Acta Oeconomica, Vol. 53 (4) pp. 429–441 (2003)

CONFERENCE REPORT

EAST–WEST CONFERENCE[1]

Last year's East–West Conference of the Oesterreichische Nationalbank (OeNB) took place from the 3rd to the 5th of November in Vienna and covered the topic *Structural Challenges and the Search for an Adequate Policy Mix in the EU and in Central and Eastern Europe*.

The conference was opened by OeNB Governor *Klaus Liebscher*. In his welcome remarks he stressed the historic changes Europe has experienced in recent years. With the bold strategy of further deepening and widening the European Union, this momentum will be continuing, probably even accelerating in the years to come. The introduction of the common European currency in 1999, the cash changeover in 2002 and the likely entry of ten new member countries into the Union in 2004 are contributing to the unification of the continent – the OeNB Governor pointed out. He went on to stress the importance for EMU members of credibly observing the provisions of the Stability and Growth Pact and of the Maastricht Treaty. The same goes for new members joining the euro area. Finally, he expressed the idea that EMU may be a harbinger of political union within Europe.

The conference consisted of eight sessions.

Structural Reforms and Competitiveness: Where Does Europe Stand Today? – was the question at the *first session* chared by OeNB Vice Governor *Gertrude Tumpel-Gugerell*. She stressed the geographic and cultural heterogeneity which enriches the Union, but at the same time renders the political decision-making process among 15 (in a few years probably up to 25) member states more cumbersome than in the USA with its homogeneous economic and political structures. In this context, she lauded the major EU compromise reached at the Brus-

[1] The report is written by Stephan Barisitz, Sandra Dvorsky, Jarko Fidrmuc, Andreas Freytag (lecturer, University of Cologne), Gerhard Reitschuler, Franz Schardax, Maria Silgoner. All authors except Andreas Freytag (affiliation above) are (or at the time of writing were) economists of the Foreign Research Division of the Oesterreichische Nationalbank.

0001-6373/03/$20.00 © *Akadémiai Kiadó, Budapest*

sels European Council a few days before the conference, which had marked a breakthrough on agricultural issues and structural and cohesion funds, thus paving the way for the Eastern EU enlargement. Tumpel-Gugerell emphasised that this decision confirmed the capacity of the EU member states to resolve important issues pragmatically and expediently. Moreover, she stressed the importance of the Lisbon process for structural change in the EU.

In the introductory keynote speech *Maria João Rodrigues* (Professor at the University of Lisbon and former advisor to the Portuguese government during the negotiations of the Lisbon Strategy) briefly sketched the motivations and main goals of the European Union for defining the Lisbon Strategy at the European Council in March 2002. Major strategic goals are paving the path for Europe's transition to a knowledge-based economy, modernising the European social model and sustaining favourable growth prospects by applying an adequate macroeconomic policy mix. Development of the information society as well as improvements in research policies were among the most successful areas of structural reform, but considerable progress was made also in the social field, the open method of coordination now being applied to social inclusion policy by all EU member states via national action plans aimed at combating social exclusion. Among key future issues Rodrigues commented on implications of the Lisbon process for EU enlargement and stressed that the applicant countries should view it as an opportunity for catching up rather than as an additional obstacle. Furthermore, she underlined that macroeconomic policies, namely budgetary policies in the framework of the Stability and Growth Pact, should be more sophisticated in order to foster structural adjustment.

Jørgen Elmeskov (Deputy Director of the Policy Study Branch at the OECD) gave his assessment of Europe's position in the global economy as compared to that of the United States, and found that Europe had made major progress in liberalising competition in product markets. He said that financial market reform and integration within Europe still remained a challenge for the future, progress being least visible on the labour market. As to the performance of individual European countries, the speaker stressed that some countries managed to outperform the average considerably, both in terms of reforms and of outcomes.

According to Elmeskov, all too often suggestions for pro-market reform are met with the counterargument that Europeans do not want the American model. A common problem of implementing structural reform is that negative effects often occur early and are felt by well-organised groups of society, whereas positive effects are typically of a long-term nature and are often spread out thinly across the whole populace, and may therefore be more difficult to understand and accept. Presuming that political willingness to carry out reform is present, recourse to role models may be helpful in overcoming resistance.

Jan Svejnar (Professor at the University of Michigan) stated that Western European economy was catching up with the US economy until the second half of the 1990s, when this tendency came to a halt. Investigating possible reasons behind this, he found that a different approach to entrepreneurship seems to have played a role. Besides, Europe's relatively high labour costs and rather rigid labour markets may also have contributed to the erosion of its competitive position. Moreover, less research done by European firms than by US firms, as well as a certain amount of brain drain to the USA may have contributed to the overall outcome. While Europe faces certain problems, it has tremendous unexploited possibilities.

S*ession two* focused on the *development of the financial sector in Central and Eastern Europe,* where the size of banking sectors of individual countries differed significantly at the beginning of transition; but the discrepancies have been reduced over the years. The session started with a presentation by *Zdeněk Tůma* (Governor of Česká Národní Banka), who gave an overview of the development of the Czech financial sector in the course of transition.

In most countries, banking reform was associated with substantial costs, which amounted to 20% of the GDP in the case of the Czech Republic. Banking-sector privatisation resulted in a foreign-dominated banking sector with more than 90% of banking-sector assets held in majority by foreign-owned banks representing a challenge for regulation and supervision. Prudential indicators of the Czech banking sector speak of a considerable pressure to improve operational efficiency since 1999. This has resulted in a marked increase in banking-sector profitability. According to the speaker, all CEECs have managed to complete the banking consolidation and privatisation process by now, which he considers the most important step in the transition process.

Herbert Stepic (Deputy Chairman of the Managing Board of Raiffeisen Zentralbank, RZB) focused on the role of foreign banks in the transition process in Central and Eastern Europe. According to Stepic, there are strong links between the development of financial intermediation and structural change in the CEECs.

Contrary to the Hungarian experiences, the delays in the bank restructuring and privatisation process in *Bulgaria* and *Romania* were responsible for initially low foreign direct investment in these two countries. The much stronger improvement in productivity in the manufacturing sector in Hungary (14% per year between 1993 and 1999) than in Bulgaria and Romania is evidence of the beneficial impact of FDI. Stepic concluded his presentation by explaining the links by which the presence of foreign banks exerts a positive impact on the economy of the host country: they serve as a catalyst for other FDI, and they provide the necessary start-up financing, tax and legal services. Moreover, they create trust and are active in collecting previously hidden deposits.

Marianne Kager (Chief Economist of Bank Austria Creditanstalt) presented her views of the current situation of the banking sector in the accession countries. Currently, the CEECs may be characterised as "underbanked", and dominated by foreign-owned banks. High earning ratios contrast with low productivity, but high future potential. In general, the macroeconomic impact of enlargement on "old" EU members will be limited due to the small size of the economies of the accession countries relative to the current EU economies and to the progress the CEECs have made with macroeconomic stabilisation. For CEE banking sectors, EU enlargement will have a number of effects: (1) stable inflation expectations will bring down interest rates; (2) an increase in GDP per capita will augment the demand for banking products; and (3) stabilisation and increasing wealth effects will increase the degree of intermediation. At the same time, the influence of liberalisation and globalisation and the impact of the development of new technologies will also be felt. Kager expects the scope of CEE banking activities to grow at an above-average rate, but margins to narrow. Because of the greater growth potential, the rewards will be greater, too, but only banks with a local presence and experience in retail banking will be able to benefit from this potential.

In the framework of the *third session*, entitled *Financing of Enlargement and Catching Up, Ewald Nowotny* (Vice President of the European Investment Bank, EIB) stressed the fact that the accession countries are experiencing real convergence, indicated by the substantial rise in average incomes in recent years. Enhancing real economic growth should always be a top priority for policymakers. He focused mainly on the public sector – where some of the accession countries experienced a widening of fiscal deficits in 2001 – and the current account. Both have to bear the brunt of the adjustment process. He also mentioned that countries with currency boards usually have fairly high external current account deficits.

Nowotny analysed the banking sector in the accession countries. The most striking change in the balance sheet structure of CEE banks was the relative decline in interbank liabilities and the simultaneous rise of interbank assets. The rising share of nonbank deposits in liabilities, together with the constant, if not falling, loan-to-asset ratio, indicates that CEE banks are mobilising savings in excess of what they are willing to lend to domestic borrowers. The surplus is invested abroad, implying that the CEE banking sector is a net exporter of capital in a group of capital-importing countries. The huge demand for infrastructure investments especially in the fields of transportation and environment in the accession countries was also mentioned. Disbursements of EIB loans are lagging behind, indicating problems of administrative and financial absorption capacities. After accession, cofinancing with the Structural Funds and ensuring a rational utilisation of grants and loans in order to accelerate the catching-up process attaining EU standards will become more important.

Mariella Nenova (Head of the Macroeconomic Research Division of the Bulgarian National Bank) stressed that macroeconomic developments of Bulgaria of the 1997–2001 period were extrapolated into the future, and real convergence would seem to be a far-fetched target. Transition should be interpreted as a preparation for an acceleration of the catching-up process.

Nenova focused mainly on developments in Bulgaria. She emphasised the importance of macroeconomic stability for growth and provided facts on the acceleration of the investment rate and the modernisation of fixed assets since 1997. Growing labour productivity in Bulgaria was shown as a measure of the combined effect of a high investment rate and human capital developments in the period from 1998 to 2001. The structural changes in exports were named as another measure of the growth potential. Consequently the EU pre-accession funds should play a more important role for human capital building and should be used more effectively as a financial resource for public investments.

Jarko Fidrmuc (Economist with the Foreign Research Division of the OeNB) presented a paper on twin deficits and the possible implications of current account and fiscal imbalances in the accession countries. He focused on the questions of whether twin deficits are inherent to the catching-up process and of what could be learned from the experience gained so far. Twin deficits were defined as a positive long-run relationship between the current account and the fiscal balance, which is predicted by the intertemporal approach to the balance of payments. He provided evidence of twin deficits in several OECD countries between 1970 and 2001 (stronger evidence in the 1980s, weaker evidence in the 1990s). Regarding the transition economies, the CEECs have been facing current account deficits of a historically unprecedented size, which were accompanied by high fiscal deficits. The Slovak current account deficit has been determined largely by investment, while Estonia and the Czech Republic show no hysteresis of the analysed variables.

The *fourth session* focused on *social security reform*. *Willi Leibfritz* (Head of the Structural Policy Division of the OECD's Economics Department) expressed serious concern about a lack of sustainability of OECD pension systems, which might be due to high pension costs for an ever-growing share of old population on the one hand, and to a decreasing economic growth rate caused by a declining work force on the other. In addition, early retirement – often used to ease pressures on the labour market – increases the problem. By appropriate policy reforms, however, the vicious circle may be broken.

Although all member states face a similar demographic trend, their future pension payment developments look very different. These differences stem from the dissimilar nature of the policy options chosen to tackle the problem. Some members, such as Italy, Sweden and Poland, have taken steps into the right direction, others are still to follow.

Italian pension reform was presented by *Daniele Franco* (Director of the Public Finance Division, Research Department of the Banca d'Italia). She emphasised that the Italian system is still a pay-as-you-go (PAYG) system, but is accompanied by a second, funded pillar, moreover, it is now based on defined contributions instead of defined benefits. The main problem of this principally successful reform effort is the long time-span devoted to the reform process, which gave rise to uncertainty among Italian citizens and provided particular incentives to retire early, as people feared severe pension cuts. In addition, fiscal sustainability has not been reached yet, and the danger of steadily decreasing pensions has not been averted. The conclusion is that economic policy in general and pension reform in particular should be characterised by long-term orientations and transparent procedures.

Marek Góra (Professor, Warsaw School of Economics) analysed theoretical problems of old-age provision systems in Europe before he described the main aspects of the Polish pension reform. The Polish pension system is also based on defined contributions. These are transformed into a lifetime pension annuity once the employee retires. The reform thus reduces or even eliminates the strong incentive to take early retirement that was built into the old system. Contributions have the character of individual savings instead of taxes. Moreover, the fiscal problems related to the old – not actuarially balanced – system combined with increasing unemployment (the Polish situation of the 1990s) can be avoided with the new system. Góra concluded that the new Polish pension system is likely to work appropriately in the long run.

Herbert Brücker (Senior Economist at the German Institute for Economic Research, DIW, Berlin) discussed the impact of East–West migration on welfare and the welfare state in an integrated Europe. After presenting some facts about current East–West migration behaviour within Europe, he introduced a simulation model assuming clearing labour markets and a closed economy with factor migration. Migration from CEE to EU members in this model is welfare enhancing, as it closes the wage gap between the EU member states and CEECs. As a general result, the migrants would take most of the welfare gains, the host country would also win, and the source country would lose. Relative wages would change. This contradiction can be explained by using an open economy framework and distorted labour markets. His conclusion was straightforward: rather than reducing overall welfare and increasing unemployment in the host countries, East–West migration will enhance welfare and improve fiscal balances there. The higher the human capital of the migrants, the higher this result will probably be. Thus, the East–West migration-related problems in the current EU member countries are negligible as compared to those caused by North–South migration in the past. Therefore, it makes sense to allow for free migration and to compensate for losses of source countries from huge gains accrued in host countries.

In the *fifth session* about *taxes and benefits/fiscal structures, István Székely* (Deputy Division Chief of the European I Department at the IMF) focused on the major fiscal policy challenges the accession countries will face after entering the EU, e.g. the convergence to EMU fiscal reference values, compliance with standards and regulations and access to net transfers from the EU budget. Accession countries will incur considerable costs in complying with the Single Market requirements and in completing transition-related structural reforms, accompanied by downward pressure on tax rates. They should also benefit from a decline in interest rates and a growth-driven revenue windfall from the prospects of accession, as well as from some EU budgetary transfers. In addition to generating estimates of the medium-term fiscal costs and benefits associated with accession for applicant countries, Székely's paper explored several options for applying the Stability and Growth Pact to new member states.

Rumen Dobrinsky (Chief of the Transition Economies Section at the UN/ECE) focused his statement on tax structures in transition economies and compared them to those in EU member states. He investigated the changes in the system of taxation by comparing the tax structures in the transition economies with those in Western economies. The focus was on three main aspects of the system of taxation: the level of the overall tax burden in the economy, the structure of tax revenue and the efficiency of tax collection. The evidence presented implies that there are still some important differences between the composition of tax revenue in the transition countries and that in the EU, which reflect both the existing gaps in the development level and the various degrees of progress individual countries have made in market reforms. The presentation also looked at the degree of tax compliance which varies considerably across countries but on average is considerably lower in the transition economies than in EU member states. This is one of the important factors that impact on the capacity of governments to provide public services.

Roger Guesnerie (Professor at Département et Laboratoire d'Economie Théorique et Appliquée, Ecole normale supérieure, DELTA-ENS, Paris) spoke about taxation rules in European countries which differ from each other either in terms of the tax burden (tax rates) or the global structure of tax income. The average level of the tax burden in Western Europe is high by international standards and reflects the comprehensiveness of the public welfare system and the level of social security spending in the wealthier countries. The harmonisation towards an equalisation of the cost of capital across EU countries is a legitimate concern and labour and personal income taxes may remain rather different. The case for a harmonisation of consumption taxation across the Union is less clear. Favourable effects of unified VAT rates and excise taxes, such as the elimination of undesirable cross-border commerce based on arbitrage, have to be compared to unfavourable consequences, such as elimination of possibly legitimate differences on allocation or redistribution issues.

Maria Antoinette Silgoner (Economist at the Foreign Research Division of the OeNB) presented a study which investigates the effect of automatic stabilisers (proxied by the adjusted government expenditure share) on cyclical volatility for a panel of EU member states in the last three decades. Evidence from the linear model of the effectiveness of automatic stabilisers is mixed. While the basic results confirm the finding of previous empirical studies that automatic stabilisers have reduced business cycle fluctuations, the coefficient for government expenditures is not significant when doing instrumental variable estimation. However, the model setting indicates that there is a smoothing effect for lower levels of government size. For countries with a high government expenditure ratio, however, the smoothing effect vanishes and cyclical volatility may thus even rise. The conclusion is that policy recommendations by international institutions to let automatic stabilisers play fully should be supplemented by taking into account the absolute level of fiscal stabilisers. Government size plays a crucial role in determining the smoothing property of fiscal stabilisers. Therefore, although the full operation of automatic stabilisers could be desirable, their overall extent might have to be reconsidered.

The first speaker in the *sixth session,* a panel discussion about *enterprise sector reform/network industries,* was *Gábor Hunya* (Senior Economist at the Vienna Institute for International Economic Studies), who compared the development of FDI inflows into different CEECs. Whereas Hungary was the major attractor of FDI in the first half of the 1990s, Poland and the Czech Republic surpassed Hungary in the second half, mainly because these economies were larger and because of the onset of the privatisation process, which led to massive share sales to foreigners. In general, while GDP growth in these countries was temporarily negative, FDI inflows increased over the whole period. In the early 1990s mostly enterprises in the manufacturing sector were privatised; sales of telecommunications industries and network utilities started later. The motivation for the privatisation of network industries was mainly the improvement of the efficiency and the quality of these utilities, the introduction of competition in previously sheltered sectors and the financing of large investments. In the long run, the FDI inflows should foster growth and exports.

In her statement, *Danuta Jablonska* (Head of Division at the Department of Economic Strategy of the Polish Ministry of the Economy) mentioned that in

2001 FDI inflows to Poland decreased for the first time since 1990, due to the slowdown in world economic activity. Currently, FDI accounts for about 5% of Polish GDP. Foreign firms invest in Poland mainly because of its growth prospects, low labour costs, the labour supply and market size, all of which (save the last factor) could change within the near future. Jáblonska also stressed the fact that FDI strengthened the competitive position of the Polish economy by improving both the access of Polish firms to new technologies and the qualification of the Polish work force. On the other hand, the innovative capacity of Poland is not affected, because foreign-owned firms hardly engage in cooperation with domestic R&D institutions.

Maria Vagliasindi (Principal Economist at the European Bank for Reconstruction and Development, EBRD) stressed that some industries that used to be considered natural monopolies have now become competitive markets due to technological progress. One example of this development is the telecommunications sector. The privatisation of such industries usually serves different aims, namely the maximisation of revenues, universal access for all customers and the improvement of service quality. In many cases the IPO of a former public monopoly was used to kick-start a country's stock market. Contrary to belief, privatisation does not automatically lead to competition, privatised monopolies tend to abuse their market power. Therefore, the choice of the adequate regulatory structure is crucial for success. She underlined that some CEECs have already shown more intense privatisation efforts than some EU member states. The panellists also agreed on the importance of the proper design of the regulations and called the regulation of the Californian utility market a negative example of regulation design.

The *seven session* dealt with the *adequate policy mix. Torben M. Andersen* (Professor, Department of Economics at the University of Århus) analysed the effects of the special assignment of fiscal and monetary policy in the euro area. The system is characterised by a clear-cut policy assignment, namely a centralised monetary policy and decentralised fiscal policies in EMU. He showed that without policy coordination, this policy assignment leads to suboptimal responses to shocks, depending on the nature of the shock. An aggregate shock causes the aggregate countercyclical response to be too strong. This overshooting effect also increases with the number of EMU member countries. On the other hand, a country-specific shock leads to a too procyclical response by the country affected. Hence, aggregate shocks without policy coordination are a fundamental problem within EMU. In addition, the Stability and Growth Pact is also unlikely to solve the underlying coordination problem. Subsequently, Andersen discussed whether an output goal for monetary policy would mitigate this effect.

Christian Popa (Vice Governor of Banca Natională a României) spoke about the recent Rumanian experiences of dynamic economic growth, improved macroeconomic stability, progress with disinflation and declining interest rates. Besides, fiscal consolidation is starting to become effective and current account adjustment is taking place. The rather high net capital inflows are being countered by rapid official reserve accumulation, explained Popa. Nevertheless, the country still needs further sustainable disinflation, as nominal convergence has not been achieved yet. The problem is that capital inflows lead to excess liquidity. Simultaneously, the efforts to stabilise fiscal policies have to be strengthened, and the financial sector has to be further developed. Further structural reforms and privatisation are also a *sine qua non* for the sustainable development of the country.

Franz Schardax (Economist at the Foreign Research Division of the OeNB) focused on three transition countries, namely the Czech Republic, Hungary and Poland, using monthly data for the period 1995–2002. While Hungary had a crawling peg, the other two countries had floating exchange rates. Using country-specific VAR models, he estimated the effect of fiscal and monetary policy on exchange rates and long-term interest rates. Schardax explained that the interest rate was not affected by budget deficits in any of the countries, and influenced by monetary policy in the Czech Republic and Hungary. The exchange rate is only affected by fiscal policy in the Czech Republic, and not by monetary policy measures in any of the three countries. The exchange rate channel of the monetary transmission mechanism in these countries was not predictable. In the following discussion, it was argued that the lack of fiscal shocks contributed to the poor correlation between fiscal policies on the one hand and the exchange rate as well as interest rates on the other.

In the *eighth session* speakers were asked to *look into the future of Europe*, and give their views of what they thought Europe might look like in 2020. *Gertrude Tumpel-Gugerell* (Vice Governor of the OeNB) briefly outlined her insights, reflecting on structural developments that are already underway or that will hopefully materialise and contribute to the shape Europe will take. She presented an optimistic vision of a European Union of 30 member states, with higher investment activity and lower unemployment than today. National borders will be even less important than today, and sociocultural regions will develop in a more natural way.

Elena Kohutikova (Vice Governor of the Národná Banka Slovenska) outlined uncertainties that necessarily have to be taken into account in Europe's quest for further integration, widening and deepening. Given the probable growth boost coming from enlargement, regional disparities may not necessarily narrow. The catching-up process is likely to be long. Nevertheless, the enlargement process will have an overall positive influence on old and new EU members and will force adjustments; in particular, it will enhance labour market flexibility.

Gert Jan Hogeweg (Director General at the European Central Bank) concentrated on some down-to-earth conclusions from recent experience in constructing EMU for future enlargements of the euro area. The Maastricht Treaty has proved to be a credible and successful framework for European monetary policy, and its high standards should be maintained. The institutional principles of price stability and of central-bank independence remain pertinent. Currently some countries are running excessive budget deficits. In such a case, it is important that decisive action be taken and credible adjustment paths be chosen. If necessary, full use should be made of the excessive deficit procedure in accordance with the Stability and Growth Pact.

Susan Schadler (Deputy Director of the European I Department of the IMF) pointed out that in her view and in the opinion of some of her colleagues at the IMF, Europe is now again at a crossroads. There is the challenge of coping with the ageing European population, pension systems, and labour-market reforms. Unemployment would need to be reduced and work effort increased in order for Europe to catch up with US levels. For all the difficulty of the political choice, Schadler stressed that the potential rewards for Europe would be extraordinary.

Brigita Schmögnerova (Executive Secretary of the UN/ECE) focused on future relations of the EU with countries that in all likelihood will not be members in the next 20 years, e.g. Russia, Ukraine, Moldova and Belarus. She pointed out that existing partnership and cooperation agreements with these countries should be modified to create something like a common European economic space which could eventually provide for free trade in products and services. Economic growth, R&D expenditure, Internet access and higher education are just a few areas where Europe still has a considerable lag compared to the US.

In the past, Europe was only a geographic notion; today, it is a living social structure and one of the most important actors on the global economic scene, according to *Richard Webb Duarte* (President of the Banco Central de Reserva del Perú). Duarte presented a Latin American perspective of Europe's future from the standpoint of a relatively poor emerging market. For him, the "new Europe" represents a role model of peaceful productive interaction, trade integration, social reform and voluntary solidarity.

The conference was characterised by excellent *luncheon and gala dinner speeches* as well. *Tommaso Padoa-Schioppa* (Member of the Executive Board of the European Central Bank) focused his luncheon speech on the challenges faced by the area he dubbed "Accessionland". As most accession countries have expressed their intention to adopt the euro as soon as possible, they have embarked on policies aimed at further advancing nominal and real convergence.

While a significant degree of nominal convergence has already been achieved, progress in real convergence appears to be much more limited. The assessment of income convergence alone, however, is likely to underestimate real convergence. Padoa-Schioppa also emphasised that a distinction should be made between catching-up-related "physiological" inflation and "pathological" inflation. The latter is a result of inappropriate macroeconomic and wage policies combined with structural weaknesses in the economy. Nominal convergence should focus on removing this "pathological" inflation, giving a major role to strengthening central-bank independence and progress in structural reforms. Therefore, further real convergence through institutional and legislative reforms and structural adjustments is crucial to advance nominal convergence.

Padoa-Schioppa concluded that nominal and real convergence are two sides of the same coin and need to be pursued in parallel. ERM II should be seen as a powerful framework to foster the combination of real and nominal convergence. It provides stability and flexibility by guiding the market while leaving sufficient margin for unavoidable market developments. In this sense ERM II should not be regarded as a mere "waiting room" prior to the adoption of the euro, but as a meaningful and flexible framework for tackling the challenges faced by the accession countries in the run-up to the euro.

Michaele Schreyer (Member of the European Commission) in her gala dinner speech focused on the budgetary implications of the EU's Eastern enlargement both for the applicant and for current member states. She briefly sketched the most important elements of the financial framework the EU proposed to the accession countries and touched upon the decision of the Brussels Council to gradually phase in direct payments to farmers until 2013. Although contributions to the EU budget will have to be paid from the first month of accession, support for farmers, for example, is paid according to ex-post rules, which creates a risk to the net budgetary position of new member states, especially in the first year of accession. Therefore, in order to avoid a situation in which the new member states would in net budgetary terms be worse off in the first year of their membership than in the preceding year, the European Council agreed to establish a temporary lump sum compensation mechanism. Furthermore, she quantified the net costs of EU enlargement for the present 15 member states at 0.06% of each country's GDP.

Although the new members will be net receivers, the first years of their membership can cause strains on their budgets, as they will be confronted with quite substantial accession-related costs. While the new members will be obliged to pay their contributions to the EU budget, some funds from the EU will only be disbursed with a time lag. Furthermore, the new member countries will have to cofinance the funds they receive and will have to pay "entrance fees" to a number of EU bodies. The overall economic benefits of enlargement will be sizeable in the medium- and long-term perspective.

Randall S. Kroszner (Member of the US President's Council of Economic Advisers) gave an overview of growth-oriented policies for the EU and the applicant countries. The key to sustainable high growth and increased GDP per capita is lasting strong productivity growth. Consequently, Kroszner highlighted the following policy issues:

– Sectors *open to international competition* are the most productive ones in an economy. To remain competitive, flexible labour markets are needed, since excessive employment protection hampers efficient labour allocation and hence productivity. The US labour market appears to have reacted more flexibly to the shocks of the year 2001 than its counterparts in Europe.
– Investing in *human capital* is the key to long-run growth. Smart benefit systems are also important to give people the right incentives.
– *Efficient venture-capital markets and lower barriers for firm entries* are major factors to increase productivity and growth. There are enormous differences between Europe and North America in terms of cost and time intensity in the establishment of new companies.
– *Well-established competition,* small governments that adhere to sound public finance policies, further market liberalisation and privatisation of state-owned companies is crucial.
– *Efficient financial and legal systems*, such as well-functioning financial intermediaries and risk-capital markets, as well as soundly established property rights, bankruptcy laws and corporate governance are needed.

The next East–West Conference will focus on key issues for Europe's future development, in particular human capital and education.