>	<i>Jürgen von Hagen, Iulia Traistaru</i>
<b>2004</b>		
B33-04	<b>The Effects of Transition and Political Instability On Foreign Direct Investment Inflows: Central Europe and the Balkans</b>	<i>Josef C. Brada, Ali M. Kutan, Tanner M. Yigit</i>
B32-04	<b>The Choice of Exchange Rate Regimes in Developing Countries: A Multinomial Panel Analysis</b>	<i>Jürgen von Hagen, Jizhong Zhou</i>
B31-04	<b>Fear of Floating and Fear of Pegging: An Empirical Analysis of De Facto Exchange Rate Regimes in Developing Countries</b>	<i>Jürgen von Hagen, Jizhong Zhou</i>
B30-04	<b>Der Vollzug von Gemeinschaftsrecht über die Mitgliedstaaten und seine Rolle für die EU und den Beitrittsprozess</b>	<i>Martin Seidel</i>
B29-04	<b>Deutschlands Wirtschaft, seine Schulden und die Unzulänglichkeiten der einheitlichen Geldpolitik im Eurosystem</b>	<i>Dieter Spethmann, Otto Steiger</i>
B28-04	<b>Fiscal Crises in U.S. Cities: Structural and Non-structural Causes</b>	<i>Guntram B. Wolff</i>
B27-04	<b>Firm Performance and Privatization in Ukraine</b>	<i>Galyna Grygorenko, Stefan Lutz</i>
B26-04	<b>Analyzing Trade Opening in Ukraine: Effects of a Customs Union with the EU</b>	<i>Oksana Harbuzyuk, Stefan Lutz</i>
B25-04	<b>Exchange Rate Risk and Convergence to the Euro</b>	<i>Lucjan T. Orlowski</i>
B24-04	<b>The Endogeneity of Money and the Eurosystem</b>	<i>Otto Steiger</i>
B23-04	<b>Which Lender of Last Resort for the Eurosystem?</b>	<i>Otto Steiger</i>
B22-04	<b>Non-Discretionary Monetary Policy: The Answer for Transition Economies?</b>	<i>Elham-Mafi Kreft, Steven F. Kreft</i>
B21-04	<b>The Effectiveness of Subsidies Revisited: Accounting for Wage and Employment Effects in Business R+D</b>	<i>Volker Reinthaler, Guntram B. Wolff</i>
B20-04	<b>Money Market Pressure and the Determinants of Banking Crises</b>	<i>Jürgen von Hagen, Tai-kuang Ho</i>
B19-04	<b>Die Stellung der Europäischen Zentralbank nach dem Verfassungsvertrag</b>	<i>Martin Seidel</i>

B18-04	<b>Transmission Channels of Business Cycles Synchronization in an Enlarged EMU</b>	<i>Iulia Traistaru</i>
B17-04	<b>Foreign Exchange Regime, the Real Exchange Rate and Current Account Sustainability: The Case of Turkey</b>	<i>Sübüdey Togan, Hasan Ersel</i>
B16-04	<b>Does It Matter Where Immigrants Work? Traded Goods, Non-traded Goods, and Sector Specific Employment</b>	<i>Harry P. Bowen, Jennifer Pédussel Wu</i>
B15-04	<b>Do Economic Integration and Fiscal Competition Help to Explain Local Patterns?</b>	<i>Christian Volpe Martincus</i>
B14-04	<b>Euro Adoption and Maastricht Criteria: Rules or Discretion?</b>	<i>Jiri Jonas</i>
B13-04	<b>The Role of Electoral and Party Systems in the Development of Fiscal Institutions in the Central and Eastern European Countries</b>	<i>Sami Yläoutinen</i>
B12-04	<b>Measuring and Explaining Levels of Regional Economic Integration</b>	<i>Jennifer Pédussel Wu</i>
B11-04	<b>Economic Integration and Location of Manufacturing Activities: Evidence from MERCOSUR</b>	<i>Pablo Sanguinetti, Iulia Traistaru, Christian Volpe Martincus</i>
B10-04	<b>Economic Integration and Industry Location in Transition Countries</b>	<i>Laura Resmini</i>
B09-04	<b>Testing Creditor Moral Hazard in Sovereign Bond Markets: A Unified Theoretical Approach and Empirical Evidence</b>	<i>Ayse Y. Evrensel, Ali M. Kutan</i>
B08-04	<b>European Integration, Productivity Growth and Real Convergence</b>	<i>Taner M. Yigit, Ali M. Kutan</i>
B07-04	<b>The Contribution of Income, Social Capital, and Institutions to Human Well-being in Africa</b>	<i>Mina Balamoune-Lutz, Stefan H. Lutz</i>
B06-04	<b>Rural Urban Inequality in Africa: A Panel Study of the Effects of Trade Liberalization and Financial Deepening</b>	<i>Mina Balamoune-Lutz, Stefan H. Lutz</i>
B05-04	<b>Money Rules for the Eurozone Candidate Countries</b>	<i>Lucjan T. Orłowski</i>
B04-04	<b>Who is in Favor of Enlargement? Determinants of Support for EU Membership in the Candidate Countries' Referenda</b>	<i>Orla Doyle, Jan Fidrmuc</i>
B03-04	<b>Over- and Underbidding in Central Bank Open Market Operations Conducted as Fixed Rate Tender</b>	<i>Ulrich Bindseil</i>
B02-04	<b>Total Factor Productivity and Economic Freedom Implications for EU Enlargement</b>	<i>Ronald L. Moomaw, Euy Seok Yang</i>
B01-04	<b>Die neuen Schutzklauseln der Artikel 38 und 39 des Beitrittsvertrages: Schutz der alten Mitgliedstaaten vor Störungen durch die neuen Mitgliedstaaten</b>	<i>Martin Seidel</i>
<b>2003</b>		
B29-03	<b>Macroeconomic Implications of Low Inflation in the Euro Area</b>	<i>Jürgen von Hagen, Boris Hofmann</i>
B28-03	<b>The Effects of Transition and Political Instability on Foreign Direct Investment: Central Europe and the Balkans</b>	<i>Josef C. Brada, Ali M. Kutan, Taner M. Yigit</i>
B27-03	<b>The Performance of the Euribor Futures Market: Efficiency and the Impact of ECB Policy Announcements (Electronic Version of International Finance)</b>	<i>Kerstin Bernoth, Juergen von Hagen</i>
B26-03	<b>Sovereign Risk Premia in the European Government Bond Market (überarbeitete Version zum Herunterladen)</b>	<i>Kerstin Bernoth, Juergen von Hagen, Ludger Schulknecht</i>
B25-03	<b>How Flexible are Wages in EU Accession Countries?</b>	<i>Anna Iara, Iulia Traistaru</i>
B24-03	<b>Monetary Policy Reaction Functions: ECB versus Bundesbank</b>	<i>Bernd Hayo, Boris Hofmann</i>
B23-03	<b>Economic Integration and Manufacturing Concentration Patterns: Evidence from Mercosur</b>	<i>Iulia Traistaru, Christian Volpe Martincus</i>
B22-03	<b>Reformzwänge innerhalb der EU angesichts der Osterweiterung</b>	<i>Martin Seidel</i>
B21-03	<b>Reputation Flows: Contractual Disputes and the Channels for Inter-Firm Communication</b>	<i>William Pyle</i>
B20-03	<b>Urban Primacy, Gigantism, and International Trade: Evidence from Asia and the Americas</b>	<i>Ronald L. Moomaw, Mohammed A. Alwosabi</i>
B19-03	<b>An Empirical Analysis of Competing Explanations of Urban Primacy Evidence from Asia and the Americas</b>	<i>Ronald L. Moomaw, Mohammed A. Alwosabi</i>

B18-03	<b>The Effects of Regional and Industry-Wide FDI Spillovers on Export of Ukrainian Firms</b>	<i>Stefan H. Lutz, Oleksandr Talavera, Sang-Min Park</i>
B17-03	<b>Determinants of Inter-Regional Migration in the Baltic States</b>	<i>Mihails Hazans</i>
B16-03	<b>South-East Europe: Economic Performance, Perspectives, and Policy Challenges</b>	<i>Iulia Traistaru, Jürgen von Hagen</i>
B15-03	<b>Employed and Unemployed Search: The Marginal Willingness to Pay for Attributes in Lithuania, the US and the Netherlands</b>	<i>Jos van Ommeren, Mihails Hazans</i>
B14-03	<b>FCIs and Economic Activity: Some International Evidence</b>	<i>Charles Goodhart, Boris Hofmann</i>
B13-03	<b>The IS Curve and the Transmission of Monetary Policy: Is there a Puzzle?</b>	<i>Charles Goodhart, Boris Hofmann</i>
B12-03	<b>What Makes Regions in Eastern Europe Catching Up? The Role of Foreign Investment, Human Resources, and Geography</b>	<i>Gabriele Tondl, Goran Vuksic</i>
B11-03	<b>Die Weisungs- und Herrschaftsmacht der Europäischen Zentralbank im europäischen System der Zentralbanken - eine rechtliche Analyse</b>	<i>Martin Seidel</i>
B10-03	<b>Foreign Direct Investment and Perceptions of Vulnerability to Foreign Exchange Crises: Evidence from Transition Economies</b>	<i>Josef C. Brada, Vladimír Tomsík</i>
B09-03	<b>The European Central Bank and the Eurosystem: An Analysis of the Missing Central Monetary Institution in European Monetary Union</b>	<i>Gunnar Heinsohn, Otto Steiger</i>
B08-03	<b>The Determination of Capital Controls: Which Role Do Exchange Rate Regimes Play?</b>	<i>Jürgen von Hagen, Jizhong Zhou</i>
B07-03	<b>Nach Nizza und Stockholm: Stand des Binnenmarktes und Prioritäten für die Zukunft</b>	<i>Martin Seidel</i>
B06-03	<b>Fiscal Discipline and Growth in Euroland. Experiences with the Stability and Growth Pact</b>	<i>Jürgen von Hagen</i>
B05-03	<b>Reconsidering the Evidence: Are Eurozone Business Cycles Converging?</b>	<i>Michael Massmann, James Mitchell</i>
B04-03	<b>Do Ukrainian Firms Benefit from FDI?</b>	<i>Stefan H. Lutz, Oleksandr Talavera</i>
B03-03	<b>Europäische Steuerkoordination und die Schweiz</b>	<i>Stefan H. Lutz</i>
B02-03	<b>Commuting in the Baltic States: Patterns, Determinants, and Gains</b>	<i>Mihails Hazans</i>
B01-03	<b>Die Wirtschafts- und Währungsunion im rechtlichen und politischen Gefüge der Europäischen Union</b>	<i>Martin Seidel</i>
<b>2002</b>		
B30-02	<b>An Adverse Selection Model of Optimal Unemployment Assurance</b>	<i>Marcus Hagedorn, Ashok Kaul, Tim Mennel</i>
B29B-02	<b>Trade Agreements as Self-protection</b>	<i>Jennifer Pédussel Wu</i>
B29A-02	<b>Growth and Business Cycles with Imperfect Credit Markets</b>	<i>Debajyoti Chakrabarty</i>
B28-02	<b>Inequality, Politics and Economic Growth</b>	<i>Debajyoti Chakrabarty</i>
B27-02	<b>Poverty Traps and Growth in a Model of Endogenous Time Preference</b>	<i>Debajyoti Chakrabarty</i>
B26-02	<b>Monetary Convergence and Risk Premiums in the EU Candidate Countries</b>	<i>Lucjan T. Orlowski</i>
B25-02	<b>Trade Policy: Institutional Vs. Economic Factors</b>	<i>Stefan Lutz</i>
B24-02	<b>The Effects of Quotas on Vertical Intra-industry Trade</b>	<i>Stefan Lutz</i>
B23-02	<b>Legal Aspects of European Economic and Monetary Union</b>	<i>Martin Seidel</i>
B22-02	<b>Der Staat als Lender of Last Resort - oder: Die Achillesverse des Eurosystems</b>	<i>Otto Steiger</i>
B21-02	<b>Nominal and Real Stochastic Convergence Within the Transition Economies and to the European Union: Evidence from Panel Data</b>	<i>Ali M. Kutan, Taner M. Yigit</i>
B20-02	<b>The Impact of News, Oil Prices, and International Spillovers on Russian Financial Markets</b>	<i>Bernd Hayo, Ali M. Kutan</i>



B19-02	<b>East Germany: Transition with Unification, Experiments and Experiences</b>	<i>Jürgen von Hagen, Rolf R. Strauch, Guntram B. Wolff</i>
B18-02	<b>Regional Specialization and Employment Dynamics in Transition Countries</b>	<i>Iulia Traistaru, Guntram B. Wolff</i>
B17-02	<b>Specialization and Growth Patterns in Border Regions of Accession Countries</b>	<i>Laura Resmini</i>
B16-02	<b>Regional Specialization and Concentration of Industrial Activity in Accession Countries</b>	<i>Iulia Traistaru, Peter Nijkamp, Simonetta Longhi</i>
B15-02	<b>Does Broad Money Matter for Interest Rate Policy?</b>	<i>Matthias Brückner, Andreas Schaber</i>
B14-02	<b>The Long and Short of It: Global Liberalization, Poverty and Inequality</b>	<i>Christian E. Weller, Adam Hersch</i>
B13-02	<b>De Facto and Official Exchange Rate Regimes in Transition Economies</b>	<i>Jürgen von Hagen, Jizhong Zhou</i>
B12-02	<b>Argentina: The Anatomy of A Crisis</b>	<i>Jiri Jonas</i>
B11-02	<b>The Eurosystem and the Art of Central Banking</b>	<i>Gunnar Heinsohn, Otto Steiger</i>
B10-02	<b>National Origins of European Law: Towards an Autonomous System of European Law?</b>	<i>Martin Seidel</i>
B09-02	<b>Monetary Policy in the Euro Area - Lessons from the First Years</b>	<i>Volker Clausen, Bernd Hayo</i>
B08-02	<b>Has the Link Between the Spot and Forward Exchange Rates Broken Down? Evidence From Rolling Cointegration Tests</b>	<i>Ali M. Kutan, Su Zhou</i>
B07-02	<b>Perspektiven der Erweiterung der Europäischen Union</b>	<i>Martin Seidel</i>
B06-02	<b>Is There Asymmetry in Forward Exchange Rate Bias? Multi-Country Evidence</b>	<i>Su Zhou, Ali M. Kutan</i>
B05-02	<b>Real and Monetary Convergence Within the European Union and Between the European Union and Candidate Countries: A Rolling Cointegration Approach</b>	<i>Josef C. Brada, Ali M. Kutan, Su Zhou</i>
B04-02	<b>Asymmetric Monetary Policy Effects in EMU</b>	<i>Volker Clausen, Bernd Hayo</i>
B03-02	<b>The Choice of Exchange Rate Regimes: An Empirical Analysis for Transition Economies</b>	<i>Jürgen von Hagen, Jizhong Zhou</i>
B02-02	<b>The Euro System and the Federal Reserve System Compared: Facts and Challenges</b>	<i>Karlheinz Ruckriegel, Franz Seitz</i>
B01-02	<b>Does Inflation Targeting Matter?</b>	<i>Manfred J. M. Neumann, Jürgen von Hagen</i>
<b>2001</b>		
B29-01	<b>Is Kazakhstan Vulnerable to the Dutch Disease?</b>	<i>Karlygash Kuralbayeva, Ali M. Kutan, Michael L. Wyzan</i>
B28-01	<b>Political Economy of the Nice Treaty: Rebalancing the EU Council. The Future of European Agricultural Policies</b>	<i>Deutsch-Französisches Wirtschaftspolitisches Forum</i>
B27-01	<b>Investor Panic, IMF Actions, and Emerging Stock Market Returns and Volatility: A Panel Investigation</b>	<i>Bernd Hayo, Ali M. Kutan</i>
B26-01	<b>Regional Effects of Terrorism on Tourism: Evidence from Three Mediterranean Countries</b>	<i>Konstantinos Drakos, Ali M. Kutan</i>
B25-01	<b>Monetary Convergence of the EU Candidates to the Euro: A Theoretical Framework and Policy Implications</b>	<i>Lucjan T. Orłowski</i>
B24-01	<b>Disintegration and Trade</b>	<i>Jarko and Jan Fidrmuc</i>
B23-01	<b>Migration and Adjustment to Shocks in Transition Economies</b>	<i>Jan Fidrmuc</i>
B22-01	<b>Strategic Delegation and International Capital Taxation</b>	<i>Matthias Brückner</i>
B21-01	<b>Balkan and Mediterranean Candidates for European Union Membership: The Convergence of Their Monetary Policy With That of the European Central Bank</b>	<i>Josef C. Brada, Ali M. Kutan</i>
B20-01	<b>An Empirical Inquiry of the Efficiency of Intergovernmental Transfers for Water Projects Based on the WRDA Data</b>	<i>Anna Rubinchik-Pessach</i>
B19-01	<b>Detrending and the Money-Output Link: International Evidence</b>	<i>R.W. Hafer, Ali M. Kutan</i>

B18-01	<b>Monetary Policy in Unknown Territory. The European Central Bank in the Early Years</b>	<i>Jürgen von Hagen, Matthias Brückner</i>
B17-01	<b>Executive Authority, the Personal Vote, and Budget Discipline in Latin American and Caribbean Countries</b>	<i>Mark Hallerberg, Patrick Marier</i>
B16-01	<b>Sources of Inflation and Output Fluctuations in Poland and Hungary: Implications for Full Membership in the European Union</b>	<i>Selahattin Dibooglu, Ali M. Kutan</i>
B15-01	<b>Programs Without Alternative: Public Pensions in the OECD</b>	<i>Christian E. Weller</i>
B14-01	<b>Formal Fiscal Restraints and Budget Processes As Solutions to a Deficit and Spending Bias in Public Finances - U.S. Experience and Possible Lessons for EMU</b>	<i>Rolf R. Strauch, Jürgen von Hagen</i>
B13-01	<b>German Public Finances: Recent Experiences and Future Challenges</b>	<i>Jürgen von Hagen, Rolf R. Strauch</i>
B12-01	<b>The Impact of Eastern Enlargement On EU-Labour Markets. Pensions Reform Between Economic and Political Problems</b>	<i>Deutsch-Französisches Wirtschaftspolitisches Forum</i>
B11-01	<b>Inflationary Performance in a Monetary Union With Large Wage Setters</b>	<i>Lilia Cavallar</i>
B10-01	<b>Integration of the Baltic States into the EU and Institutions of Fiscal Convergence: A Critical Evaluation of Key Issues and Empirical Evidence</b>	<i>Ali M. Kutan, Niina Pautola-Mol</i>
B09-01	<b>Democracy in Transition Economies: Grease or Sand in the Wheels of Growth?</b>	<i>Jan Fidrmuc</i>
B08-01	<b>The Functioning of Economic Policy Coordination</b>	<i>Jürgen von Hagen, Susanne Mundschenk</i>
B07-01	<b>The Convergence of Monetary Policy Between Candidate Countries and the European Union</b>	<i>Josef C. Brada, Ali M. Kutan</i>
B06-01	<b>Opposites Attract: The Case of Greek and Turkish Financial Markets</b>	<i>Konstantinos Drakos, Ali M. Kutan</i>
B05-01	<b>Trade Rules and Global Governance: A Long Term Agenda. The Future of Banking.</b>	<i>Deutsch-Französisches Wirtschaftspolitisches Forum</i>
B04-01	<b>The Determination of Unemployment Benefits</b>	<i>Rafael di Tella, Robert J. McCulloch</i>
B03-01	<b>Preferences Over Inflation and Unemployment: Evidence from Surveys of Happiness</b>	<i>Rafael di Tella, Robert J. McCulloch, Andrew J. Oswald</i>
B02-01	<b>The Konstanz Seminar on Monetary Theory and Policy at Thirty</b>	<i>Michele Fratianni, Jürgen von Hagen</i>
B01-01	<b>Divided Boards: Partisanship Through Delegated Monetary Policy</b>	<i>Etienne Farvaque, Gael Lagadec</i>
<b>2000</b>		
B20-00	<b>Breakin-up a Nation, From the Inside</b>	<i>Etienne Farvaque</i>
B19-00	<b>Income Dynamics and Stability in the Transition Process, general Reflections applied to the Czech Republic</b>	<i>Jens Hölscher</i>
B18-00	<b>Budget Processes: Theory and Experimental Evidence</b>	<i>Karl-Martin Ehrhart, Roy Gardner, Jürgen von Hagen, Claudia Keser</i>
B17-00	<b>Rückführung der Landwirtschaftspolitik in die Verantwortung der Mitgliedsstaaten? - Rechts- und Verfassungsfragen des Gemeinschaftsrechts</b>	<i>Martin Seidel</i>
B16-00	<b>The European Central Bank: Independence and Accountability</b>	<i>Christa Randzio-Plath, Tomasso Padoa-Schioppa</i>
B15-00	<b>Regional Risk Sharing and Redistribution in the German Federation</b>	<i>Jürgen von Hagen, Ralf Hepp</i>
B14-00	<b>Sources of Real Exchange Rate Fluctuations in Transition Economies: The Case of Poland and Hungary</b>	<i>Selahattin Dibooglu, Ali M. Kutan</i>
B13-00	<b>Back to the Future: The Growth Prospects of Transition Economies Reconsidered</b>	<i>Nauro F. Campos</i>

B12-00	<b>Rechtsetzung und Rechtsangleichung als Folge der Einheitlichen Europäischen Wahrung</b>	<i>Martin Seidel</i>
B11-00	<b>A Dynamic Approach to Inflation Targeting in Transition Economies</b>	<i>Lucjan T. Orlowski</i>
B10-00	<b>The Importance of Domestic Political Institutions: Why and How Belgium Qualified for EMU</b>	<i>Marc Hallerberg</i>
B09-00	<b>Rational Institutions Yield Hysteresis</b>	<i>Rafael Di Tella, Robert MacCulloch</i>
B08-00	<b>The Effectiveness of Self-Protection Policies for Safeguarding Emerging Market Economies from Crises</b>	<i>Kenneth Kletzer</i>
B07-00	<b>Financial Supervision and Policy Coordination in The EMU</b>	<i>Deutsch-Franzosisches Wirtschaftspolitisches Forum</i>
B06-00	<b>The Demand for Money in Austria</b>	<i>Bernd Hayo</i>
B05-00	<b>Liberalization, Democracy and Economic Performance during Transition</b>	<i>Jan Fidrmuc</i>
B04-00	<b>A New Political Culture in The EU - Democratic Accountability of the ECB</b>	<i>Christa Randzio-Plath</i>
B03-00	<b>Integration, Disintegration and Trade in Europe: Evolution of Trade Relations during the 1990's</b>	<i>Jarko Fidrmuc, Jan Fidrmuc</i>
B02-00	<b>Inflation Bias and Productivity Shocks in Transition Economies: The Case of the Czech Republic</b>	<i>Josef C. Brada, Arthur E. King, Ali M. Kutan</i>
B01-00	<b>Monetary Union and Fiscal Federalism</b>	<i>Kenneth Kletzer, Jurgen von Hagen</i>
<b>1999</b>		
B26-99	<b>Skills, Labour Costs, and Vertically Differentiated Industries: A General Equilibrium Analysis</b>	<i>Stefan Lutz, Alessandro Turrini</i>
B25-99	<b>Micro and Macro Determinants of Public Support for Market Reforms in Eastern Europe</b>	<i>Bernd Hayo</i>
B24-99	<b>What Makes a Revolution?</b>	<i>Robert MacCulloch</i>
B23-99	<b>Informal Family Insurance and the Design of the Welfare State</b>	<i>Rafael Di Tella, Robert MacCulloch</i>
B22-99	<b>Partisan Social Happiness</b>	<i>Rafael Di Tella, Robert MacCulloch</i>
B21-99	<b>The End of Moderate Inflation in Three Transition Economies?</b>	<i>Josef C. Brada, Ali M. Kutan</i>
B20-99	<b>Subnational Government Bailouts in Germany</b>	<i>Helmut Seitz</i>
B19-99	<b>The Evolution of Monetary Policy in Transition Economies</b>	<i>Ali M. Kutan, Josef C. Brada</i>
B18-99	<b>Why are Eastern Europe's Banks not failing when everybody else's are?</b>	<i>Christian E. Weller, Bernard Morzuch</i>
B17-99	<b>Stability of Monetary Unions: Lessons from the Break-Up of Czechoslovakia</b>	<i>Jan Fidrmuc, Julius Horvath and Jarko Fidrmuc</i>
B16-99	<b>Multinational Banks and Development Finance</b>	<i>Christian E. Weller and Mark J. Scher</i>
B15-99	<b>Financial Crises after Financial Liberalization: Exceptional Circumstances or Structural Weakness?</b>	<i>Christian E. Weller</i>
B14-99	<b>Industry Effects of Monetary Policy in Germany</b>	<i>Bernd Hayo and Birgit Uhlenbrock</i>
B13-99	<b>Financial Fragility or What Went Right and What Could Go Wrong in Central European Banking?</b>	<i>Christian E. Weller and Jurgen von Hagen</i>
B12-99	<b>Size Distortions of Tests of the Null Hypothesis of Stationarity: Evidence and Implications for Applied Work</b>	<i>Mehmet Caner and Lutz Kilian</i>
B11-99	<b>Financial Supervision and Policy Coordination in the EMU</b>	<i>Deutsch-Franzosisches Wirtschaftspolitisches Forum</i>
B10-99	<b>Financial Liberalization, Multinational Banks and Credit Supply: The Case of Poland</b>	<i>Christian Weller</i>
B09-99	<b>Monetary Policy, Parameter Uncertainty and Optimal Learning</b>	<i>Volker Wieland</i>
B08-99	<b>The Connection between more Multinational Banks and less Real Credit in Transition Economies</b>	<i>Christian Weller</i>

- B07-99 **Comovement and Catch-up in Productivity across Sectors: Evidence from the OECD** *Christopher M. Cornwell and Jens-Uwe Wächter*
- B06-99 **Productivity Convergence and Economic Growth: A Frontier Production Function Approach** *Christopher M. Cornwell and Jens-Uwe Wächter*
- B05-99 **Tumbling Giant: Germany's Experience with the Maastricht Fiscal Criteria** *Jürgen von Hagen and Rolf Strauch*
- B04-99 **The Finance-Investment Link in a Transition Economy: Evidence for Poland from Panel Data** *Christian Weller*
- B03-99 **The Macroeconomics of Happiness** *Rafael Di Tella, Robert McCulloch and Andrew J. Oswald*
- B02-99 **The Consequences of Labour Market Flexibility: Panel Evidence Based on Survey Data** *Rafael Di Tella and Robert McCulloch*
- B01-99 **The Excess Volatility of Foreign Exchange Rates: Statistical Puzzle or Theoretical Artifact?** *Robert B.H. Hauswald*
- 1998**
- B16-98 **Labour Market + Tax Policy in the EMU** *Deutsch-Französisches Wirtschaftspolitisches Forum*
- B15-98 **Can Taxing Foreign Competition Harm the Domestic Industry?** *Stefan Lutz*
- B14-98 **Free Trade and Arms Races: Some Thoughts Regarding EU-Russian Trade** *Rafael Reuveny and John Maxwell*
- B13-98 **Fiscal Policy and Intranational Risk-Sharing** *Jürgen von Hagen*
- B12-98 **Price Stability and Monetary Policy Effectiveness when Nominal Interest Rates are Bounded at Zero** *Athanasios Orphanides and Volker Wieland*
- B11A-98 **Die Bewertung der "dauerhaft tragbaren öffentlichen Finanzlage" der EU Mitgliedstaaten beim Übergang zur dritten Stufe der EWWU** *Rolf Strauch*
- B11-98 **Exchange Rate Regimes in the Transition Economies: Case Study of the Czech Republic: 1990-1997** *Julius Horvath and Jiri Jonas*
- B10-98 **Der Wettbewerb der Rechts- und politischen Systeme in der Europäischen Union** *Martin Seidel*
- B09-98 **U.S. Monetary Policy and Monetary Policy and the ESCB** *Robert L. Hetzel*
- B08-98 **Money-Output Granger Causality Revisited: An Empirical Analysis of EU Countries (überarbeitete Version zum Herunterladen)** *Bernd Hayo*
- B07-98 **Designing Voluntary Environmental Agreements in Europe: Some Lessons from the U.S. EPA's 33/50 Program** *John W. Maxwell*
- B06-98 **Monetary Union, Asymmetric Productivity Shocks and Fiscal Insurance: an Analytical Discussion of Welfare Issues** *Kenneth Kletzer*
- B05-98 **Estimating a European Demand for Money (überarbeitete Version zum Herunterladen)** *Bernd Hayo*
- B04-98 **The EMU's Exchange Rate Policy** *Deutsch-Französisches Wirtschaftspolitisches Forum*
- B03-98 **Central Bank Policy in a More Perfect Financial System** *Jürgen von Hagen / Ingo Fender*
- B02-98 **Trade with Low-Wage Countries and Wage Inequality** *Jaleel Ahmad*
- B01-98 **Budgeting Institutions for Aggregate Fiscal Discipline** *Jürgen von Hagen*
- 1997**
- B04-97 **Macroeconomic Stabilization with a Common Currency: Does European Monetary Unification Create a Need for Fiscal Insurance or Federalism?** *Kenneth Kletzer*
- B-03-97 **Liberalising European Markets for Energy and Telecommunications: Some Lessons from the US Electric Utility Industry** *Tom Lyon / John Mayo*
- B02-97 **Employment and EMU** *Deutsch-Französisches Wirtschaftspolitisches Forum*
- B01-97 **A Stability Pact for Europe** *(a Forum organized by ZEI)*

---

ISSN 1436 - 6053

---

Zentrum für Europäische Integrationsforschung  
Center for European Integration Studies  
Rheinische Friedrich-Wilhelms-Universität Bonn

Walter-Flex-Strasse 3  
D-53113 Bonn  
Germany

Tel.: +49-228-73-1732  
Fax: +49-228-73-1809  
[www.zei.de](http://www.zei.de)