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ECONOMIC DEVELOPMENTS IN THE UNECE REGION: MAIN CONCLUSIONS OF THE FIRST ISSUE OF THE ECONOMIC SURVEY OF EUROPE, 2005

Note by the Executive Secretary

Executive summary

This note discusses some important issues facing the policy makers in the UNECE Region. Despite a generally favourable economic performance in the majority of the countries, there remain a number of major concerns that require policy attention. Many of them are discussed in more detail in the *Economic Survey of Europe No. 1 2005*. The note provides a summary of these issues and proposed policy responses. For the global economy, large current account imbalances and misaligned exchange rates need to be adjusted to more sustainable levels; this will require policy coordination among the major economies. In order to improve the economic performance of western Europe, policy measures are required in a number of areas addressing *inter alia* issues such as labour market flexibility, human capital investment, innovation and entrepreneurship, trade liberalization, and the conduct of fiscal and monetary policy. A major challenge facing the new EU members will be to reconcile the strict macroeconomic requirements for EMU accession with the goal of real convergence, which requires increased investments in public infrastructure, human capital, R&D activity, and significant adjustments in sectoral employment. South-east Europe needs, in addition to political stability, further institutional reform, larger infrastructure investments towards creating knowledge-based economies, higher domestic saving and investment rates and, at the same time, lower current account deficits. The CIS also requires more policy focus on structural and institutional reforms, more emphasis on trade integration amongst themselves and the rest of the world, and a policy agenda to address their industrial production and export concentration in a few natural resource products. Political instability in some regions continues to create a level of uncertainty, which is not conducive towards promoting investment and growth.

I. INTRODUCTION

1. The global economy performed quite favourably in 2004. Sustained growth has spread to all the major regions of the world and the average rate of economic growth in 2004 was the highest in three decades. A striking feature in the economic performance of Europe is the contrast between the persistence of moderate growth in the euro area and the economic dynamism in most of the rest of the region. In the new EU Member States and South-east Europe, economic growth has continued at much higher rates which were broadly based on robust domestic demand and rapid export growth. The CIS, together with developing Asia, was one of the two fastest growing regions of the world economy in 2004 (as in 2003). Rapid growth was propelled by the surge in international demand and prices for primary commodities and the associated spillover effects on domestic demand. However, national income in this region still remains significantly below levels prior to their transition to market economies. The outlook for 2005 is that this relatively strong performance in east Europe and the CIS will be maintained.

2. Despite this generally favourable performance, there remain a number of major concerns that will require the attention of policy makers in order to ensure that sustainable economic growth continues in Europe and the CIS. Many of these issues are discussed in more detail in the recent *Economic Survey of Europe No. 1 2005*; this paper provides a summary of these issues and proposed policy responses.

3. For the global economy, large current account imbalances and misaligned exchange rates need to be adjusted to more sustainable levels; this will require policy coordination among the major economies. The pronounced appreciation of the euro has lowered the price competitiveness of European firms and, if continued, could risk acting as a brake on economic growth, with adverse effects on labour markets. In order to improve the economic performance of western Europe in terms of both productivity and employment growth, policy changes are required in a number of areas addressing issues such as labour market flexibility, human capital investment, innovation and entrepreneurship, trade liberalization, and the conduct of fiscal and monetary policy. The Lisbon agenda addresses a number of these supply-side constraints on growth, but its implementation has been slow. A reform of the Stability and Growth Pact, moreover, could contribute to improving the overall flexibility of macroeconomic policy to support economic activity. The major challenge facing the new EU members will be to reconcile the strict macroeconomic requirements for EMU accession with the goal of real convergence which requires increased investments in public infrastructure, human capital, R&D activity, and adjustments in sectoral employment. Fiscal consolidation will be especially challenging since many of the new members' fiscal deficits are significantly above the 3 per cent of GDP threshold yet investment in public infrastructure is urgently needed, and flexibility in using countercyclical fiscal policy is also required.

4. South-east Europe needs further institutional reform, political stability, infrastructure and human capital investments towards creating knowledge-based economies, higher domestic saving and investment rates and, at the same time, lower current account deficits. The prospect of EU membership is an important stimulus for reform in the candidate countries.

5. The CIS also requires more policy focus on the deepening of structural and institutional reforms in product and labour markets, public administration and the financial sector. Renewed emphasis is needed towards WTO accession and further trade integration amongst themselves and the rest of the world. A policy agenda to address their industrial

production and export concentration in a few natural resource products should be initiated which will allow them to develop a longer-term comparative advantage in more dynamic industrial sectors. Political instability in some regions continues to create a level of uncertainty which is not conducive towards promoting investment and growth.

II. REDUCING GLOBAL IMBALANCES

6. The large and rising current account deficit of the United States has been an important potential downside risk for the global economy for several years. 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. But the reversal of the United States deficit seems to have been postponed by the country's unique position in the international economy. In any case, there is wide agreement that 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. 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.

7. Basically, a current account deficit reflects an excess of payments for imports of goods and services over revenues from exports of goods and services. By definition, any current account deficit is equivalent to an excess of domestic investment over national saving. Accordingly, domestic absorption of goods and services 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.

8. 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" (Greenspan), 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.

9. 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 adjustment would, of course, be facilitated by stronger growth of domestic demand in the rest of the world, which would provide an additional stimulus to United States exports.

10. 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, given the exchange rate policies pursued in Asia, especially China and Japan. This raises the issue of an appropriate burden sharing of these inevitable exchange rate adjustments across the major regions of the world economy.

11. 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.

12. The exchange rate adjustment is 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 (in fact, the government budget deficit now constitutes the main counterpart to the current account deficit). In the private sector, corporate net savings (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.

13. The upshot is that the adjustment of global financial imbalances will inevitably involve a 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.

14. As already noted, 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. 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 some large trade partners of the United States successfully resist exchange rate adjustments, a larger share of the adjustment burden will fall on United States domestic absorption, with possibly even worse consequences for the world economy.

15. It is against this background that the recent G-20 Meeting of Finance Ministers and Central Bank Governors in November 2004 underscored the significance of medium-term fiscal consolidation in the United States, continued structural reforms to boost growth in Europe and Japan, and steps towards greater exchange rate flexibility, supported by continued financial sector reform, in emerging Asia.

16. Given the formidable adjustment challenge that lies ahead, there is an important role to be played by policy coordination, be it in the form of exchanges of information, shared analysis or cooperation over exchange rate policies. The latter would notably involve cooperation between the Federal Reserve, the ECB and the Bank of Japan, but also the central banks of other countries, especially China.

17. 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.

III. STRENGTHENING GROWTH AND COMPETITIVENESS IN EUROPE

18. The overall growth performance of the European economy has been disappointing in recent years. The better performance of the United States relative to Europe in terms of output and productivity growth over the past decade is a well established statistical fact. There are also concerns about risks of declining competitiveness in the face of increasing supply of medium- and high-tech products from low-cost countries driven by foreign direct investment.

19. The main policy challenge is to bridge the gap between the rhetoric of the ambitious Lisbon agenda adopted in March 2000, 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.

20. The recent review of the Lisbon strategy – the so-called Kok report – published in November 2004 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.

21. In fact, a major factor in the disappointing economic performance in Europe is insufficient investment in key drivers of growth and competitiveness, namely education, R&D, innovation, and the diffusion of new technologies, notably ICT (see UNECE *Economic Survey of Europe 2005 No. 1*, Chapter 7). The challenge is therefore to design effective national and complementary supranational policy strategies that will help improve performance in these areas.

22. In early February 2005, the European Commission acknowledged that a major problem of the Lisbon strategy is inadequate delivery of agreed actions at both the European and country level, which was attributed *inter alia* to the overloaded policy agenda and conflicting priorities (Commission of the European Communities, *Communication to the Spring European Council:* Working together for growth and jobs. A new start for the Lisbon Strategy. Brussels, 02.02.2005 COM(2005) 24; this report was issued after the *Economic Survey of Europe 2005 No. 1* had already been finalized). It proposed, in fact, a revitalization of the Lisbon Strategy largely along the lines of the recommendations made in the Kok report. The main focus of the renewed strategy is to raise Europe's growth potential and create more jobs, aiming at the same time at improving environmental quality and the preservation of the European social model. The Commission emphasized the shared responsibility between the European Union and its Member States as regards the delivery of reforms and other policy measures required to meet the Lisbon targets. It therefore has proposed a European Partnership for Growth and Employment, which should also involve the social partners. Member States are to develop National Lisbon Programmes which detail how the specific

targets are to be achieved. These national programmes are to be complemented by action programmes at the level of the European Union.

23. The proposed new Lisbon Action Programme will focus on measures in three areas, namely (i) making Europe a more attractive place to invest and work, (ii) knowledge and innovation for growth, (iii) creating more and better jobs. More specifically this will involve, *inter alia,* completion of the Single Market, improvement of European and national regulation to reduce the burden of administrative costs; enhancement and improvement of the European infrastructure; stronger investment in R&D; promotion of technological innovation, especially the development and diffusion of ICT, stronger investment in human capital formation, reforms to further increase labour market flexibility and an overhaul ("modernization") of the social protection systems. The full implementation of the Lisbon Action Plan is estimated to raise the level of European real GDP by 3 per cent by 2010 and, associated with that, create more than 6 million jobs. There is also expected to be an increase in the EU's rate of potential output growth to some 3 per cent per annum, up from currently slightly more than 2 per cent.

24. A major problem with the Lisbon agenda, however, 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.

25. Achieving sustained 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 associated with economic globalization, 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.

26. Raising Europe's growth potential therefore 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" (Kok Report), while paying adequate attention to preserving macroeconomic stability (UNECE *Economic Survey of Europe, 2004 No. 2*, pp. 49-50). In a similar vein, the Sapir Report (July 2003) 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.

27. Against this background, it is important that a sensible reform of the Stability and Growth Pact be achieved as soon as possible. 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. The recent proposals made by the European Commission that would lead to greater emphasis on public debt and medium- and long-term fiscal sustainability in the surveillance process therefore go in the right direction, but it may not be easy to achieve a consensus on these matters (see communication by the Commission on *Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact*, 3 September 2004).

28. To further enhance growth in western Europe, continued progress on the Doha round of WTO negotiations is essential; although there will be adjustment costs for a number of

sectors, especially in the agricultural area, the benefits of more open markets clearly outweigh these costs. Progress on this front will not only improve Europe's economy but will also contribute to Europe's broader foreign policy and humanitarian objectives in promoting growth in the developing countries. However, with high levels of unemployment and downward wage pressure on the unskilled, the domestic support for trade liberalization may weaken. Adjustment and redistribution programmes need to be fine-tuned so that the programmes are able to address the real problems that they were step up to address without making labour markets even more inflexible.

IV. THE NEW EU MEMBER STATES: REAL VS. NOMINAL CONVERGENCE

29. EU membership raises a number of policy challenges. On the macroeconomic front, the new members are expected to meet the Stability and Growth Pact criteria pertaining to inflation, long-term interest rates, government deficits, public debt and exchange rate stability, and eventually to enter the Economic and Monetary Union (EMU). But one of the central macroeconomic policy challenges that the new EU members are facing is how to reconcile the requirements for EMU accession with the goal of real convergence.

30. The average per capita GDP level (at purchasing power parity) in the EU-10 is currently less than one half of the comparable level in the euro zone, reflecting low labour productivity and low employment rates in the former. While a strong productivity catch-up has occurred in recent years, the gap in employment rates has not diminished. The real convergence challenge is amplified by shortcomings in the human capital stock. The intensity of R&D spending in the EU-10, moreover, is less than one half of the EU-15 average. Policies to deal with these issues can be classified into two major categories: the "liberal" model (based on the British or Irish experience over the last quarter century) or the "dynamic welfare state" model (based on the Austrian or Scandinavian experience).

31. Nominal convergence in the EU-10 is a multi-speed project. Fiscal consolidation remains a serious problem in most of the new Member States, including the relatively large central European economies as well as Cyprus and Malta. The majority of the 10 economies have also failed so far to satisfy the EMU inflation criterion, which partly reflects the ongoing process of productivity catch-up. None of the 10 new Member States fulfil the exchange rate stability and legal requirements necessary for entry into the euro zone. The legal criteria include the independence of the central bank in pursuit of price stability and other legal norms of the EMU.

32. Fiscal consolidation remains the principal macroeconomic policy challenge in most new Member States. A number of countries exceeded the 3 per cent threshold for the deficit to GDP ratio in 2003 and 2004. Fiscal consolidation is particularly urgent in order to set public finances on a sustainable path in the face of rapidly ageing populations, which will put added pressures on public pension and health-care systems in the medium to long term. However, strict abidance by the EU fiscal framework may impose unnecessary rigidities for some of the new Member States. In particular, these economies need to undertake a lasting effort to improve their public infrastructure, which is an essential precondition for a successful catching up to higher productivity and income levels. Even more than the most developed members of the EU, the new members would benefit from a possible relaxation of some of the constraints on government borrowing for financing public investment. Relaxing these constraints would help prevent counterproductive fiscal tightening in these economies. For example, the so-called golden rule that allows for public borrowing to finance public investment has been successfully followed by the United Kingdom in conjunction with a self-

imposed upper limit on net public debt, without unduly restricting the operation of automatic stabilizers.

33. Three EU-10 economies (Estonia, Lithuania and Slovenia) joined ERM-2 in the second month of their EU membership. Given their comparatively good fiscal positions and commitment to strong monetary discipline, the adoption of the euro by Estonia, Lithuania and Slovenia may well take place in 2007. Cyprus, Latvia, Malta and Slovakia also appear to be committed to a relatively early adoption of the euro. But the Czech Republic, Hungary and Poland are unlikely to adopt the euro before 2010.

34. A difficult challenge facing the EU-10 will be to maintain exchange rate stability preceding entry into the euro zone. The fundamental problem 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 may 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 which they must meet as part of the Maastricht criteria to qualify for entry into the EMU. Therefore there is the possibility that the targets will not be consistent with one another and thus cannot be achieved simultaneously. It is also possible that with these targets to satisfy, these countries will be forced to ignore what should perhaps be the most important target – employment. Given that countries will be quite vulnerable when they are in the ERM-2, they are well advised to choose carefully the period when they embark on this stage of currency integration.

35. Countries in central Europe and the Baltic States have generally found a comparative advantage or global production niche in low and medium-technology manufacturing. However, this segment of the market is likely to become extremely competitive in the coming years due to the rapid industrialization of a number of developing countries, especially China. If these countries are to avoid the undesirable situation of having to compete on the basis of low wages, they would appear to have little choice but to create knowledge-based societies by increasing investment in human capital and implementing policies to promote entrepreneurship and innovation. Given their close cultural ties and their geographical proximity to western Europe, they may be able to attract significant amounts of high-technology manufacturing and service sector operations that are being outsourced from there. Policies to encourage technological spillovers from such FDI investments to domestic firms need to be better implemented.

V. SOUTH-EAST EUROPE: THE PROSPECT OF EU MEMBERSHIP IS A CATALYST OF ECONOMIC REFORMS

36. With the entry of 10 new members in 2004, the agenda for the next round of EU enlargement focuses on candidates from south-east Europe. In 2004, Bulgaria and Romania closed all the negotiation chapters and are scheduled to join the EU in 2007. Accession negotiations with Croatia and Turkey are expected to start very soon. The emergence of a new, regional group of potential EU members will have a wide-ranging and positive economic impact on the whole south-east European region.

37. The realistic prospect of EU membership is an important stimulus to the economic reforms in these countries. The preparation for accession to the EU defines a broad reform agenda with clearly specified goals and the means to achieve them, and establishes strong and

clear incentives for policy makers. The institutionalization of the policy commitments within a tight schedule of accession negotiations helps both to accelerate and provide direction to the reform process. By changing investors' expectations, the realistic prospect of EU accession can also act as a major stimulus to FDI, as happened recently in Bulgaria, Romania and, to a lesser extent, Croatia. The current economic revival in Turkey is largely associated with a successful stabilization programme and a faster pace of reform. The expected start of accession negotiations with the EU will also provide strong support to the economic and legislative reforms being pursued in this country.

38. The policy process and agenda in the other parts of south-east Europe, however, lack the clear direction that can be seen in the EU candidate countries. In Serbia and Montenegro, the largest of these economies, the reform effort has lost some momentum and focus, largely because of a difficult political situation (involving four rounds of election in 12 months). Very high and persistent levels of unemployment and abject poverty in most of these countries remain an acute problem that policy makers in the region have yet to solve. Clearly resolution of outstanding political conflicts is a necessary pre-condition towards establishing solid economic growth.

39. The outlook for these economies depends on several key policy-related issues and factors. The first is whether individual countries will be successful in their attempts at integration with the EU, which can trigger a virtuous cycle of strong economic growth and focused market reforms. However, in order to get to this point, clear, long-term policy goals need to be established as national priorities and accepted as such by a significant majority of their populations. The absence of such a consensus about the general direction of reform in some of these countries is one of the major stumbling blocks to their economic transformation.

40. Structural and institutional reforms remain an important challenge for the whole south-east European region. The reforms of health care and pension systems are either at an early stage or have not yet started at all. Public institutions for a market economy in most of these countries are still underdeveloped and this has a negative effect on the business environment: the protection of property rights, including law and contract enforcement, is generally weak; the public administration is widely perceived as inefficient and lacking in transparency; and corruption is still widespread. Significant reform in these areas is a fundamental requirement for successful economic integration with the EU.

41. All the south-east European economies still have per capita incomes which are much lower than those in the more developed market economies. A key prerequisite for closing the gap, namely sustaining relatively high rates of economic growth for a sufficiently long period of time, is the development of human capital. This is an important determinant of national competitiveness and a key factor of their long-term growth. Hence human capital development should be among the principal priorities of public policy in the countries of south-east Europe.

42. Social cohesion is a crucial dimension of human capital development. The lingering social tensions amid widespread poverty in some of the south-east European countries will require a leading role for public policy if they are to be eliminated or defused. In this regard, an integrated set of structural reforms focused on increasing employment (employment rates being excessively low at present) is one of the areas where success could bring wide-ranging benefits. Policies aimed at reducing inequality – without diluting incentives to work – can also have a positive effect on future growth prospects. In particular, greater social solidarity

will help to create a general consensus about the nature and direction of the reform process which, in turn, will increase the probability of it being maintained.

43. The south-east European economies need to ensure that their trade and current account deficits stay within sustainable levels, especially given that their significant increases in national income are likely to continue and this is likely to further increase imports and attract additional capital inflows. During the first six months of 2004, the south-east European economies had a trade and services deficit of 10.3 per cent of GDP and a current account deficit of 9.4 per cent of GDP. Without Turkey, these deficits were even larger with trade deficits of 17.6 per cent and current account deficits of 12.0 per cent. These deficits are being financed by capital inflows but FDI, a relatively stable form of capital inflow, corresponded to only 2.7 per cent of GDP of the south-east European economies. Deficits of this size raise questions about long run sustainability and vulnerability to currency crises, especially given the possibility that some external shock might further increase them unexpectedly. Policies to promote exchange rate stability while increasing international reserves may be warranted.

44. Aside from Turkey, market fragmentation in the region limits investment and decreases the ability of these countries to reap the benefits of scale economies. More progress is needed to create some type of umbrella over all of the FTAs that exist in this region with the aim of ensuring consistency and making the rules of origin less difficult to fulfil. Ideally, a customs union might be the most desirable alternative, but achievement of this objective is unlikely due to a number of practical considerations such as Bulgaria and Romania joining the EU.

VI. THE CIS: THE POLICY CHALLENGE OF ECONOMIC DIVERSIFICATION

Can policy foster economic diversification?

45. The key factor behind the current 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. The narrow base of the recovery exposes these economies to fluctuations in the highly volatile global commodity markets, making them vulnerable to external shocks. The central 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. However, there is still much ambiguity as regards the ways and means to achieve this objective.

46. 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.

47. 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”. The

channels through which it 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. 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. 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.

48. 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.

49. 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.

50. The potential existence of comparative advantage 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. 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. However, experience has also shown that while markets alone may not be sufficient to steer economic restructuring, governments alone cannot deliver satisfactory results either. 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.

51. 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.

52. 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.

53. There is no unique policy model of economic diversification; 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". In this regard, the establishment of adequate institutions should be regarded as part and parcel of the diversification strategy. The actual institutional changes will depend on the specific socio-economic and political context in the country where such a strategy is being implemented.

54. 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. Instead of "picking winners" in the sense of traditional industrial policy, this approach involves a more flexible strategic alliance 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. Through strategic collaboration between 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. 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.

Economic diversification and systemic reforms in the CIS

55. 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. Compared with eastern Europe, market reforms in the CIS have been complicated by the legacy of a greatly distorted economic structure, the lack of unequivocal political and popular support for reform, and the absence of an external anchor for the reform process, such as a realistic expectation of EU membership. Nor are the CIS countries close to the large west European markets. Despite these disadvantages, reforms in the CIS have nevertheless advanced, although at a slower pace and with significant differences across countries.

56. Most of the progress has been concentrated in basic market reforms, such as price and trade liberalization and small-scale privatization. Structural and institutional reforms – for example, of major institutions (the judiciary, public administration, health care, the pension system), labour markets, the banking system, competition policy, the establishment of effective bankruptcy procedures, etc. – have been much patchier. Compared with the basic reforms, the latter are more complicated as they require the creation and development of the structures and institutions that govern a market economy. In other words, they involve a transformation of the role of the state from direct participant in economic activity to regulator and institution-builder in a market context. The new institutional structures are required to define and implement policy, without directly interfering in the functioning of markets, and to enable these functions to be performed in an efficient, transparent and predictable manner.

57. Overall, reform initiatives targeting diversification 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 the context of economic diversification, 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. Further efforts are also needed to improve public and corporate governance and the protection of property rights.

58. The broader policy agenda should also target innovation and human capital development, which are key factors of long-term growth, competitiveness and entrepreneurship. In fact, many of the CIS countries (in particular the Russian Federation 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 and market imperfections that may hamper the transformation of human capital endowments into innovative entrepreneurial activity.

59. Labour market reforms are another key ingredient of the broad reform agenda of the CIS economies, and should be assigned high priority. Policies fostering labour mobility, including the removal of bottlenecks in the housing market and of obstacles to the creation of new companies, are required to absorb the excess labour released from particular activities and companies. Unemployment benefit systems in the CIS (which appear to be rather inefficient in stimulating labour adjustment and active job search) also require a radical overhaul. But most importantly, in order to lay the foundations for sustained and high rates of growth, these economies need to foster job creation in modern, high value added manufacturing and market services.

60. Financial reforms are another key component of the reform agenda as financial development can foster the growth of investment and promote the desired economic 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.

61. There are substantial differences in the depth of CIS financial sectors but even in the countries with more sophisticated financial sectors, comparative indicators highlight the need for further progress. The prevalent large spreads on domestic interest rates indicate high levels of risk and widespread inefficiencies in the banking sectors. Improvements in the business environment and increased competition should be encouraged in order to address these deficiencies. Difficult access to credit is often quoted as a constraint on the development of small and medium-sized enterprises (SME), which are expected to play a significant role in the development of activities outside the commodities sector. Poor corporate governance and outdated accounting practices, as well as weak banking supervision add to the underlying vulnerabilities of the region's financial systems. The development of other non-banking financial intermediaries, such as insurance companies, pension funds and the organization of capital markets, should also be assigned due priority. More generally, the investment climate in the CIS needs significant improvement with additional institutional reform. Extensive government regulation combined with weak public administration, barriers to entry, ineffective bankruptcy procedures, and weak corporate governance continue to be cited as impediments to FDI.

62. 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 so that economies of scale can be exploited 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. Regional trade integration with the other CIS members should be as broad as possible both in terms of geography and issues. Not only do trade impediments need to be reduced but harmonization of standards and regulations should be given increased attention. Continued progress on WTO membership will not only increase trade flows but will also help promote FDI. But trade liberalization alone may not necessarily stimulate new economic activities; for these to materialize, the integration efforts should complement domestic policies fostering diversification. The current lack of a strong manufacturing base greatly weakens the economic dynamism of these countries and reduces their potential for long-term sustainable growth based upon technological advancement. Dependence on commodity trade subjects the CIS to the risks of instability in export earnings and exposes them to the risk of a long-run deterioration in their terms of trade. Given that manufacturing is likely to be labour intensive in these countries, the lack of a manufacturing base contributes to low levels of employment. Regional cooperation to improve transport links amongst the CIS members is also needed. 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 these beneficial effects are to be obtained.

63. 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.

64. 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.
