CHAPTER 1

THE ECONOMIC SITUATION IN THE ECE REGION AND SELECTED POLICY ISSUES

1.1 Europe and the CIS in 2004-2005

(i) Major developments

A favourable global context for Europe and the CIS

Overall, 2004 was a very good year for the world economy. The recovery continued at a robust rate, although the sharp rise in oil prices dampened the cyclical momentum in the course of the year. The United States and China remained the principal engines of global growth. In the United States, the recovery continued to be driven by strong domestic demand and accommodative economic policies. In China, the long economic boom abated slightly due to headwinds from the rise in energy prices and measures to check overheating and achieve a soft landing. Hopes that in Japan the economy would finally achieve a sustained recovery were frustrated. Global inflation remained moderate despite the upward pressures on energy prices. Emerging markets continued to benefit from favourable financing conditions in the international capital markets, with risk premia remaining at very low levels. In the foreign exchange markets, the dollar came under renewed selling pressure in the second half of 2004, reflecting concerns over the widening United States current account deficit and persistently high fiscal deficits.

The increase in the external imbalances between the major economies, however, poses a major threat to the stability of the world economy. A major policy challenge is to achieve an orderly realignment of the exchange rates of major currencies. Redressing these global imbalances without disruptive exchange rate movements will require appropriate national and international economic policy responses (section 1.2(i)).

A permanent upward shift of oil prices?

In mid-December 2004, oil prices had fallen by some $10 per barrel from their record level (in nominal terms) of more than $50 per barrel in October 2004. To some extent this fall may reflect the lingering volatility of assessments concerning the short-term balance of supply and demand, and also a reduced presence of speculators in the oil markets. But there appears to be a broad consensus that high oil prices are likely to be a feature of the world economy for many years to come. This is based on the projected strong rise in demand for oil and other energy products in rapidly growing (and industrializing) emerging market economies such as China and India. These countries, moreover, are still characterized by relatively low levels of energy efficiency. The recent surge in global demand for oil has also coincided with relatively tight supply capacities, given a lack of sufficient investment in the development of new oil fields in recent years. Enhancing oil supply capacity will not only take time but is also subject to large risks and constraints, including those imposed by environmental concerns. This situation makes oil prices vulnerable to interruptions of supply due to unforeseen developments, including geopolitical uncertainties. A significant and permanent increase in oil prices will inevitably have negative effects on levels of output in the oil importing countries in the short and medium run. But in the long run, higher oil prices should stimulate investment to improve energy efficiency and accelerate the process of substitution away from oil to other forms of energy (including renewable energy sources such as wind, sun and hydroelectric power), thereby reducing the vulnerability of the global economy to new oil price shocks. An appropriate orientation of energy policies can foster this process, also taking into account the need to ensure security of energy supplies and to curb carbon emissions from the burning of fossil fuels.

Rising oil prices moderately dampen the cyclical momentum in 2004

The sharp rise in oil prices in 2004, so far, appears to have had only a relatively moderate negative impact on global economic activity. This is reflected in the fact that demand for crude oil (in volume) rose at its fastest rate in nearly 30 years. The growth of global output and incomes has thus clearly dominated the dampening effects on oil demand resulting from higher prices. About half of the rise in oil demand in 2004 was due to China and the United States.

The impact of a given rise in oil prices on economic growth and inflation in western Europe and North America is now much smaller compared with the 1970s or 1980s because of the substantial decline in the oil intensity of output.[1] The resilience of the advanced industrialized

[1] Oil intensity of output is defined as oil consumption (in physical units) per unit of real GDP.

countries to oil price shocks has also been strengthened by more flexible product and labour markets. In Europe, the appreciation of the euro and other currencies against the dollar also mitigated the adverse impact. In several major Asian economies final energy users were shielded by retail and wholesale price controls (and associated oil subsidies) from the full impact of rising world market prices.[2]

It is noteworthy that so-called second-round effects of higher oil prices were largely absent in 2004. The oil price shock therefore had little, if any, impact on the stance of monetary policy in the major economies, given the persistently low rates of core inflation. Although the subject of extensive research, the impact of oil prices on economic activity remains difficult to assess, and estimates are surrounded by a large margin of uncertainty.[3] The impact will vary across regions depending, *inter alia*, on the oil intensity of economic activity, the share of oil imports in total energy consumption and on economic policy responses. (It goes without saying that rising oil prices tend to boost economic activity in the oil exporting countries.) What is also difficult to gauge is the extent to which rising energy prices affect business and consumer confidence, with attendant negative effects on spending propensities. The reason is that, apart from raising energy input costs and reducing real disposable incomes, a surge in oil prices increases uncertainty about future price developments and the economic outlook in general.

Western Europe's recovery lost momentum

In western Europe, the cyclical recovery lost significant momentum in the second half of 2004. Export growth, which had been leading the recovery, weakened against the background of a moderate slowdown in the global economy. Domestic demand was sluggish and consequently lacked the vigour to offset the weakening of external demand. Business confidence was dampened by the sharp appreciation of the euro in the final weeks of 2004. Real GDP in western Europe rose by 2.2 per cent in 2004. In the euro area, the increase was slightly lower at 1.9 per cent (table 1.1.1). Economic activity continued to be supported by low interest rates, but the accelerating apreciation of the euro in the second half of 2004 led to a further tightening of monetary conditions. Fiscal policy in the euro area was slightly expansionary in 2004.

…but growth was robust in central and eastern Europe and the CIS

Economic activity in the eight new EU member states from central and eastern Europe (EU-8) picked up noticeably in 2004. Preliminary estimates suggest that their aggregate GDP grew by some 5 per cent led by a strengthening recovery in Poland. In 2004, growth in the

TABLE 1.1.1

Annual changes in real GDP in Europe, North America and Japan, 2002-2005

(Percentage change over the previous year)

	2002	2003	2004 [a]	2005 [a]
France	1.2	0.5	2.2	1.9
Germany	0.1	-0.1	1.7	1.3
Italy	0.4	0.3	1.2	1.6
Austria	1.2	0.8	1.8	2.3
Belgium	0.9	1.3	2.6	2.4
Finland	2.3	1.9	2.9	2.9
Greece	3.6	4.5	3.8	2.7
Ireland	6.1	3.7	4.3	4.6
Luxembourg	2.5	2.9	4.0	3.5
Netherlands	0.6	-0.9	1.2	1.6
Portugal	0.4	-1.2	1.2	1.9
Spain	2.2	2.5	2.6	2.5
Euro area	0.9	0.6	1.9	1.8
United Kingdom	1.8	2.2	3.2	2.5
Denmark	1.0	0.5	2.2	2.3
Sweden	2.0	1.5	3.4	2.9
EU-15	1.1	0.9	2.2	2.0
Cyprus	2.1	1.9	3.2	3.6
Czech Republic	1.5	3.7	3.8	3.9
Estonia	7.2	5.1	5.9	5.6
Hungary	3.5	3.0	3.8	3.8
Latvia	6.4	7.5	7.0	6.0
Lithuania	6.8	9.7	6.7	5.8
Malta	2.6	-0.3	1.0	1.5
Poland	1.4	3.8	5.7	4.9
Slovakia	4.6	4.5	5.1	5.0
Slovenia	3.3	2.5	3.8	3.9
New EU members-10	2.4	4.0	4.9	4.5
EU-25	1.2	1.1	2.4	2.2
Iceland	-0.5	4.0	4.3	4.7
Israel	-0.7	1.3	3.5	3.7
Norway	1.4	0.4	3.4	2.9
Switzerland	0.3	-0.4	1.8	1.7
WECEE	1.2	1.1	2.4	2.2
Canada	3.4	2.0	2.7	3.0
United States	1.9	3.0	4.4	3.5
North America	2.0	3.0	4.3	3.5
Japan	-0.3	1.3	3.9	1.5
Europe, North America and Japan	1.3	1.9	3.4	2.7
Memorandum items:				
EU-8	2.4	4.0	5.0	4.6
Western Europe-20	1.1	0.9	2.2	2.0
Western Europe and North America	1.6	2.0	3.3	2.8

Source: Eurostat; OECD national accounts and national statistics; UNECE secretariat estimates; Consensus Economics, *Consensus Forecasts*, 6 December 2004 and *Eastern Europe Consensus Forecasts*, 15 November 2004.

Note: All aggregates exclude Israel. WECEE (western Europe, central and eastern Europe) comprises the EU-25 plus Iceland, Norway and Switzerland. EU-8 (central Europe and the Baltic states) includes the new EU members less Cyprus and Malta. Western Europe-20 comprises the EU-15 plus Cyprus, Iceland, Malta, Norway and Switzerland. For data on south-east European and European CIS countries, see table 1.1.2.

a Forecasts.

[2] IEA, *Oil Market Report* (Paris), 10 December 2004, p. 12 [www.oilmarketreport.org]. To the extent that these energy subsidies are not sustainable, the adjustment costs to higher world market prices are, of course, only postponed.

[3] R. Barrel and O. Pomerantz, "Oil prices and the world economy", Austrian National Bank, *Focus on European Economic Integration*, 1/2004 (Vienna), pp. 152-177. See also UNECE, *Economic Survey of Europe, 2004 No. 2*, p. 5, box 1.1.1.

TABLE 1.1.2

Annual changes in real GDP in south-east Europe and the CIS, 2002-2005

(Percentage change over the previous year)

	2002	2003	2004 [a]	2005 [a]
South-east Europe	6.5	5.1	7.9	5.2
Albania	3.4	6.0	6.0	6.0
Bosnia and Herzegovina	3.7	3.2	4.0	4.3
Bulgaria	4.9	4.3	5.5	5.3
Croatia	5.2	4.3	4.0	4.4
Romania	5.0	4.9	7.5	5.2
Serbia and Montenegro [b]	3.8	1.5	7.0	4.5
The former Yugoslav Republic of Macedonia	0.9	3.4	2.5	3.5
Turkey	7.9	5.8	9.0	5.3
CIS	5.2	7.7	7.9	6.4
Armenia	15.1	13.9	10.0	8.0
Azerbaijan	10.6	11.2	9.5	14.0
Belarus	5.0	6.8	10.0	9.0
Georgia	5.5	11.1	6.0	5.0
Kazakhstan	9.8	9.3	9.3	7.9
Kyrgyzstan	0.0	6.7	6.5	7.0
Republic of Moldova [c]	7.8	6.3	8.0	6.0
Russian Federation	4.7	7.3	6.8	5.8
Tajikistan	9.5	10.2	11.0	8.3
Turkmenistan [d]	1.8	6.8	6.0	7.0
Ukraine	5.2	9.4	12.4	6.5
Uzbekistan	4.2	4.4	7.6	6.4
Total above	5.6	6.9	7.9	6.0
Memorandum items:				
South-east Europe without Turkey	4.6	4.2	6.4	5.0
CIS without Russian Federation	6.2	8.5	10.1	7.5
Caucasian CIS countries	9.9	11.7	8.6	10.0
Central Asian CIS countries	6.6	7.5	8.4	7.3
Three European CIS countries	5.3	8.6	11.6	7.2
Low-income CIS economies	6.3	7.7	8.1	7.9

Source: National statistics, CIS Statistical Committee; reports by official forecasting agencies.

Note: The aggregation was performed using weights based on purchasing power parities. Aggregates shown are: south-east Europe (the 8 countries below that line); CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates are: Caucasian CIS countries: Armenia, Azerbaijan, Georgia; central Asian CIS countries: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries: Belarus, Republic of Moldova, Ukraine; low-income CIS economies: Armenia, Azerbaijan, Georgia, Republic of Moldova, Kyrgyzstan, Tajikistan and Uzbekistan. Unless otherwise noted, country forecasts shown are those reported by official forecasting agencies.

a Forecasts.

b Excluding Kosovo and Metohia.

c Excluding Transdniestria.

d UNECE secretariat estimates. On the methodology used, see box 5.2.1.

EU-8 economies became more broadly based, driven by robust consumption and investment expenditures and strong external demand. Macroeconomic policies were broadly supportive of growth. Good fiscal outcomes allowed the central banks to maintain accommodating monetary conditions.

Economic growth in south-east Europe also accelerated considerably, underpinned by strong domestic demand and exports. According to preliminary estimates, aggregate GDP rose by some 8 per cent (table 1.1.2) on the strength of the recovery in the region's largest economies, Romania and Turkey.

The CIS economies continued to grow strongly for a second consecutive year, with GDP increasing by almost 8 per cent. The whole CIS region, including the largest economy, Russia, continued to benefit from the surge in world commodity prices. In most resource-rich CIS economies, the main factor behind their output growth was the rapid growth of commodity exports (particularly oil and natural gas). At the same time, several years of strong output growth have been associated with a surge in domestic demand, especially private consumption. In many countries, fixed investment has also recovered, most of it in extractive industries. Total employment in the CIS has continued to increase since the last quarter of 2003; however, this mainly reflects developments in some of the largest economies (foremost Russia). Macroeconomic policy in many CIS economies was expansionary, which gave a further boost to economic activity. One consequence, however, was that rates of inflation began to fall more slowly, and in some cases there was also a deterioration of fiscal balances. The currencies of most commodity exporting economies were under growing pressure to appreciate as a result of their surging export revenues. The symptoms of the "Dutch Disease" are increasingly evident in some economies, particularly Russia, putting monetary management under considerable strain.

(ii) The short-term outlook

A still favourable but somewhat less supportive international economic environment

Global economic growth is expected to slow down in 2005, but it should still average close to 4 per cent, more than 1 percentage point less than in 2004.[4] The continued robust expansion of the world economy is also mirrored in world trade, which is projected to increase by some 8 per cent in 2005, down from nearly 10 per cent in 2004. The global business cycle will continue to rely on China and the United States as the main locomotives of growth. Rapid growth rates are also expected to continue in Asia and Latin America. The moderate slowdown in the global economy mainly reflects the lagged effects of the sharp rise in oil prices on economic activity in combination with a gradual tightening of economic policies in China, Japan and the United States.

In the United States, real GDP is forecast to increase by some 3.5 per cent in 2005, down from 4.4. per cent in 2004 (table 1.1.1). The rate of growth will still remain slightly above potential in 2005. Overall, activity will be supported by the continued, albeit moderating, strength of domestic demand. Exports should be stimulated by the

[4] Calculated on the basis of GDP weights based on PPPs. On the basis of weights at market exchange rate, world output is expected to increase by 3.1 per cent in 2005, down from 4.1 per cent in 2004.

depreciation of the dollar and by strong external demand in the United States major markets in Asia[5] and Latin America. But imports will also rise and so the change in real net exports will continue to act as a drag on economic activity. The Federal Reserve is expected to continue gradually raising short-term interest rates[6] to move monetary policy closer to a neutral stance during 2005. Fiscal policy will be slightly restrictive in 2005.

In Japan, forecasts for economic growth were lowered significantly in late 2004, reflecting the stalling of the recovery in the second and third quarters of 2004. Real GDP is now expected to increase by only 1.5 per cent in 2005, reflecting the combined impact of slower growth of both domestic demand and exports.

Continued growth in Europe and the CIS but at different rates

The short-term outlook for Europe and the CIS is for economic growth to continue in 2005, albeit at significantly different rates in the major subregions. The euro area will continue to lag behind the other major regions of the world economy. Central and eastern Europe will continue to perform significantly better than the euro area. Economic growth will weaken somewhat in the CIS, but average rates will remain well above the European average.

A moderate rate of recovery in the euro area

For the euro area, real GDP is forecast to increase on average by 1.8 per cent in 2005 (table 1.1.1). For western Europe as a whole, the growth rate will be marginally higher at 2 per cent, reflecting the slightly stronger growth momentum in countries outside the euro area. These growth rates for 2005 are slightly lower than in 2004, partly because of a smaller number of working days.[7] Positive growth in the rest of the world will continue to support exports, which remain the mainstay of growth. For the recovery to accelerate, domestic demand would have to pick up more strongly than is currently expected. Among the four major west European economies, economic growth will remain relatively sluggish in Germany and Italy; only in the United Kingdom is real GPD forecast to increase by more than 2 per cent in 2005. The stance of fiscal policy is expected to be broadly neutral (possibly even slightly restrictive) for the euro area and western Europe in aggregate in 2005. In view of the fragility of factors of domestic growth and the dampening effects of the stronger euro on domestic economic activity and inflation, monetary policy in the euro area is likely to continue to "wait-and-see". The European Central Bank (ECB) is expected to leave interest rates unchanged in 2005, but there is scope for countering any weakening of the recovery by lowering interest rates, particularly as the stronger euro will dampen imported inflation.

Economic growth should remain strong in central and eastern Europe and the CIS

Although GDP growth has started to decelerate in the EU-8 countries, recent economic sentiment indicators suggest a favourable short-term outlook. In 2005, the average rate of growth in the EU-8 may slow down somewhat compared with 2004 but, at some 4½ per cent, will remain considerably above the average of western Europe. A noticeable surge in greenfield FDI projects should accelerate the ongoing process of restructuring and boost exports. Further fiscal consolidation is envisaged in some countries in 2005 but its dampening effect on domestic demand should be marginal. Most of the south-east European economies are also set to maintain strong rates of growth in 2005 but the unusually high rates in some countries in 2004 will be difficult to sustain. Overall, domestic demand is set to remain buoyant, and should provide solid support to economic activity in these countries. Better financial intermediation and rapid credit expansion will continue to fuel output growth throughout central and eastern Europe. However, despite the relatively strong rates of output growth in 2005 the increases in employment are likely to be small.

Economic activity in the CIS as a whole may lose some steam in 2005, but aggregate GDP is nevertheless expected to expand by some 6½ per cent. Decelerating growth rates will prevail in all the large CIS economies – Belarus, Kazakhstan, Russia and Ukraine – following the evolution of external factors such as commodity prices and demand in the region's main markets. Domestic demand in the CIS should generally remain buoyant but its effect on domestic economic activity will depend on the responsiveness of domestic supply. The macroeconomic policy stance should remain broadly neutral in the large economies, with the possible exception of Ukraine where some fiscal tightening can be expected. While in the short run there may be some further improvement in the labour markets, many CIS economies still have to address the challenge of restructuring as labour adjustment has in general been lagging behind that in output.

Downside risks are dominating

The baseline short-term outlook is relatively favourable for the global economy, although this masks disappointingly weak growth in the euro area. But the outlook is surrounded by risks, which continue to be predominantly on the downside. A major uncertainty is the likely development of the international oil markets.

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[5] The overall economic impact of the devastating tidal waves ("tsunamis") in several countries caused by an earthquake in the Pacific on 26 December 2004 is currently estimated to be relatively small.

[6] In mid-December 2004, the Federal Reserve raised its target for the federal funds rate by a further 25 basis points to 2¼ per cent.

[7] It should be noted that annual changes in real GDP are not adjusted for the number of working days. In contrast, seasonally adjusted quarterly GDP data typically take into account calendar effects.

On the one hand, oil prices remain subject to potential upward pressure from actual or threats of supply disruptions and the continued robust growth of the world economy. On the other hand, a return of oil inventories to more comfortable levels and reduced speculation could introduce some downward pressure on prices. The latter, however, is expected to remain relatively moderate.

The fact that the global economy continues to rely so much on the United States as a major engine of growth evidently makes the outlook very vulnerable to a more pronounced slowdown of the United States economy. This is all the more so, because the necessary correction of the large domestic and external imbalances that have developed in the United States economy will hardly be possible without a more or less pronounced slowdown of domestic demand and output growth. Downside risks are also related to uncertainty about the strength of personal consumption spending, given that the savings rate fell to a very low level in 2004 and that the wealth effects from rising house prices may start to wane in 2005. Consumer spending could also be restrained by a weaker than expected improvement in the labour markets. In any case, a sharp fall in house prices would be likely to have a considerable dampening effect on private household spending and overall economic growth. This could create a dilemma for the United States monetary authorities because a lowering of interest rates in response to such a development would risk a further decline in the value of the dollar with the attendant risk of higher inflation. Long-term interest rates have remained at unusually low levels in the recovery so far, reflecting, *inter alia*, the persistence of moderate inflationary expectations, a weak supply of corporate bonds (a reflection of balance sheet consolidation) and the massive purchase of United States treasury bills by Asian central banks. A stronger than expected rise in long-term interest rates could be caused by the fading of these factors but also by increasing concerns in financial markets about the persistently large fiscal deficit, with a consequent dampening effect on economic growth.

Other risks to the outlook include a possible hard landing in China, which has become an important source of demand for goods and services produced in the rest of Asia and other regions of the world economy.

In western Europe, given its present strong reliance on export growth, the recovery is very vulnerable to a more pronounced weakening of global growth than is currently forecast. A further sharp appreciation of the euro could considerably dampen growth prospects with even the risk of economic growth stalling in 2005. In some countries (France, Ireland, Spain, United Kingdom), the downside risks also include a possible sudden and pronounced reversal of the rise in house prices, with consequent negative wealth effects and, in turn, severe repercussions on private household consumption and the overall rate of economic growth. A potential upside risk is that business investment may respond more favourably than anticipated to the continuation of favourable financing conditions and improved profitability. But the probability of the latter occurring is not very high given the expected deceleration in economic growth.

The main external risks to the outlook for central and eastern Europe include a possible sharp deceleration of economic growth in the euro zone and significantly higher than expected energy prices. If imported inflation continues to rise, this may prompt a more restrictive policy stance, with negative implications for economic activity. A number of economies in this region still face important macroeconomic policy challenges such as large fiscal and current account deficits. Forthcoming elections in several countries carry the risk of pre-election increases in public spending, which could undermine policy credibility and probably result in monetary tightening, lower inflows of FDI and reduced competitiveness. The most pressing policy challenges facing the new EU member states are to achieve sustainable fiscal consolidation and implement structural reforms for job-rich growth.

The main structural weakness of the CIS economies remains their high dependence on exports of natural resources and low value added products, implying a high degree of vulnerability to external shocks. In addition, there are already signs, especially in Russia, that the loss of competitiveness associated with real exchange rate appreciation (the "Dutch Disease") is becoming a burden on local producers and is choking off aggregate domestic economic activity. The capacity of macroeconomic policy to address these negative developments is fairly limited. Unless local producers manage to counteract them at the micro level through further restructuring, there are likely to be negative repercussions on output growth in the affected countries, especially in their manufacturing industries. The long-term growth prospects of the CIS economies thus hinge on their success in diversifying their economies and implementing key reforms in product and financial markets.

1.2 Selected policy issues

(i) Reducing global imbalances

The large and rising current account deficit of the United States has been an important potential downside risk for the global economy for some time.[8] It rose to $670 billion or 5.7 per cent of GDP in 2004 and on current economic trends is projected to reach $760 billion or 6.2 per cent of GDP in 2005. The external deficit has now passed the threshold (some 5 per cent of GDP), which in the past has tended to trigger current account reversals in industrialized countries.[9] But the reversal of the United States deficit seems to have been postponed by

[8] UNECE, *Economic Survey of Europe, 2004 No. 1*, chap. 1, pp. 5-6 and *Economic Survey of Europe, 2003 No. 1*, chap. 1, p. 12.

[9] C. Freund, *Current Account Adjustment in Industrialized Countries*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 692 (Washington, D.C.), December 2000.

the country's unique position in the international economy. The cumulative deficits have led to a progressive deterioration of the United States net investment position, i.e. the balance of United States-owned assets abroad and foreign-owned assets in the United States. The United States net foreign liabilities corresponded to some 25 per cent of GDP in 2004. Whereas in 1980 the United States was the world's largest creditor, it has now become the world's largest debtor. The point has been reached, where these imbalances have to be corrected for the sake of the stability of the United States economy and the world economy at large. The orderly reversal of the United States current account deficit is therefore a major challenge for policy makers both in the United States and other major economies.

The current account deficit is largely the consequence of the unbalanced growth of the United States economy since the second half of the 1990s, with buoyant domestic demand leading to a surge in imports from the rest of the world. At the same time, exports were restrained by the pronounced real appreciation of the dollar (until early 2002) and the uneven distribution of economic growth rates in the global economy. Domestic demand growth in the other major trading economies has been weaker than in the United States, with a correspondingly reduced demand for United States products abroad.

A current account deficit reflects, by definition, an excess of domestic investment over national saving.[10] Accordingly, domestic absorption of goods and service is larger than national output and income. This gap is financed by borrowing abroad, i.e. by attracting the excess savings of the rest of the world. From this perspective, the root cause of the widening current account imbalance is the decline, to a very low level, of the United States national saving rate, both private and public. The former reflects mainly the declining trend in personal savings since the early 1990s, which had fallen to only 0.2 per cent of disposable incomes by the autumn of 2004. A major concern is that the external deficit has been used not only to finance investment in productive capacity but also private consumption, which has been supported by the real estate boom. The main counterpart to the current account deficit since 2002, however, has been the swing in the government financial balance from a comfortable surplus in 2000 to a large deficit of more than 4 per cent of GDP in 2004.

The financing of the current account deficit, moreover, now relies to a large extent on massive purchases of United States government bonds by foreign, mainly Asian, central banks (especially China and Japan) whose motive has been to defend existing exchange rate parities or, at least, to limit the appreciation of their currencies against the dollar. It can be assumed that eventually the financing of the current account deficit will face ever greater problems in view of an increasingly "unacceptable amount of concentration risk",[11] which will affect the willingness of private investors and foreign central banks to hold more dollar-denominated financial assets at current exchange rates and interest rates. This exposes the United States to the risk of sudden and sharp portfolio adjustments with associated downward pressure on the dollar and risks for overall economic stability. Viewed from the perspective of China and Japan, the question is at what point will they consider the costs of accumulating more dollars to outweigh the benefits of stabilizing their exchange rates and maintaining their export competitiveness. The possibility of sudden massive reserve sales by foreign central banks evidently has also a geopolitical dimension.[12] It could, of course, be argued that the reserve holdings of the central banks of China and Japan are now so huge that they will likely not easily risk the losses associated with "sudden massive reserve sales" of the dollar. (Central banks were also very careful about the effects on the gold price in reducing their gold holdings.) In any case, there are fears of strong selling pressure on the dollar, feeding on itself and becoming unstoppable, leading to a "hard landing" (or even a crash) rather than the desired gradual decline or "soft landing" of the currency. The risk of a hard landing could be accentuated by portfolio shifts of United States investors towards foreign currency-denominated financial assets.

While there exists a broad consensus that the United States current account deficit is not sustainable, what is uncertain is the timing and extent of the necessary adjustment of the deficit to a level that is likely to be sustainable over the medium term. The latter is estimated by the IMF to be around 2-3 per cent of GDP.[13]

The current account adjustment will involve a combination of reduced domestic absorption (i.e lower domestic demand for goods and services) and a depreciation of the real effective exchange rate. The latter is likely to be brought about by a decline of the nominal

[10] The latter can be further disaggregated into the private sector saving-investment balance and the government net saving, i.e. the government budget deficit or surplus. If private sector savings are equal to private sector investments then any current account deficit (surplus) is matched by a corresponding government budget deficit (surplus). In such a case, current account deficits and budget deficits will move together, a constellation which has been labeled the "twin deficits" problem.

[11] Remarks made by Chairman Greenspan at the European Banking Congress 2004 (Frankfurt), 19 November 2004, [www.federalreserve.gov/boarddocs/speeches].

[12] It "cannot be prudent for [the United States] to rely on a kind of balance of financial terror to hold back reserve sales that would threaten our stability". L. Summers, *The United States and the Global Adjustment Process*, Third Annual Stavros S. Niarchos Lecture, Institute for International Economics (Washington, D.C.), 23 March 2004 [www.iie.com/publications/papers].

[13] R. Rajan, "Credible policies will break the dollar's fall", *Financial Times*, 15 December 2004.

effective exchange rate. This has been the case in previous episodes of current account adjustment in the United States and other industrialized countries.[14] The adjustment would, of course, be facilitated by the strong growth of domestic demand in the rest of the world, which would provide an additional stimulus to United States exports.

It is not possible, however, to say how large an exchange rate depreciation will be required to achieve a given reduction of the deficit. This is so because the dollar exchange rate is not exogeneously determined but is rather endogeneous to the global economic system. In any case, depreciation will stimulate United States exports, while at the same time dampening the demand for imports from the rest of the world.

The effectiveness of the exchange rate as an adjustment instrument will depend on the flexibility of the exchange rate policies pursued by the United States major trading partners. So far the major adjustment burden of the declining dollar has been borne by the euro,[15] given the policies pursued in Asia, especially China and Japan.[16] This raises the issue of an appropriate burden sharing of these inevitable exchange rate adjustments across the major regions of the world economy.

Given the size of the United States current account deficit, it can nevertheless be assumed that a substantial depreciation of the real effective exchange rate of the dollar will be needed to achieve better internal and external balance. The dollar has declined so far in a relatively orderly fashion and both the nominal and real effective exchange rates have fallen significantly compared with their recent peak in February 2002. But a further sharp decline is likely and the risks of disruptions in the international financial markets cannot be ignored. How smooth this adjustment process will be depends also on credible policy responses designed to redress the global imbalances, which, in turn, will shape the expectations and behaviour of investors in the financial markets.

The main role of a depreciation of the dollar is to help reduce the United States excess demand for foreign goods. This will occur not only via the impact on the prices of tradeables (relative to non-tradeables) but also because the sales of dollar-denominated financial assets (which bring about the depreciation) will tend to put upward pressure on United States interest rates which, in turn, will lead to lower domestic expenditure. The exchange rate adjustment is thus complementary to policies aimed directly at reducing domestic absorption, or, conversely, at raising the level of domestic savings relative to investment. Domestic savings can notably be raised by a reduction of the United States fiscal deficit, which can be expected to lead to a lower current account deficit.[17] In the private sector, corporate net saving (i.e. undistributed profits) rose to very high levels in 2004 both in comparison with their recent low in 2000 and also in a longer-term perspective. Any rise in the private sector's overall saving rate will therefore most likely depend on an increase in the personal savings rate from its present unsustainably low level. An open question is to what extent this can be fostered by appropriate policy measures.

The upshot is that the adjustment of global financial imbalances will inevitably involve a – possibly quite significant – weakening of United States domestic demand with adverse consequences for economic growth in the rest of the world economy. The risk of a recession in the United States cannot be excluded. To some extent the current account adjustment could be facilitated by stronger demand in the rest of the world, although United States exports respond less strongly to changes in foreign economic activity than United States imports to changes in United States real incomes.[18] In the absence of such a conducive external environment a greater burden will have to be carried by exchange rate adjustments with a concomitantly larger risk of disruptive capital flows. To the extent that exchange rate adjustments are successfully resisted, a larger share of the adjustment burden will fall on domestic absorption, with possibly even worse consequences for the world economy.

It is against this background that the recent G-20 Meeting of Finance Ministers and Central Bank Governors underscored "the importance of medium-term fiscal consolidation in the United States, continued structural reforms to boost growth in Europe and Japan, and, in emerging Asia, steps towards greater exchange rate flexibility, supported by continued financial sector reform, as appropriate".[19]

Given the formidable adjustment challenge that lies ahead, there is an important role to be played by policy

[14] C. Freund, op. cit.

[15] An open issue is to what extent a more accommodative monetary policy and a more flexible Stability and Growth Pact in the euro area would have reduced this adjustment burden.

[16] To illustrate: compared with its recent peak in February 2002, the broad nominal effective exchange rate of the dollar had declined by 14.4 per cent by November 2004. Over the same period, the narrower effective exchange rate against major currencies (which excludes the Chinese yuan and the currencies of other emerging Asian economies) fell by 27.6 per cent.

[17] Although the actual fiscal and current account deficits are often characterized as "twin deficits" this is *stricto sensu* only true in the definitional sense of national income accounting. A reduction of the fiscal deficit need not necessarily lead to a proportionate decline of the current account deficit. This will also depend on the private sector's spending (and saving) behaviour.

[18] Liberalization of trade in services should also tend to improve the United States structural trade balance, given its comparative advantages in this sector, reflected in the long-standing surplus in services. C. Mann, *Is the U.S. Trade Deficit Sustainable?* (Washington, D.C., Institute for International Economics, 1999), pp. 88-89.

[19] "Communiqué. Meeting of Finance Ministers and Central Bank Governors" (Berlin), 20-21 November 2004 [www.g7.utoronto.ca/g20].

coordination, be it in the form of exchanges of information, shared analysis or cooperation over exchange rate policies.[20] The latter would notably involve cooperation between the Federal Reserve, the ECB and the Bank of Japan,[21] but also the central banks of other countries, especially China.

In a more general way, the gyrations in the dollar exchange rate not only confirm the tendency for significant overshooting but also the risk of speculative bubbles in the foreign exchange markets as in other asset markets. This instability has damaging effects on the real economy and points to broader issues of international economic governance.

(ii) Finding the balance: structural reforms and the macroeconomic policy framework in Europe

In Europe, the short-term prospects for weak domestic demand growth being offset by a strengthening of exports to the rest of the world do not look very favourable. The recovery in the European economy virtually came to a halt in the third quarter of 2004 and current forecasts are for only a moderate rise in economic activity in 2005.

The main policy challenge is to bridge the gap between the rhetoric of the ambitious Lisbon agenda, which aims at creating a competitive and dynamic economy at par with the United States, and the disappointing reality of progress falling significantly short of the intermediate targets. A major problem with the Lisbon agenda is its almost exclusive focus on supply-side reforms as a basis for creating a dynamic economy that combines both strong employment and productivity growth. But market outcomes are not determined solely by supply but by the interaction of the forces of supply and demand. It will be difficult to meet the targets of the Lisbon agenda in a context of weak growth of domestic demand.

Sustaining higher rates of growth is also a *conditio sine qua non* for preserving the European model, with its strong concern for social cohesion. The adjustment pressures arising from the intensification of international competitive pressures, rapid rates of technical change (with a clear bias against low-skilled labour), as well as population ageing, all make this challenge even more difficult.

A recent review of the Lisbon strategy[22] – the so-called Kok report – has concluded that the agenda is far too broad and has partly conflicting objectives. It therefore proposed that the strategy should focus on five, although still quite broad, priority areas where progress is to be pursued within the framework of national action programmes. These areas are the formation of a knowledge society with a strong emphasis on innovation and research; the completion of the internal market, which requires a closer integration of services markets and network industries; the fostering of a more conducive business climate, *inter alia*, by facilitating market entry and the development of venture capital markets; further reforms of labour markets designed to improve intra-EU labour mobility; and the promotion of environmental sustainability.

Raising Europe's growth potential, however, requires not only supply-side reforms but also a sufficiently flexible macroeconomic policy framework (i.e. mainly monetary and fiscal policy) that is "as supportive of growth as possible",[23] while paying adequate attention to preserving macroeconomic stability.[24] In a similar vein, the Sapir Report[25] has emphasized the need for combining microeconomic reforms with a revision of the EMU's macroeconomic policy framework, taking especially into account the increased heterogeneity of the EU after enlargement, which calls for more flexible rules to limit the potentially adverse implications of "one-size-fits-all" policies. The challenge is to find the proper balance between discipline and flexibility.[26]

Against this background, it is important that a sensible reform of the Stability and Growth Pact be achieved as soon as possible.[27] It would strengthen private sector confidence that the overriding priority of fiscal policy is to ensure the sustainability of the public finances while at the same time allowing sufficient flexibility for anti-cyclical fiscal policy responses.[28] The recent proposals made by the European Commission[29] therefore go in the right direction, but it may not be easy to achieve a consensus on these matters.

A sensible reform of the Stability and Growth Pact, combined with realistic and firm objectives for medium-

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[20] E. Truman, "The US current account deficit and the euro area", speech prepared for the conference, *The ECB and its Watchers VI* (Frankfurt), 2 July 2004 [www.iie.com/publications].

[21] "ECB considers joint currency move", *Financial Times*, 2 December 2004.

[22] "Facing the challenge", report from the High Level Group chaired by Wim Kok (Brussels), November 2004 [europa.eu.int/comm/lisbon_strategy/index_en.html].

[23] Ibid., p. 6

[24] UNECE, *Economic Survey of Europe, 2004 No. 2*, pp. 49-50.

[25] "An agenda for a growing Europe – making the EU economic system deliver", report of an Independent High-Level Study Group established on the initiative of the President of the European Commission (Brussels), July 2003 [www.euractiv.com/ndbtext/innovation/sapirreport.pdf].

[26] Ibid., p. 135.

[27] This is also proposed in the Kok report.

[28] UNECE, *Economic Survey of Europe, 2004 No. 1,* pp. 10-15.

[29] Communication by the Commission on, *Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact,* COM (2004) 581 (Brussels), 3 September 2004.

term fiscal consolidation, could also create a new basis for a kind of European "policy mix", that is, for cooperation between the European Central Bank and the European Council (or the so-called euro group).[30] Monetary policy should be symmetric over the business cycle, giving equal weight to upside and downside risks to both price stability and economic growth. This becomes even more important given the general orientation of fiscal policy towards ambitious consolidation targets, which will be achieved much more easily in a context of sustained economic growth.

(iii) The policy challenge of economic diversification in the CIS

While rates of GDP growth in most CIS economies have been impressive in recent years, there are nevertheless concerns about their sustainability. The key factor behind the economic boom in the resource-rich CIS economies has been the expansion of their extractive industries (especially, the crude oil and natural gas sectors) coupled with a surge in world commodity prices in the last few years. The narrow base of the recovery exposes these economies to fluctuations in the highly volatile global commodity markets, making them vulnerable to external shocks. Besides, mineral extraction is a capital-intensive activity generating little employment and is likely to result in geographically unbalanced development and greater income inequality.

The key policy issue is whether and how public policy can help to broaden the growth base and reduce the excessive reliance on natural resources in the medium and longer term. The recent policy debate in some CIS economies has focused on the need for economic diversification as a key factor of economic development as well as the basis of high and sustainable rates of growth. Despite the differences in national circumstances, diversification has figured prominently in the development strategies recently elaborated in some countries.[31] However, there is still much ambiguity as regards the ways and means to achieve this objective.

The disintegration of the CMEA and then of the Soviet Union triggered a collapse of much of the manufacturing industry in the CIS. As a result, the production and export structures in most CIS economies have become more specialized and concentrated, especially in the resource-rich economies. For example, in Russia the share of the top five export products in total exports increased from 62 per cent in 1996 to 68 per cent in 2003 (four of these five products were primary commodities and fuels) and the share of the top 10 products increased from 72 per cent to 77 per cent.[32] A similar process of concentration towards commodity exports is observable in many CIS economies.[33] Such a narrow specialization pattern may be counterproductive for a balanced development path, especially for the low-income CIS countries.[34]

Economic diversification has, of course, different aspects and dimensions across the CIS countries. There is a clear distinction between economies with abundant resources of crude oil and natural gas, and the less richly endowed countries, where the increased shares of commodity exports mostly reflect the outcomes of post-Soviet deindustrialization. At the same time, resource-rich economies face specific problems that may even risk becoming impediments to their economic development.

While natural resource abundance can in principle be an important source of development finance, the relationship between natural resource endowments and economic performance cannot be considered as deterministic. In fact, past experience provides ample evidence of a negative relationship, sometimes referred to as the "resource curse".[35] The channels through which

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[30] *Le sursaut. Vers une nouvelle croissance pour la France,* Rapport official, Groupe de travail présidé par Michel Camdessus, La documentation Française (Paris), 2004, pp. 142-143 [www.ladocumentationfrancaise.fr].

[31] In Russia, the policy debates on the need for economic diversification have been underway for several years. The recently announced draft medium-term economic programme sets the target of shifting from a resource-based to a technology-driven growth pattern. "Programma sotsial'no-ekonomicheskogo razvitiya Rossiiskoi Federatsii na srednesrochnuyu perspektivu (2005-2008 gody) (proekt)" [www.economy.gov.ru/wps/portal]. The government of Kazakhstan has adopted an "Innovative Industrial Development Strategy of the Republic of Kazakhstan for 2003-2015 [www.undp.kz/library_of_publications/files/2846-13355.pdf]. In Azerbaijan, the authorities also address the issue of economic diversification in the recent policy document "Republic of Azerbaijan State Programme on Poverty Reduction and Economic Development 2003-2005" [www.economy.gov.az]. The authorities in Turkmenistan have also recently announced plans to reduce the dependence of the economy on the exports of unprocessed primary commodities.

[32] The products are identified at the three-digit level of the SITC, Rev.3 classification. UNECE secretariat calculations on the basis of data from the United Nations COMTRADE Database.

[33] Thus in 2003, the top five products accounted for 90 per cent of total exports in Azerbaijan; for 72 per cent in the case of Kazakhstan; 68 per cent in Armenia and 66 per cent in Kyrgyzstan. In almost all these cases the top export products were dominated by commodities. The trend towards this type of export specialization is also evident in the recent dynamics of other export concentration indices for the CIS economies. UNCTAD, *Handbook of Statistics 2004 on CD-Rom* (New York), 2004. For comparison, the average share of the top five export products in the central European and Baltic countries (EU-8) in 2003 was 32.5 per cent.

[34] A recent cross-country study based on a large sample of more than 90 countries comes up with the robust finding that economic diversification has been the typical evolutionary pattern over the development path of most countries, until they reach a certain (fairly high) level of per capita income; above that threshold the prevailing pattern is that of specialization. J. Imbs and R. Wacziarg, "Stages of diversification", *American Economic Review*, Vol. 93, No. 1, March 2003, pp. 63-86. This analysis supports the view that for less advanced economies development goes along with diversification and vice versa; these are indeed the two sides of one and the same coin.

[35] P. Stevens, "Resource impact: curse or blessing? A literature survey", *Journal of Energy Literature*, Vol. 9, No. 1, June 2003, pp. 3-42; D. Lederman and W. Maloney, *Open Questions about the Link between Natural Resources and Economic Growth: Sachs and Warner Revisited,* Central Bank of Chile Working Papers, No. 141 (Santiago), February 2002.

the "resource curse" can emerge and escalate include, *inter alia*, a weak institutional environment and poor public governance (notably, resource riches tend to be associated with higher degrees of corruption and rent-seeking activities). The real exchange rate appreciation associated with large and rising exports of natural resources can become an impediment to other economic activities (the so-called Dutch Disease). Another problem is the general economic volatility and vulnerability of the economy to external shocks.[36] However, there have also been a number of cases where natural resources have served as a basis for successful economic diversification and development of a country.[37] Prudent financial management and an appropriate institutional environment (Norway being a good example) can prevent or minimize the potential negative side effects. Whether a resource-rich country falls into the trap of the "resource curse" or manages to use the resource endowment to jump-start economic diversification largely depends on the country-specific institutional context and the policy framework designed to foster economic development.[38] In any case, a carefully designed, and duly implemented, policy agenda can greatly reduce the risks of the "resource curse" in the resource-rich CIS countries and can facilitate the process of their economic diversification.

The policy challenge of economic diversification is even more daunting in the CIS countries that are not so rich in natural resources. These are also the countries with lower levels of per capita income and a higher incidence of poverty. While policy makers in these economies face some basic development problems, they do not have at their disposal the financial cushion created by resource windfalls. Nevertheless, the main principles of addressing the goal of economic diversification should be broadly similar across the CIS.

[36] It has also been argued that the transmission channels from natural resource abundance to slow economic growth can be described in terms of crowding out: a heavy dependence on natural capital tends to crowd out other types of capital, with negative implications on economic growth. T. Gylfason, *Natural Resources and Economic Growth: From Dependence to Diversification*, CEPR Discussion Paper, No. 4804 (London), December 2004.

[37] Thus, the transformation of Finland and Sweden, two of Europe's poorest countries until the middle of the nineteenth century, into leading industrialized economies is an example of successful diversification initially drawing on domestic natural resources. M. Blomström and A. Kokko, *From Natural Resources to High-tech Production: The Evolution of Industrial Competitiveness in Sweden and Finland*, CEPR Discussion Paper, No. 3804 (London), February 2003. The experience of some newly industrialized economies in south-east Asia also provides examples of how natural riches can be used as part of an overall development strategy to diversify the economy away from primary commodities. K. Jomo and M. Rock, *Economic Diversification And Primary Commodity Processing In The Second-tier South-east Asian Newly Industrializing Countries*, UNCTAD Discussion Paper, No. 136 (Geneva), June 1998.

[38] For a discussion of the potential dangers of resource-led development in Russia and other CIS countries see Y. Kim, *The Resource Curse in a Post-communist Regime: Russia in Comparative Perspective* (Aldershot, Ashgate, 2003).

The economic argument underlying diversification policies is that a comparative advantage in the international division of labour should not be regarded as something given once and for all. Comparative advantage (as revealed in the structure of net exports) changes over time as a result of shifts in the pattern of physical and human capital accumulation. But new areas of comparative advantage will only be cultivated if properly developed by venturing entrepreneurs. The CIS economies are by no means doomed to be locked into their current, highly skewed production and export structures; they need, however, to undertake a dedicated long-term effort to cultivate their potential and develop new areas of comparative advantage.

The potential existence of comparative advantage (of the type discussed above) that is not cultivated under market conditions may be regarded as a case of market failure. Both economic theory and experience indicate that one of the efficient ways to deal with this type of market failure is through appropriate policy intervention.[39] In a global perspective, successful industrialization or economic diversification (including west European industrialization in the nineteenth century but also the post-war rise of the south-east Asian economies and, more recently, the experience of Ireland), has almost always been driven by an active government policy stance.[40] However, experience has also shown that while markets alone may not be sufficient to steer economic restructuring, governments alone cannot deliver satisfactory results either, as illustrated by the disastrous welfare outcome of central planning (of which the CIS economies still bear the cost). Also some traditional approaches to industrial policy (such as "picking winners", or import substitution policies) are notorious for negative side effects such as market distortions, inefficient resource allocation and corruption.

In the absence of well functioning markets there may be other factors impeding the cultivation of potential comparative advantage (for example, poor protection of property rights, weak contract enforcement, etc.). This argument applies to many of the CIS economies, especially those that are less advanced in their economic transformation. The establishment of well functioning markets is thus not only a necessary condition for the successful implementation of diversification policies but can be expected to provide a further boost to this process.

[39] D. Rodrik, *Industrial Policy for the Twenty-first Century*, CEPR Discussion Paper, No. 4767 (London), November 2004. Rodrik points to two fundamental economic factors that explain why market forces alone are not sufficient to drive economic diversification: 1) the existence of information externalities (the markets cannot provide information of the cost structure/profitability of products that do not yet exist); 2) the existence of coordination externalities (many projects require simultaneous, large-scale investments to be made in order to become profitable).

[40] K. Jomo and M. Rock, op. cit.; D. Rodrik, op. cit.

Based on the experiences of other countries, the broad paradigm of a policy framework targeting economic diversification in the CIS economies should incorporate key ingredients such as:

- A coherent long-term strategy outlining the main goals to be achieved. Importantly, the formulation of long-term goals should involve a broad public debate. It is essential that the strategy reflect national goals that enjoy broad public support and popular legitimacy and will not be subject to revisions over the political cycles;
- An incentive structure that will stimulate economic agents to act in a direction consistent with the policy goals as well as the mechanisms of coordination and management of conflicting interests (for example, between the public and private sectors). Incentives should include both "carrots" (motivating agents to undertake specific actions) and "sticks" (including early identification of failure and exit strategies);
- An appropriate framework of public institutions with delegated authority to implement the related policies. Clear rules of practical implementation of policy conventions coupled with transparency and accountability in the operation of these institutions are essential to avoid the capture of policy by vested interests and to prevent corrupt practices;
- Adequate funding. Policy actions targeting diversification inevitably involve public funding. Resource-rich economies can in principle draw on the rents associated with natural resources to fund the strategies targeting new areas of comparative advantage. When natural wealth is not abundant, the channelling of public funds towards diversification policies should not endanger long-term fiscal sustainability.

There is no unique policy model of economic diversification (and for that matter, no unique diversification pattern); success (as well as failure) can take many different forms, and this applies with full force to the related policy agenda in the CIS. But experience of other countries unambiguously suggests that the adequacy and quality of the institutional arrangement is probably the key factor of success in implementing diversification policies. In other words, the normative policy rules and objectives must be matched by an appropriate institutional framework in the broader sense of formal and informal "rules of the game".[41] Many negative side effects of industrial policy in the traditional sense can be directly linked to the deficiency or inadequacy of the institutional framework within which it was being implemented. In this regard, the establishment of adequate institutions should be regarded as part and parcel of the diversification strategy. Strong and dependable institutions are also required for high rates of GDP growth to be sustained in the context of adverse shocks. The actual institutional changes will depend on the specific socio-economic and political context in the country where such a strategy is being implemented.

In countries that are still undergoing a profound economic transformation, such as the CIS economies, the policy challenges of economic diversification are compounded by their unfinished systemic and structural reforms required to establish a fully functioning market economy. At the same time, the existing gaps in some areas of market development can also be regarded as an opportunity for policy makers. Indeed, it may be easier to establish a new, well-functioning institution starting from scratch (provided it is well designed and properly assembled) than by trying to change or amend an already existing (but malfunctioning) institution.

Recent experience suggests that the most effective institutional arrangements targeting economic diversification are those that engage all the relevant stakeholders (both from the public and from the private sector) in the process of policy design and in its implementation, and steer them towards the common goal.[42] Instead of "picking winners" in the sense of traditional industrial policy, this approach involves a more flexible strategic alliance (that can be of a long-term nature) in which the government and the private sector exchange information and ideas, and coordinate their actions in the development of new activities, products or technologies.[43] Through strategic collaboration between

[41] D. North, *Institutions, Institutional Change and Economic Performance* (Cambridge, Cambridge University Press, 1990).

[42] There can be a wide variety of efficient institutional arrangements that involve the private and the public sectors in the pursuit of goals of common interest related to economic diversification. For a comparative cross-country overview of relevant practices see D. Rodrik, op. cit. Specific cases of successful implementation of this approach are described in F. Bonaglia and K. Fukasaku, *Export Diversification In Low-Income Countries: An International Challenge After Doha*, OECD Development Centre, Technical Paper No. 209 (Paris), June 2003.

[43] UNECE has been promoting the development of some forms of public-private partnerships in the ECE region (especially in the countries undertaking transition from plan to market) as an institutional framework for sharing the risks between, as well as for coordinating the interests of, the private and public sectors (in particular, in large-scale public investment projects). Within the ECE emerging market economies, the greatest number of functioning public-private partnerships have been established in infrastructure development (in the sectors of energy, transport and telecommunications). More recently, public-private partnerships have gained entry into urban development, municipal and social services. UNECE has also been instrumental in steering intergovernmental policy discussions on various issues related to the institutional building of efficient public-private partnerships, including the issue of good governance. UNECE Committee for Trade, Industry and Enterprise Development, *Report of the Third PPP Alliance Meeting,* TRADE/WP.5/AG.1/2004/3 (Barcelona), 14-17 September 2004. A recent UNECE intergovernmental forum advanced the idea of promoting public-private partnerships as an institutional framework for industrial restructuring in the CIS region. Forum on "Public-Private Co-operation in Industrial Restructuring", co-organized by UNECE and the Organization for Security and Co-operation in Europe (OSCE) (Almaty, Kazakhstan), 3-4 November 2004 [www.unece.org/ie/wp8/almt.html].

the parties involved, this policy model seeks to identify the causes of market failures that result in the underprovision of entrepreneurship in the pursuit of economic restructuring.[44] If properly designed and instituted, the rules of interaction, the shared commitments and responsibilities, the transparency in operation and accountability in the use of public funds within such alliances should help to minimize the market distortions and corrupt practices that sometimes taint conventional industrial policy.

Obviously, the appropriate institutional framework is only one component of the broad policy agenda targeting economic diversification and development in the CIS economies. Overall, reform initiatives should focus on those areas that have a general impact on the cost of economic activities, including basic infrastructures, where public investment plays a central role. In this context, as the private sector becomes the means of achieving public goals, public policy should foster private sector development and entrepreneurship by reducing the cost of doing business and establishing a conducive environment for the attraction of both domestic and foreign investment.[45] Further efforts are also needed to improve public and corporate governance and eliminate the existing numerous market imperfections.

The broader policy agenda should also target innovation and human capital development, which are key factors of long-term growth and competitiveness. In fact, many of the CIS countries (in particular Russia and other larger economies) are better placed to pursue an innovation-driven diversification agenda than some of the resource-rich developing countries due to their already existing human capital endowment. But policy should also seek to eliminate existing structural rigidities that may hamper the transformation of human capital endowments into innovative entrepreneurial activity.

The development of the financial system is of particular importance in fostering productive investment and hence diversification. Facilitating credit access would ease a key constraint on the development of new economic activities and the promotion of innovation. A well-functioning banking system in resource-rich economies is also required to efficiently channel the surpluses generated in fast-growing, commodity-based activities to investment opportunities in other sectors.

Wider regional economic cooperation and further integration into the global economy can also serve to foster economic diversification by increasing the effective size of the market and encouraging FDI outside the resource sectors. This is particularly relevant for the smaller CIS economies, where the role of external demand for economic development is more obvious and for many landlocked countries where transit issues are more painfully felt. But as a word of caution, trade liberalization alone may not necessarily stimulate new economic activities (as evidenced by recent experience); for these to materialize, the integration efforts should complement domestic policies fostering diversification. In addition, it is crucial that trade and transit arrangements that increase market access are perceived as stable and not subject to possible reversals if those beneficial effects are to be obtained.

In addition, diversification policies require specific skills from the government agencies that will be involved in implementation. A public administration with adequate capacity is in fact a precondition for engaging in any large-scale government-sponsored programmes. Capacity building efforts thus emerge as an important policy step that should be assigned high priority, especially in the lower-income CIS countries. Obviously, this is also an area where targeted assistance by the international community (which will not necessarily require large-scale funding) can generate high returns in terms of its welfare effect in the recipient countries.

Economic diversification in the CIS region should be regarded as a long-term policy goal. Given the economic structures that prevail at present, dependence on commodity exports is likely to remain a dominant feature of many CIS economies for some time to come. Successful economic diversification requires an integrated and consistent policy framework that relies on comprehensive reforms in many areas and calls for a lasting and dedicated policy effort.

(iv) Financial vulnerability in the ECE emerging market economies

The level of net capital inflows and the corresponding current account deficits of the majority of the ECE emerging market economies (EME) have been relatively large for the last decade. This has allowed investment and consumption to be maintained at levels above those that would have been possible in their absence. Growth can be increased with external finance since the level of domestic investment is no longer constrained by domestic savings. These capital inflows have allowed the EME to partially rebuild their productive capital stocks that were inadequate for a market economy.[46] In addition, this inflow allowed consumption levels to be partially maintained despite the

[44] D. Rodrik, op. cit.

[45] Reducing the cost of doing business concerns not only explicit burdens, such as taxes and social contributions, but also other types of regulatory and administrative costs.

[46] Early in the transition process, moreover, some enterprise capital assets were stripped due to the lack of adequate corporate and public governance. It is possible that capital market liberalization contributed to this since it allows capital to be hidden abroad where it cannot be seized. K. Hoff and J. Stiglitz, "After the Big Bang? Obstacles to the emergence of the rule of law in post-communist societies", *American Economic Review*, Vol. 94 No. 3, June 2004, pp. 753-763.

collapse in economic activity during the transition phase. Although these advantages are very important, the EME should remain cognisant of a number of additional constraints and qualifications that apply to a development strategy based upon a strong reliance on external finance. These primarily include more stringent constraints on macroeconomic policy, the opportunity cost of holding increased amounts of international reserves, and the loss of national income during a currency crisis if one should occur. Due to these constraints, the benefits of capital market openness may well be smaller for emerging markets than for more advanced economies.[47]

Given the significant levels of capital inflows into the EME, there is the possibility that for some of these economies capital account liberalization may have proceeded too rapidly given their domestic institutional reforms. Since boom-bust cycles seem to characterize emerging market economies throughout the world, especially given the current international financial architecture, additional prudence towards adjusting both current account and fiscal deficits to sustainable levels during this period of relatively favourable performance would be in order.

It is difficult to assess the degree to which the EME current account deficits are likely to be problematic for economic stability.[48] Almost all analyses of previous exchange rate crises have concluded that large or increasing current account deficits were a significant contributing factor. However, the risk posed by a current account deficit cannot be evaluated solely by its size; it will also depend on how it is being financed, how it is being used, the exchange rate regime, current debt levels, the size of international reserves, the health of the financial system and the country's overall macroeconomic condition. Although there has been some progress in understanding the factors that may eventually trigger a currency crisis, there remain significant gaps in knowledge, and each crisis appears to be somewhat different from previous ones.[49] The fundamental problem is that current account deficits that appear sustainable under current conditions may no longer be viewed as such after some unforeseen, and perhaps totally external, shock. The question of sustainability is often raised for countries with current account deficits significantly above their GDP growth rates. This is especially the case for those countries with double-digit current account deficits and high levels of external debt relative to official reserves or GDP (data on these variables is provided in chapter 6.1). Most of the EME have maintained current accounts deficits below 10 per cent of GDP, the level of Mexico's deficit in the years prior to its financial crisis in 1994. However, many have deficits that are larger than several of the east Asian countries prior to their financial crises in 1997-1998.[50] Given that the region has limited experience with open capital accounts and a susceptibility to currency crises,[51] including Bulgaria in 1996,[52] the Czech Republic[53] and Romania in 1997,[54] Russia in 1998,[55] Turkey in 2000-2001, and several speculative attacks against Hungary in 2003,[56] concern about possible future currency instability would seem to be warranted. Attention towards current account deficits and possible financing difficulties needs to be heightened during periods, such as the current one, when global liquidity is being tightened.

If a currency crisis were to occur in eastern Europe, the ability of the IMF to deal with it would depend to a large degree on how much contagion was involved since IMF funds are limited. The degree to which the EU would provide additional support is another significant factor. The ECB's focus on price stability, however, may limit its ability to intervene to support currencies in the ERM-2.[57] The United States special assistance to Mexico

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[47] M. Obstfeld, *Globalization, Macroeconomic Performance and the Exchange Rates of Emerging Economies*, Bank of Japan Institute for Monetary and Economic Studies, Discussion Paper Series, 2004-E-14 (Tokyo), 2004.

[48] The sustainability of the current account deficits of the EU-10 is examined by P. Zanghieri, *Current Account Dynamics in New EU Members: Sustainability and Policy Issues*, CEPII Working Paper 2004-07 (Paris), July 2004. Concerns about specific countries have been raised in the press, e.g. E. Yeldan and M. Weisbrot, "Is Turkey the next Argentina?", *International Herald Tribune*, 4 December 2004.

[49] Even when the fundamentals are reasonably sound it is possible to have a self-fulfilling crisis that need not have occurred. Speculators will attack a currency when there is reasonable confidence that the attack will succeed regardless of the fundamentals.

[50] According to Joseph Stiglitz, the major contributing factors to the east Asian currency crisis were: 1) an exchange rate peg, 2) sterilization of capital inflows, 3) liberalization of capital accounts, and 4) inadequate financial regulation; speech delivered to the Council on Foreign Relations, *The Role of International Financial Institutions in the Current Global Economy* (Chicago), 27 February 1998.

[51] Exactly what constitutes a crisis is somewhat ambiguous; some define it as any time the nominal exchange rate depreciates by at least 20 per cent within 10 trading days, other criteria include changes in additional variables such as currency reserves and interest rates. These different measures are discussed in A. Brüggemann and T. Linne, *Are the Central and Eastern European Transition Countries Still Vulnerable to a Financial Crisis? Results from the Signals Approach*, Bank of Finland, Institute for Economies in Transition, Discussion Papers, No. 5 (Helsinki), 2002.

[52] For an analysis of this crisis and an earlier, milder one in 1994, see UNECE, *Economic Survey of Europe, 1996-1997*, chap. 3.1(iii).

[53] UNECE, *Economic Survey of Europe*, *2001 No. 2*, p. 128, box 5.2.1.

[54] Although there was a significant and rapid depreciation of the Romanian leu during 1997, it did not result in a more generalized financial or economic crisis.

[55] Russia had a trade and current account surplus in the years prior to its crisis; see UNECE, *Economic Survey of Europe*, *1998 No. 2*, chap. 1.2(ii).

[56] The attacks on Hungary's currency are described in UNECE, *Economic Survey of Europe*, *2004 No. 1*, p. 51, box 3.1.1.

[57] Some argue that the ECB could intervene believing it would not increase the euro area money supply by enough to significantly affect inflation. K. Gern, F. Hammermann, R. Schweickert and L. Vinhas de Souza, *European Monetary Integration after EU Enlargement*, Kiel Discussion Paper, No. 413 (Kiel), September 2004.

in 1994-1995 was considerable and played an important role in containing that crisis. The lack of any special bilateral assistance from any of the major economies in the Asian crisis (although Japan offered to supply it) contributed to its magnitude.

Current account deficits should mainly finance investment

A major consideration in evaluating the sustainability of current account deficits is the degree to which the associated capital inflows are being invested or used for consumption. Although the emphasis on international financial integration is often on the potential for increasing fixed investment, empirical analysis finds that reduced savings instead of increased investment is often the main effect of capital market openness.[58] The lower interest rates that can result from capital account liberalization encourage private households to borrow for consumption purposes. Although additional consumption in the EME is not necessarily inappropriate, especially given the initial fall in living standards throughout much of the EME, it must be recognized that net foreign debt will have to be paid back with trade surpluses at some time in the future.[59] When current account deficits are used to increase fixed investment in the tradeables sector, they thereby contribute to growth and an increased capacity to earn the foreign exchange required to service and repay foreign debt; consumption driven deficits do not have this property. One lesson from the Mexican and east Asian crises is that investment in non-traded sectors such as real estate are of little value when foreign exchange is needed for debt repayment.

Although it is clear theoretically that current accounts deficits should ideally finance additional investment instead of additional consumption, it is difficult to determine empirically if this is actually happening. One possible approach that analysts use to address this question is to examine current account balances and investment over time to see how the former affects the latter. However, for the EME it would be inappropriate to use the pre-market years, and the early transition years when national income was falling were obviously not typical. Thus, the EME do not have an historical record that can be appropriately used to make this comparison.

Given that empirical analysis finds that financial liberalization is likely to lower domestic savings, and given the difficulty of altering private sector savings behaviour, the most effective way to counter this fall in domestic savings is to increase public saving. However, this may not be desirable if fiscal deficits are being used to finance infrastructure investment. Investment can be directed into the tradeable sectors by giving those sectors favourable tax treatment. In terms of macro-stability, investment from equity is preferable to debt,[60] and FDI to portfolio investment.[61] Public policy should therefore be directed at providing incentives for FDI in the traded goods sectors. However, any incentives need to be carefully designed to minimize rent-seeking behaviours. In addition, any FDI promotion policy should also include complementary measures to increase positive technological spillovers. Research on EME economies has generally found that knowledge spillovers from FDI are weak[62] since firms have an incentive to limit spillovers to domestic competitors. The public policy emphasis should be on encouraging linkages to upstream and downstream firms in less direct competition.[63] In addition, the effects of foreign firms on market structure need to be monitored to ensure that these firms, which generally have superior technology, are not able to monopolize markets.

Currency arrangements complicate external finance

The task of managing capital market openness can be further complicated by currency arrangements that may constrain the set of potential policy options. This is especially the case for those economies that are attempting to fix or peg their exchange rates.[64] Countries with open capital accounts and pegged exchange rates will find it especially difficult to maintain domestic

[58] O. Blanchard and F. Giavazzi, "Current account deficits in the euro area: the end of the Feldstein-Horioka puzzle?", *Brookings Papers on Economic Activity*, 2 (Washington, D.C.), 2002, pp. 147-209.

[59] Technically, if creditors can be found debt never needs to be repaid, it can just be continuously rolled over. However, given limits to debt levels, higher current account deficits today imply lower current account deficits in the future and thus lower future domestic absorption than would have occurred otherwise.

[60] And long-term debt is preferable to short-term debt. A definitive verdict has yet to be reached on the advisability of capital account restrictions, as in Chile, that attempted to tilt the structure of investment by maturity from short term to long term.

[61] Most crises are accompanied by a significant stock market decline as equity investors try to get out; large and destabilizing reversals of portfolio investment were a central aspect of the crises in Argentina, Brazil, Mexico, the Republic of Korea and Russia.

[62] S. Djankov and B. Hoekman, "Foreign investment and productivity growth in Czech enterprises", *World Bank Economic Review*, Vol. 14, No. 1, January 2000, pp. 49-64; J. Konings, "The effects of foreign direct investment on domestic firms", *Economics of Transition*, Vol. 9, No. 3, November 2001, pp. 619-633.

[63] For a detailed analysis see UNCTAD, *World Investment Report 2001: Promoting Linkages* (United Nations publication, Sales No. E.01.II.D.12). Recent evidence for backward linkages in Lithuania is described in B. Javorcik, "Does foreign direct investment increase productivity of domestic firms? In search of spillovers through backward linkages", *American Economic Review*, Vol. 94, No. 3, June 2004, pp. 605-627.

[64] Estonia, Lithuania and Slovenia have joined the Exchange Rate Mechanism (ERM-2) as a preliminary step to adopting the euro; Latvia is expected to follow. All of the EU-10 are scheduled to adopt the euro by 2010, and must maintain a fixed exchange rate (around a band of ±15 per cent) in the two years prior to joining. Other countries such as Ukraine have maintained a de facto peg with the dollar, and Bosnia and Herzegovina and Bulgaria have implemented currency boards.

balance.[65] It will be a major policy challenge for them to reap the benefits of foreign borrowing without falling victim to a currency crisis. The fundamental problem facing the EU-10, as well as the other EME that attempt to maintain a fixed exchange rate, is the so-called trilemma of international finance – with open capital markets and a fixed exchange rate a country loses control over domestic monetary policy. In practical terms this means that the monetary authorities do not have sufficient instruments to achieve exchange rate stability and price stability at the same time. The EU-10, however, have macroeconomic targets for inflation and interest rates, and in addition limits on fiscal deficits, which they must meet as part of the Maastricht criteria to qualify for entry into the EMU. Therefore there is the possibility that these targets will not be consistent with one another and thus cannot be achieved simultaneously.[66] It is also possible that with these targets to satisfy, these countries will be forced to ignore, as their richer counterparts have, what should perhaps be the most important target – employment. The "classical" view, that if the other macroeconomic targets are achieved then macroeconomic policy is not needed to take care of employment, which is implicit in the Maastricht criteria, has proven to be a costly delusion.

Given that countries will be quite vulnerable once they are in the ERM-2, they are well advised to choose carefully the moment at which they embark on this stage of currency integration.[67] One of the main economic benefits from entry into the euro is the elimination of the possibility of a currency crisis and the absence of stabilization costs.

Increased international reserves could provide important insurance

A significant step that the EME may take to limit the possibility of a currency crisis is to increase the level of their official reserve assets. Concern about unexpected external shocks is a significant factor behind the tripling of international reserve assets by developing countries between 1993 and 2002. This has been especially the case for the east Asian countries, which are especially sensitive to potential risks given their experience in the 1997-1998 crises. These countries have also attempted to create a regional market for domestic currency debt as added insurance. However, the accumulation of international reserves, although providing some protection from a currency crisis, entails significant opportunity costs. The reserves, normally held as short-term euro or dollar bills, pay interest rates that are relatively low, while real resources, in terms of foregone imports, must be sacrificed. In addition, the accumulation of reserves presents a fiscal burden in that in order to sterilize them (in order to avoid monetary growth and inflation), higher interest rate domestic bonds must be issued, while the government receives a much lower rate on its holdings of foreign bonds. The opportunity costs of holding international reserves can be reduced by purchasing slightly more risky assets with higher yields such as long-term government bonds or equity indexed funds; the overall risk is likely to be smaller by having more but riskier reserves than by having a smaller amount of less risky assets.[68] Another alternative that allows accumulation of reserves without an immediate decline in consumption, is for the central bank to borrow abroad long-term and invest the funds in liquid international securities. Although this has a cost due to the interest rate differential, the overall social costs are lower since the probability of an attack is lower and the interest spread on private debt and equity capital may fall as well.[69] As a further fall in the dollar would erode the value of existing official reserves, a re-evaluation of the currency allocations of current reserve portfolios would be prudent.

(v) Upcoming challenges posed by globalization in manufacturing and services

In order to reap the benefits of international trade integration, just as with financial integration, it is necessary to have in place the necessary complementary domestic institutions and policies. The failure to do so can be just as costly although not as dramatic as a currency crisis resulting from an institutional failure under financial integration. In the case of trade integration, the result can be increased unemployment, lower investment and increased inequality. The traditional benefits of increased specialization from trade openness can be easily negated if the displaced workers become unemployed, and the benefits of higher national income can be lost if it is more unequally distributed.

Each of the EME subregions will need to find a niche for themselves in the global production system. The EU-10 should be able to find a place in the manufacturing chain given their open access to the EU market, their relatively high levels of human capital but considerably lower wages. Market fragmentation and limited institutional reform are continuing to limit manufacturing in some of the south-east European countries. Currently, the CIS economies appear to be

[65] Even Brazil with a flexible exchange rate was subject to capital flight and a currency crisis in 2002.

[66] For a more detailed analysis see UNECE, *Economic Survey of Europe*, *2002 No. 1*, chap. 5.

[67] The possibility of a currency crisis in the new EU members is examined in H. Gibson and E. Tsakalotos, "Capital flows and speculative attacks in prospective EU member states", *Economics of Transition,* Vol. 12 No. 3, 2004, pp. 559-586.

[68] M. Feldstein, *Aspects of Global Economic Integration: Outlook for the Future*, NBER Working Paper, No. 7899 (Cambridge, MA), September 2000.

[69] M. Feldstein, "A self-help guide for emerging markets", *Foreign Affairs*, Vol. 78, No. 2, March/April 1999, pp. 93-109.

largely outside the global manufacturing network; this is due to both the devastation of their manufacturing sectors during the transition phase and their natural competitive advantage in natural resource products. However, these primary commodities will not provide these countries with the basis to become dynamic growth economies.

Over the last half-century, countries in the middle of the global income distribution, which were also integrating into the world trading system, had relatively good growth rates and were able to converge towards the per capita income levels of the richer countries.[70] If this historical pattern were to hold in the coming decades, most of the EME, which clearly fit into this middle zone, would be expected to do relatively well. However, over the last half-century, those industrializing middle-income countries were not under a significant competitive threat from industrializing countries with even lower per capita incomes. In the coming decades, however, the EME will have to compete with countries such as Brazil, China and India; these countries have not only much lower wages but are in many areas as advanced or even more advanced technologically than the EME.[71] There are of course some high-tech niche markets in the EME, but they are not sufficient to employ large numbers of people.[72] Thus, the challenge will be to determine the sectors in which they will have a comparative advantage and also the potential for technological growth along with high and increasing wages. To avoid the undesirable situation of having to compete on the basis of low wages, the EME would appear to have little choice but to create knowledge-based societies by increasing investment in human capital formation and implementing policies to promote more entrepreneurship and innovation.

The outsourcing of services takes off

The issue of outsourcing,[73] especially of services, received intense public scrutiny during the last year. Although still a relatively minor activity, the concern was more a reflection of its longer-run potential to eliminate large numbers of service sector jobs in the advanced economies. For the east European countries and the CIS, service sector outsourcing represents more of an opportunity for employment and wage growth. Outsourcing is basically an expansion of trade and allows a further increase in the international division of labour and the productivity gains associated with it. For manufactured goods this has been an ongoing process for decades. More specifically multinational corporations have tended to move the assembly stage of production, which is generally a low-skilled labour-intensive activity, to low-wage low-skilled countries. The major factors which limit the ability of firms to engage in this activity are the costs of transporting the components and final products, the ability to manage and coordinate the outsourced stage in a distant location, the costs of maintaining larger inventories, the availability of complementary social infrastructure such as roads and ports, the availability of a sufficiently skilled workforce, and concerns about the protection of intellectual property rights.

With the significant decline in international telecommunications costs and the expansion of service activities that can be conducted over the phone or the Internet, certain service sector activities began during the 1990s to follow the pattern of manufacturing and began to be located in lower wage countries. Many of the same factors that limit manufacturing outsourcing also limit service sector outsourcing, but the disadvantages of transportation costs and distance are much less significant for many services. In fact, some service industries have used distance as a plus by taking advantage of the time differences that come with distance. Call centre or other activities can be maintained around the clock, and items can be processed during the night as a way to improve the speed and efficiency of operations. Since the workers performing many of these service sector jobs must have far more interaction with residents in the home country, or documents in the home country language, linguistic similarity appears to be a far more important consideration for service sector outsourcing than is the case for manufacturing. For this reason, the United Kingdom and the United States have been particularly interested in India – a country where 150 million people have English as their primary language and where wages are often one tenth of United States wages for comparable occupations.

Firms in western European countries have also outsourced to India, but for a variety of reasons including linguistic dissimilarity, they have not been as active in outsourcing service sector operations. Estimates for the next decade suggest that west European firms are likely to outsource only about 1.2 million service sector jobs or only one third as many jobs as United States firms are likely to outsource.[74] Nevertheless, a recent McKinsey

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[70] C. Jones, “On the evolution of the world income distribution”, *Journal of Economic Perspectives*, Vol. 11, No. 3, 1997, pp. 19-36; D. Ben-David, “Equalizing exchange: trade liberalization and income convergence”, *Quarterly Journal of Economics*, Vol. 108, No. 3, 1993, pp. 653-679.

[71] This development is already becoming apparent. G. Garrett, “Globalization’s missing middle”, *Foreign Affairs,* November/December 2004, pp. 84-96.

[72] The recent acquisition by Microsoft Corporation of a Romanian software firm as the center for its anti-virus software is such an example.

[73] Outsourcing is defined as the process where firms split up the production process into smaller steps with each step located in a different geographical area depending on where each step can be produced at the lowest cost; these different steps may be produced by the same or by different firms. The term generally implies that an activity, which had previously been produced domestically, has been moved to a different country.

[74] A. Parker, “Two-speed Europe: why 1 million jobs will move offshore”, Forrester Research (Cambridge, MA), 18 August 2004.

study reports that 40 per cent of western Europe's 500 largest companies have begun moving some of their service operations offshore. European firms, for now at least, seem to be staying closer to home and outsourcing more of their service activities to eastern Europe. For example, 60 per cent of German outsourcing goes to eastern Europe and only about 40 per cent to Asia. However, because of higher wages and infrastructure costs in eastern Europe, the cost savings are lower than going to Asia. Outsourcing provides western European firms a significant benefit, which is only marginally important for United States firms, in that they can adjust the size of their labour force without being subject to domestic labour regulations.

Given the high proportion of services in the GDPs of the advanced market economies, the rise of service sector outsourcing provides additional opportunities for the EME, particularly in the light of the prevailing high rates of unemployment in many of them. The usual factors which attract FDI apply to services as well; these include a skilled workforce, social infrastructure and appropriate regulatory institutions. A number of the EME have attracted some service sector FDI investment. Call-centre jobs have gone to the Czech Republic, Hungary, Poland and Slovakia; billing and back office jobs have gone to the Czech Republic, Hungary and Poland, while software and ICT jobs have gone to the Czech Republic, Hungary, Poland and Russia. Bulgaria, Estonia, Romania and Serbia and Montenegro are also beginning to be considered as possible destinations. Russia has the potential to become a significant destination for higher-skilled ICT services due to its large number of math and science graduates. Other major destinations outside the EME, especially for United States outsourced services, include China, Malaysia, the Philippines and Singapore.

As with trade generally, given the long-run full employment assumptions, the effect of outsourcing of either goods or services is to increase national income. Distributional problems arise, however, where certain groups of workers by skill category might lose from this development or where conditions of less than full employment exist; since the latter plagues much of Europe, there are legitimate employment concerns about outsourcing. So far, however, the level of outsourcing has not been large enough to significantly affect the level of unemployment. However, the most significant implication of service sector outsourcing is its potential to significantly increase the number of sectors and workers whose prices and wages will be determined in global markets which, in turn, will tend to put downward pressure on the wages of the unskilled in the advanced economies.[75]

A number of international economists have downplayed the potential for trade in goods to adversely affect wages in the advanced economies by arguing that the amount of trade is too small to dominate domestic employment conditions. With so many jobs in the "protected" non-traded sectors, foreign wages and prices can only have a minimal impact on the overall domestic employment situation. Therefore the possibility, suggested by some simple trade models, of factor price equalization – where wages for similar skill levels are the same throughout the world – is unlikely. Thus the wages of the unskilled in the advanced economies become unhooked from global wages as these countries fully specialize in non-traded goods and skill-intensive traded goods. The wage pressure from the traded sector is therefore limited by its small size. However, if a significant portion of the so-called "non-traded" service sector is actually tradeable, then this insulation of wages from global influences falls away, and the tendency towards factor price equalization returns. However, there are many services that cannot be outsourced, so there remains a question as to how extensive outsourcing and its effects are likely to be. An additional concern is that in some countries workers displaced by the outsourcing of services are not covered by trade adjustment assistance or by other types of job protections that may have evolved in the past to protect workers in the manufacturing sectors when they were subject to external shocks. In the countries receiving the outsourced services, which may include many of the EME, the distributional effects may be positive as new and better jobs are created for medium-skilled workers.

Many of the benefits from trade derive not from relative differences in factor costs, but from trade in differentiated products. Services are similar; trade among countries at similar levels of development can increase both the variety of services available and national income without creating significant distribution problems or adjustment costs.[76] The basic arguments for and against free trade in goods generally apply to trade in services. Although the political process has been slow, those in the advanced economies that have benefited from more open trade in goods have been able to convince enough of the losers (unskilled labour) that the general welfare is served by their gains. To some degree this has been due to the fact that many of those that lose from trade, such as unskilled labour in the non-traded sectors, do not perceive the way they are harmed through trade's impact on the unskilled labour market, but only appreciate the lower prices of goods. However, when large segments of the labour force see more directly how service sector outsourcing may harm them, this social consensus for open trade may dissolve.

[75] R. Shelburne, "Trade and inequality: the role of vertical specialization and outsourcing", *Global Economy Journal*, Vol. 4, No. 2, 2004 [www.bepress.com/gej/].

[76] R. Shelburne and J. Gonzalez, "The role of intra-industry trade in the service sector", in M. Plummer (ed.), *Empirical Methods in International Trade: Essays in Honor of Mordechai Kreinin* (London, Edward Elgar Press, 2005), pp. 110-128.

One approach to resolve this dilemma may be for the winners to provide more compensation to the losers. The system of public finance provides for various mechanisms and channels through which an additional redistribution could be performed. For example, more public funds could be allocated to training and skill upgrading of the affected workforce that could facilitate their reintegration into the more skilled segments of the labour market. More generally, national public policies targeting human capital development will strengthen the future competitive position of a country and allow it to benefit from expanding trade in services. Although in time, firms in the EME may also begin outsourcing services to even lower wage countries, over the next several years at least, workers in the EME, especially skilled workers, are likely to benefit from the opportunities provided by outsourcing. As with FDI generally, it would be highly beneficial if these investments in the EME service industries did not produce isolated clusters but could produce technological spillovers, stimulate competition and promote human capital formation.