EUROPEAN ECONOMIC PERSPECTIVES

Centre for Economic Policy Research

Poles Apart?

As European integration deepens, will the clustering of people and firms lead to a polarized Europe, in which some regions buzz with activity while others decline? A new CEPR Report explains how the right policies can prevent polarization.

Further European integration will increase the incentives for regional specialization of economic activity. People and firms will increasingly cluster together with those that share their particular know-how and skills – which may be those within the same industry as conventionally defined, or simply those that share a functional specialization whatever the industry in which they are classified. But according to CEPR's latest *Monitoring European Integration* Report, this specialization need not imply polarization of Europe into rich and poor regions, those with jobs and those without. Three main types of outcome are conceivable:

- *The Dispersion Outcome*. There could be a broad dispersion of activity and considerable regional equality: there will be specialization, but most regions will be able to specialize in something.
- *The Concentration Outcome*. There could be strong geographical concentration accompanied by high labour mobility, leading to depopulation of declining regions but not to great inequality of per capita income or access to jobs.
- *The Regional Stagnation Outcome*. There could be long-run polarization of Europe into advanced regions with high incomes and low unemployment, and depressed regions with low incomes and high unemployment.

Which outcome seems most likely? The Report considers the forces favouring agglomeration, and the contrary forces favouring dispersion. Certain forces – scale economies, learning effects and various pecuniary and non-pecuniary externalities – encourage firms to cluster, while others – factor immobility, congestion externalities and the intrinsic diversity of people's preferences – tend to keep firms dispersed. Whether Europe becomes more concentrated or dispersed depends on the balance between these forces, as well as on the various barriers erected to prevent people and firms from acting under their influence.

The Report stresses that what matters is not just the mobility of the various factors of

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Regional specialization need not imply polarization of Europe into rich and poor regions

production – labour, capital and entrepreneurship – but also their *relative* mobility, since their location decisions depend on each other. It makes all the difference in the world whether jobs follow people or people follow jobs – or indeed, if neither follows the other.

The Report examines the mobility of firms and the mobility of labour in Europe. The evidence it uncovers strongly implies that the Concentration Outcome is very unlikely. Evidence from the investment behaviour of multinational firms suggests that agglomeration gains are significant but not overwhelming, and can be offset by the higher costs of operating in areas where labour and public goods are scarce. At the same time, labour mobility is low in Europe and has even declined in recent years.

So will Europe experience Dispersion or Regional Stagnation? This is still unclear. But it is clear that misguided regional policies, which try but fail to freeze existing patterns of economic activity, can paradoxically increase the likelihood of the very polarization they seek to prevent. Wage subsidies and discretionary state aids, for example, may discourage people and firms from seeking out the new opportunities that are central to generating innovation, employment and growth.

Growth and cohesion are not enemies; the right policies can make them allies

Nevertheless, both the Report's evidence on the mobility of firms and the contrast it draws between the successful development policies of Ireland and the unsuccessful regional policies of the Italian Mezzogiorno suggest that government policy has an important role to play in preventing polarization. Firms locate not just according to comparative labour costs and other country endowments, but also in pursuit of skilled and educated labour, and clusters of know-how and technical ability, both features of a country that can be strongly influenced by policy.

The evidence on firm mobility and the experiences of Ireland and the Italian Mezzogiorno also strongly suggest that the process is not a zero-sum game: one region's success does not have to be at the expense of another. This is particularly true because of the character of the policies that work: they are ones that build up a region's productive skills rather than merely allow it to bid for business more cheaply. The essential components of a successful policy include:

Firms locate partly in pursuit of skilled and educated labour, something that can be strongly influenced by policy

- Public investment in a skilled and educated workforce – this is important not just because skilled workers are more productive, but also because better educated workers can benefit more from the transfer of know-how between firms that takes place in local agglomerations. They are also more mobile and hence more likely to shift from low to high yield activities.
- A tax and regulatory environment that encourages entrepreneurship – this does not necessarily mean very low profit taxes (though they may help) but it certainly requires a simple and predictable tax structure, and a clear link between the taxes firms pay and the benefits they perceive from locating where they do.
- Labour market policies that encourage wage flexibility in response to economic shocks – this is especially important within the euro zone, ensuring that wages will not fall out of line with productivity trends and undermine regional competitiveness.
- Redistributive policies that diminish workers' fear of unemployment without acting as a disincentive for geographical mobility – this means using the tax system rather than public employment and subsidies to firms as a method of redistributing income.
- Acceptance and encouragement by policy-makers of geographical clustering by firms using related skills.
- Reduced reliance on policies to support existing firms in difficulty, or simply to compensate firms for operating in an adverse environment without making any attempt to improve that environment.
- Policy consistency over time.

These are all ingredients of a policy environment that is good for growth as well as for regional convergence. The Report's most central message is that growth and cohesion are not enemies; unless misguided policies determine otherwise, they are allies.

This article summarizes 'Integration and the Regions of Europe: How the Right Policies Can Prevent Polarization: *Monitoring European Integration* 10' by Pontus Braunerhjelm, Riccardo Faini, Victor Norman, Frances Ruane and Paul Seabright (CEPR, 2000).

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David Begg, Francesco Giavazzi, Jürgen von Hagen and Charles Wyplosz

Humpty Dumpty

What are the chances of launching a new round of world trade talks after Seattle? A new CEPR *Policy Paper* outlines a plan for 'putting Humpty together again' – one that balances the needs of the developed and developing worlds.

After Seattle, developing countries must be brought much more securely into the world trading system

The Seattle Ministerial meeting of the World Trade Organization (WTO) in December proved incapable of initiating a new round of world trade talks. This failure reflected several negative forces: the parties' widely disparate positions; the lukewarm attitude of many governments towards further trade liberalization; and the difficulties experienced by the WTO as an institution. The trust necessary to span the large differences in attitudes and interests encountered in trade negotiations was completely absent, and among the worst fractures was that between the developed and developing countries. The latter felt completely excluded from the process, both procedurally and because they were unable to make their voices heard in the substantive debates.

If the WTO is to recover from Seattle, it will need to bring the developing countries much more securely into the trading system. That is the conclusion of Zhun Kun Wang and Alan Winters in the latest publication in CEPR's new *Policy Paper* series. After all, developing countries comprise a large majority of WTO membership and account for an increasing share of world trade and the bulk of its growth. At present, they feel frustrated about the difficulties of implementing the Uruguay Round and by the unsympathetic attitude of the developed countries towards their aspirations. They were reluctant to come to Seattle and the outcome made it worse.

Having torn the fabric of the world trading system, it will be impossible to put it together again without the active enthusiasm of a majority of its members. But restoring the system's legitimacy in the eyes of a majority of its members is not mere charity: rather, it is a matter of self-interest for the developed countries. They still have much to gain from both the further liberalization of world trade and the disciplines that an effective WTO imposes on domestic policy discretion.

An effective coalition in favour of the trading system must be constructed before starting another round of talks. This requires paying greater attention to both the substantive needs of developing countries and procedural reform of the WTO. Wang and Winters argue that the best strategy for developing countries is not to resist the liberalization of a new round, but to focus it on their development needs. They should take a firm view of their development priorities and seek to ensure that WTO obligations they take on will assist in achieving them. But to be plausible in the current circumstances, that requires real concessions from the developed world.

To balance the needs of the developing and developed worlds, Wang and Winters propose an eight-point plan:

Putting 'Humpty' together again needs the active enthusiasm of a majority of WTO members

1) *A broad-based liberalization of trade in agriculture, manufactures and services.* Agricultural liberalization is a job for developed countries – particularly the EU and Japan. It calls for reducing bound tariffs from their current 50-150% range to 0-15%, a ban on agricultural export subsidies, and cuts in domestic support. Developing countries need to act too, by liberalizing manufactured imports, where tariffs alone currently average over 10%. This will stimulate mutual trade and provide 'specie' with which to 'buy' other concessions from developed countries. Among the latter, tariff escalation should be eliminated.

   Developing countries have been reluctant to liberalize services, fearing that they have nothing to gain. This is wrong, the researchers argue. As importers, a supply of reliable and cheap business services would aid efficiency in all sectors of their economies. As exporters of services, particularly through the temporary movement of workers to supply services in foreign markets, the potential gains are huge. The current success stories of developing countries exporting services, such as Indian software or Cuban health services, rely significantly on provider mobility, but this is severely constrained at present.

Restoring the system's legitimacy is not mere charity: it is a matter of self-interest

A new trade round should involve broad-based liberalization of trade in agriculture, manufactures and services

The fundamental problem is that developed countries make almost no distinction between temporary and permanent labour movement. With suitable provision for short-term mobility of workers, many more developing countries could export services (such as construction, distribution and health and transport) to the great advantage of consumers and many businesses in the developed world. Preliminary estimates suggest gains from 'ordinary' trade liberalization like this running into hundreds of billions of dollars per year.

2) *Credit for past unilateral liberalization.* Developed countries should treat part of developing countries' recent unilateral liberalizations as something to be reciprocated by their own concessions. This would recognize that developed countries have also been beneficiaries from unilateral reforms as well as reassuring developing countries, which feel that they often have to make concessions twice to persuade developed countries to liberalize. But for their own sakes, developing countries should use credit not to avoid making cuts in actual tariffs but as a way to encourage deeper liberalization by developed countries.

Labour and environmental standards and investment and competition policy should be off the agenda

3) *Reinventing special and differential treatment for the 21st century.* This would recognize developing countries' needs for cheap and effective institutional routes to implementing liberalization and allow them greater procedural flexibility in some rules areas. Old-style special and differential treatment, which just let the developing countries off many GATT obligations and offered extended adjustment periods at random, should be junked.

4) *Legally binding promises of technical assistance.* Where developed countries persuade developing countries to accept a policy with promises of technical assistance in implementing the policy, these promises should be legally binding. In the past, such assistance has not always been delivered. One way to ensure this happens is for the developed countries to pay for the assistance when it is agreed, by depositing earmarked funds with the WTO.

Governance of the WTO needs to be dramatically improved

5) *Honour the agreement on phasing out the MFA.* Developing countries need to make plain that there will be no settlement to the next round if the textiles and clothing agreement negotiated in the Uruguay Round is not implemented in good faith. That means that quantitative barriers must be removed and not replaced by alternative restrictions such as anti-dumping duties. The intention, floated in Seattle, of a three-year round was never very plausible, but developing countries have a clear interest in postponing its conclusion well into 2005, when the MFA quotas should have all been off for some time.

6) *Keep labour and environmental standards off the agenda.* The fear that introducing labour and environmental clauses might foster protectionism is well grounded: think how anti-dumping measures have been abused. Labour discussions should be moved to the International Labour Organization. If that body's lack of teeth is a problem for developed countries, let the agenda include discussions on enforcement.

7) *Drop investment and competition policy.* These will certainly be contentious and they will divert attention from the more straightforward and rewarding business of trade liberalization. Comprehensive rounds are desirable because they increase the opportunities for trade-offs, but in the aftermath of Seattle, it seems better not to burden developing countries with threatening and complex issues. The last thing they need is the external imposition of another set of institutions that they cannot operate effectively.

8) *Dramatically improve the governance of the WTO.* This clearly involves strengthening developing countries' capacity to deal with trade issues and with the WTO. In the WTO itself, more streamlined governance would be desirable. This would facilitate pre-negotiation discussions, but it could not create binding agreements, which, for sovereign governments, can only be agreed by consensus.

Wang and Winters acknowledge that their plan is no walkover; indeed, it will require considerable courage. Developing country policy-makers will have to tackle fundamental institutional problems and confront domestic protectionist interests. Developed country leaders will need to get over their blind insistence that their own models of policy and institutions are the only acceptable ones. They will also need to confront their own interest groups in order to make the significant concessions necessary to ensure that, in the long run, the world trading system survives intact and that all countries can benefit from it.

This article summarizes 'Putting "Humpty" Together Again: Including Developing Countries in a Consensus for the WTO' (CEPR *Policy Paper* No. 4, March 2000) by Zhen Kun Wang and Alan Winters. Wang is at the Royal Institute of International Affairs; Winters is at the University of Sussex and a Research Fellow in CEPR's International Trade programme.

Capital Gains

One of the hopes for the single currency is that it will eventually lead to pan-European capital markets. New CEPR research assesses the initial evidence on the impact of the euro on Europe's financial landscape.

The euro zone could become a domestic financial market to rival the US market

Europe's economic and monetary union (EMU) offers the possibility of creating a domestic financial market to rival that of the United States. In 1995, for example, the combined value of outstanding equities, bonds and bank assets in the 11 countries in the euro zone was $21,084 billion, compared to $22,865 billion in the US market. The key question is to what extent this arithmetic is likely to translate into economic reality. While a single currency is a necessary condition for the emergence of pan-European capital markets, it is by no means a sufficient one.

In a recent CEPR *Discussion Paper*, Jean-Pierre Danthine, Francesco Giavazzi and Ernst-Ludwig von Thadden review progress so far. Their assessment of the initial evidence on the impact of the euro on European capital markets is very favourable. They conclude that, on almost all counts, EMU has either already drastically changed the financial landscape of Europe or has the potential to do so in the future. This success is all the more surprising given the euro's current weakness against the dollar.

The researchers point out that Europe's capital markets have undergone a remarkable transformation since the euro was launched. A euro-denominated corporate bond market has emerged with issuing activity in 1999 in excess of that in the dollar market. Primary issues in European equity have reached record highs. Europe-wide indices have been established and portfolios have begun to be allocated along pan-European sectoral lines rather than on a country basis. Eurex, the German-Swiss exchange founded in 1998, has overtaken the Chicago Board of Trade to become the world's largest derivative exchange. Banks all over Europe have merged or formed alliances on an unprecedented scale, dramatically changing national banking environments and beginning to create international firms and networks. And cross-border mergers in all industries have increased strongly, giving rise to record volumes in Europe's mergers and acquisitions (M&A) industry.

Danthine and his colleagues argue that some of these developments could have been expected as consequences of the 'direct effects' of the euro. These effects comprise standardization and transparency in pricing; shrinking of the foreign exchange market; elimination of currency risk; elimination of currency-related investment regulations; and homogenization of the public bond market and bank refinancing procedures. But the euro also has indirect effects, which fall into four categories:

- the cost of cross-country transactions within the euro zone;
- the liquidity of European financial markets;
- the diversification opportunities available to European investors;
- and the institutional changes stimulated by EMU.

EMU has increased the demand side of the market for every asset traded in the euro zone

Transactions costs: Up to now, EMU has had little direct effect on transaction costs, but it has clearly made the existing obstacles and inefficiencies more visible. Within Europe, cross-border payments and securities settlements are more expensive, lengthier, riskier and less standardized than equivalent domestic transactions. What is more, the euro zone has 18 large-value systems (compared to two in the United States), 23 securities settlement systems (compared to three in the United States) and 13 retail payments systems (again, compared to three in the United States). Differences in taxation, legislation and standards create further obstacles.

EMU has prompted a renewed urgency among policy-makers to address these problems. The establishment of TARGET and EURO1 – the settlement systems for large transactions for the European System of Central Banks and the European Banking Association, respectively – and the implementation of the European Commission's Directive on cross-border credit transfers are the most visible steps taken in this direction.

EMU is reorienting traditional international asset allocation to a pan-European basis

Liquidity risk: Despite the problem of transaction costs, by eliminating currency risk,

EMU has drastically changed the financial landscape of Europe

EMU has put traders in foreign euro-denominated assets on an equal risk base with domestic traders. Together with the increase in transparency resulting from the single currency, this has greatly reduced the barriers to trading such assets. In this sense, EMU has increased the demand side of the market for every asset traded in the euro zone. And to the extent that expanded markets give rise to increased trading, this should reduce liquidity risk.

Nevertheless, as Danthine *et al* note, economic theory suggests that markets with transaction costs and liquidity risk may experience 'multiple equilibria'. In other words, the possibility of good equilibria – 'virtuous circles' of high trading activity and low liquidity risk – sits alongside the threat of bad equilibria – 'vicious circles' of low trading and high liquidity risk.

When assessing the euro's impact on liquidity, it is therefore important not only to add up the different pre-euro domestic markets, but also to evaluate the relationships between market prices, trading volume, the number and size of participants and transaction costs in the market after EMU. These researchers' analysis of public and private bond and equity markets indicates that markets have indeed deepened considerably, though there is still scope for further integration of the public bond market. Private bond and primary equity markets have expanded at a speed where it is possible to speak of an 'equilibrium switch', with secondary equity markets somewhere in between.

There has been a shift from banks to markets in the traditional deposit and lending business

Diversification: A second potential benefit of increased market size is the opportunity for greater diversification. In theory, the reduction in the costs and risks of cross-border transactions allows investors to improve the spread of risk of their holdings and to rebalance portfolios towards assets that were previously too costly in terms of the risk-return trade-off of standard portfolio theory. The problem with this theoretical argument is that it is counterfactual. As documented repeatedly in the 1980s and early 1990s, the share of international equity in total equity holdings by domestic investors has traditionally been too small to be compatible with the standard portfolio model – the so-called home-bias puzzle.

Danthine and his colleagues argue that the home bias for equity may be better explained by information problems that domestic investors face when valuing foreign securities. In this view, both the weakly developed equity culture of European investors and the lack of transparency and trading opportunities in European firms explain the paucity of equity flows in and out of Europe prior to 1990. And the change in both these features during the 1990s explains the observed increases in equity flows. Thus, EMU fosters market integration not by eliminating foreign exchange risk, but by improving information flows and by reorienting traditional international asset allocation methods from a country basis to a pan-European industry basis. The extent to which the record turnover on European primary and secondary equity markets in 1999 can be attributed to this effect is still, however, unclear.

Institutional change: In assessing how EMU has affected financial market institutions, the researchers note some surprising success stories, such as the rise of Eurex and the increased competition between stock exchanges. But the banks, the main players in the European capital markets, have been affected by the euro in different ways. In particular, while the changes in capital market activity tend to hurt the traditional deposit and lending business of commercial banks – by producing a 'shift from banks to markets' – they benefit the more market-based asset management and investment activities.

Danthine *et al* conclude that banks, especially in Europe, continue to be important in an environment of deepening and broadening capital markets. But they have had to adjust significantly in the past few years and the evidence suggests that this adjustment has not always been successful. Several indicators, such as the evolution of M&A activity, suggest that EMU has had a major effect on bank restructuring in Europe.

This article discusses research reported in 'European Financial Markets After EMU: A First Assessment', CEPR *Discussion Paper* No. 2413 (March 2000) by Jean-Pierre Danthine, Francesco Giavazzi and Ernst-Ludwig von Thadden. Danthine and von Thadden are at the Université de Lausanne; Giavazzi is at the Università Bocconi, Milan; and all are CEPR Research Fellows.

Banks continue to be important even though capital markets are becoming deeper and broader

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Moving Targets

Should central banks respond to movements in equity, housing and foreign exchange markets? A new Report, published jointly with the International Centre for Monetary and Banking Studies in Geneva, argues that they should.

Central banks should take account of forecast inflation, the output gap and asset prices in setting interest rates

Developments in asset markets can have a significant impact on both inflation and real economic activity. Large swings in equity, housing and foreign exchange markets have often coincided with prolonged booms and busts. So it is worth asking whether there are any actions central banks can, and should, take to minimize the likelihood of macroeconomic instability arising from extreme changes in asset prices. Or – as many influential economists argue – should monetary policy-makers ignore asset prices and set interest rates in response only to inflation forecasts and perhaps the output gap?

In a new Report, four leading economists argue that a central bank concerned with stabilizing inflation is likely to achieve superior performance by adjusting its policy instruments in response not only to forecasts of inflation and the output gap but also to asset prices. This conclusion is based in part on the view that reaction to asset prices in the normal course of policy-making will reduce the likelihood of asset price misalignments in the first place. Furthermore, inflation forecasts depend on assumptions about asset prices, which must, in turn, depend on views about the size of asset price misalignments.

Responding to asset prices will reduce the likelihood of major asset price misalignments

A central bank that reacts to asset price changes must attempt to estimate misalignments, something that many regard as impractical. The Report takes issue with this argument: the difficulties associated with measuring asset price misalignments are not substantially different from those of estimating such theoretical constructs as potential GDP or the equilibrium real interest rate. Quite rightly, these difficulties have not prevented central banks from using the concepts in the course of monetary policy-making. Similarly, although asset price misalignments are difficult to measure, this should be no reason to ignore them.

That being said, there will always be imprecision in estimates of these misalignments, just as there are in estimates of the other key macroeconomic variables that are crucial in setting interest rates. So it is important for central bankers to develop a framework for policy-making that accounts for the various sources of uncertainty that they face in seeking to meet their inflation and growth objectives.

Should asset prices be included directly in measures of inflation? Some economists have argued that a properly constructed inflation index should be based on both the prices of what is currently consumed, which conventional consumer price indices now measure, and the prices of future goods and services (as captured by asset prices). Proponents of this view suggest that monetary policy should seek to stabilize such a combined index.

There are reasons to be sceptical of the arguments for such an index since no one has yet shown why focusing on such a measure of prices is the most effective way to reduce inflation. Furthermore, most common implementations of this proposal place a very high weight on asset prices, which amounts to suggesting that central banks target them rather than the prices of current consumption. The Report provides an alternative set of calculations based on the idea that inflation affects all nominal prices, including those of equity and housing. The conclusion is that changes in equity prices are much too 'noisy' to be useful in inflation measurement, but that house prices contain significant useful information about aggregate price movements.

The Report also asks whether asset prices can be used to improve forecasts of future inflation. Many studies show a relationship between retail price inflation and movements in equity prices, housing prices and exchange rates. The Report's calculations as well as assessment of other evidence suggest that asset prices have a strong effect on future inflation, although the impact differs across countries and may shift over time.

Measuring asset price misalignment is difficult but so is estimating any macroeconomic variable

This article summarizes 'Asset Prices and Central Bank Policy', the second *Geneva Report on the World Economy* (CEPR, 2000) by Stephen Cecchetti (Ohio State University), Hans Genberg (Graduate Institute of International Studies, Geneva), John Lipsky (Chase Manhattan Bank) and Sushil Wadhwani (Monetary Policy Committee, Bank of England).

Benign Neglect

An Update to *Monitoring the European Central Bank* (*MECB*) 2

Two recent developments are challenging the ECB: rising inflation and the weakness of the euro. Neither of these is likely to have serious economic repercussions over the long term, the latest *MECB Update* concludes, yet both call for explanations. For good and bad reasons, those provided by the ECB so far have left the markets unsatisfied. In a world where perceptions greatly matter, things look a lot worse than they really are.

Some popular explanations for the recent weakness of the euro are dubious. The 'new economy' view that information technology has transformed the US economy does not explain why Europe could not adopt the same technologies. Nor does it explain why the euro is weak against other European currencies such as the Swedish krona and Swiss franc. Likewise, 'eurosclerosis', in its various forms, is a fact among the largest euro-zone countries, but why should it hit the exchange rate now that growth has returned to Europe and without any US-style current account deficit? Nor is there any evidence to support the view that continuing budget deficits in Europe hurt the euro.

'Easy money' is one explanation that carries some weight. Various estimates suggest that the ECB has been behind the curve – and behind the Fed – in reacting to the growth turnaround in the closing months of 1999. Increases in the interest rate have been lagging and long-term rates reveal market doubts about the ability to contain inflation below 2%.

The ECB's oft-criticised communication strategy also remains wanting. The monetary framework is poorly equipped to deal with conflicting signals. The widely advertised, self-imposed ceiling of 2% for inflation makes the ECB more vulnerable to temporary overshooting than is, for example, the more pragmatic Fed. More importantly, perhaps, a continuing gap between ECB words and deeds may result in a risk premium that affects the interest rate, the exchange rate or both.

Europe's monetary architecture is unfinished, and this may further raise uncertainty. The Maastricht Treaty is unclear on who is in charge of the exchange rate: the ECB or national governments. Foreign exchange market intervention is controversial, which encourages prudence but only up to a point. With unclear attribution of responsibilities, neither party may be willing to take a risk. What is more, governments are likely to take different views among themselves as they face diverging economic conditions.

In the end, however, the current euro weakness may simply be yet another instance of vagaries in the foreign exchange markets. Freely floating exchange rates are known to fluctuate wildly with little link to the fundamentals. In the face of such fluctuations, there is nothing wrong with benign neglect – provided it is explicitly accepted. Once again, it is not the policy that is at fault but some lack of clarity in its formulation.

The full text of *MECB* 2 Update is available from CEPR. The full report was published by CEPR in January 2000: 'One Money, Many Countries – *Monitoring the European Central Bank* No. 2' by Carlo Favero, Xavier Freixas, Torsten Persson and Charles Wyplosz.

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