Foreword

This is the second report of the European Economic Advisory Group at CESifo. The group was set up in 2001 by CESifo, a joint initiative of the Ifo Institute for Economic Research and the Center for Economic Studies (CES) of the University of Munich. Its aim is to comment on the state and prospects of the European economy. With Ifo's support it provides a business forecast and discusses topical economic issues which are of general interest to policy makers, managers, academics and the European public in general.

The group consists of a team of nine economists from seven European countries. It is chaired by Giancarlo Corsetti (University of Rome III and consultant to the Bank of Italy, and chairman of the group) and includes Lars Calmfors (University of Stockholm), John Flemming (Warden of Wadham College, Oxford), Seppo Honkapohja (University of Helsinki, EEAG vice chairman), John Kay (St. John's College, Oxford, joined in November 2002), Willi Leibfritz (OECD), Gilles Saint-Paul (University of Toulouse), Xavier Vives (INSEAD), and myself. The group plans to deliver reports on an annual basis, remaining in toto responsible for the content.

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Executive Summary

The report includes five chapters and an executive summary. The executive summary provides a brief synopsis of the report, including both analyses and policy proposals, and presents the main conclusions of the group on the issues raised by each individual chapter.

Chapter 1 presents forecasts of growth and inflation in the European economy for the year 2003 and assesses the current macroeconomic conditions for the whole area and for some individual countries.

Chapter 2 analyses the role of fiscal policy as a tool of macroeconomic stabilisation and proposes changes in the EU fiscal rules with the aim of making them more flexible while at the same time maintaining fiscal discipline.

Chapter 3 reconsiders and assesses subsidiarity as one of the general principles to guide the political and institutional development of the European Union, and proposes a framework to assess the consistency of alternative plans.

Chapter 4 analyses the current financial architecture of the euro area, questioning whether the current institutional arrangements are adequate to reduce the risk of financial crises, and deal with them if they occur.

Chapter 5 presents evidence on the brain drain from European countries towards the US, identifying possible causes and costs for the economy, and looks at factors and policies that could reduce the net outflows of skilled people from Europe.

The macroeconomic scenario

In 2002, output in the euro area grew on average by less 0.8 percent, down from 1.4 percent in 2001. Our baseline forecast for the year 2003 is somewhat better, with a positive, but moderate, growth rate as high as 1.4 percent. This rate is too low to reduce the gap between actual and potential output. Thus, for the third year in a row, output will remain significantly below potential (or trend) growth. Growth will also be too low to reduce the unemployment rate, which increase to 8.5 percent.

The scenario used in the above growth forecast is somewhat optimistic, and may fail to materialise. Serious concerns about both the short-term and the medium-term outlook arise from two sources: First, there is great uncertainty about the geopolitical situation. The forecast assumes that war with Iraq will be averted, or that if it occurs it will be short in duration and decisive in outcome, and that sentiment will not be substantially affected by further major terrorist attacks or threats of such attacks. Second, the legacy of the long American boom and the resulting stock market bubble have created structural imbalances in the world economy which cannot be sustained over the longer term. If adjustments were accompanied by a rapid fall in the dollar exchange rate and a sharp appreciation of the euro, Europe could lose a significant share of its external demand – any remaining hope for export-led recovery in Europe would come to an end. Any estimate of the magnitude or timing of these influences is, however, subject to considerable uncertainty.

A large part of the poor performance of the euro area in 2002 is due to developments in the world economy, reflecting fears that wars could disrupt an already unsettled world, the aftermath of the puncturing of the US market bubble, and concerns about firms' profits and profit reporting. But developments in the world economy are not sufficient to explain the weak growth performance in Europe in 2002, particularly relative to the US.

Different macroeconomic policies have played an important role. While demand in Europe has been constrained by continuing fiscal consolidation, US demand was supported by an unprecedented increase in the structural deficit, which in 2002 rose from $^1/_4$ to $2^3/_4$ percent of GDP. General monetary conditions are easy on both sides of the Atlantic, but the European Central Bank has cut rates cautiously. The Fed did more, and did it more aggressively.

There are arguments supporting the view that a more aggressive reduction of interest rate by the ECB could have been useful. Despite relatively low interest rates, the cost of financing investment has considerably increased in the past year due to the decline in stock prices (making equity financing more expensive) and the increase in the risk premium of industrial bonds. By reducing the capital base of the banking sector, the fall in stock prices may have made banks reluctant to lend. Falling stock prices and the consequences of the terrorist attacks on September 11, 2001 have hit the insurance sector, a traditionally important source of finance for corporations in the corporate bond market. The appreciation of the euro over the year reduced external demand. A prompter reaction by the ECB to the Fed interest cuts could have contained the appreciation.

Why then was the ECB so cautious? An important reason why the ECB did not cut rates more aggressively is that core inflation[1] in the euro area has remained above the two percent upper bound in the ECB definition of price stability. The ECB has pointed to a number of special factors explaining why inflation has persistently remained above the medium-term bound since 2001, such as oil price hikes, food price hikes due to bad weather conditions and animal diseases, and the increase in indirect taxes in some countries.

Yet perhaps an even more important factor is that unit labour costs in the euro area have continued to grow unabated, by almost 3 percent per year, as wage growth did not fall while labour productivity continued to stagnate. The contrast with the US is striking. There, the strong deceleration of unit labour costs (associated with unabated productivity growth) in a phase of weak demand made it easier for the Fed to provide a strong stimulus to growth, without much concern about inflationary consequences.

Consistent with its mandate the ECB is extremely wary of letting the economy stay above the 2 percent ceiling on inflation for too long. During 2002 the ECB faced a difficult trade-off between supporting growth and acting to bring the inflation rate down below 2 percent.

There is little room for disagreement about the importance of sticking credibly to a clearly defined nominal anchor. But problems arise if the anchor is set at too low a level. One important and well-known reason is the fact that nominal interest rates cannot be negative. In an environment with very low inflation expectations, the central bank may simply not be able to reduce the real interest rate as much as needed to sustain recovery. Recent macroeconomic models go one step beyond this, suggesting that the equilibrium (natural) rate of unemployment may become higher at very low levels of inflation[2] – providing an additional reason to be on the safe side and to avoid very low inflation.

Another important reason for avoiding excessively low inflation targets is the need for relative price adjustments in the common currency area, which necessarily drive measured inflation in some regions higher than in other regions. In this case an inflation target below 2 percent for the area as a whole may mean that the rate of inflation in the group of regions that need to reduce their relative price levels could become very low, under some circumstances even dangerously close to deflation.

The 2001 EEAG report included a chapter on relative price adjustment within the euro area. One source of differential inflation dynamics in the area is the different rates of productivity growth of countries at different levels of industrial development (according to the Balassa-Samuelson hypothesis[3]).

[1] Core inflation is defined as the rate of growth of the Harmonised Index of Consumer Prices excluding energy and unprocessed food.

[2] See Akerlof, G.A., W.T. Dickens, and G.L. Perry (2000), Near-Rational Wage and Price Setting and the Long-Run Phillips Curve, Brookings Papers on Economic Activity (1), 1–44 and Akerlof, G.A., W.T. Dickens, and G.L. Perry (1996), The Macroeconomics of Low Inflation, Brookings Papers on Economic Activity (1). Suppose for example that a fraction of the firms in a country are always exposed to negative shocks, such that they can stay in business only if they manage to reduce their wage costs in real terms. When inflation is very low, a real wage reduction can only be achieved by cutting nominal wages. If these are rigid downward, firms hit by a negative shock will go out of the market. Whether or not these models are supported by empirical evidence is still too early to tell.

[3] In a nutshell: consider two economies integrated in the world markets, with the same level of productivity in the sector producing nontradables. In the sector producing tradables, instead, productivity is higher in one economy than in the other. Now, if international markets of capital and goods are competitive, the rate of profits and the price of tradables will be the same across these countries. What will be different is the real wage – which must be higher in the economy where workers in the tradable sector are more productive. But higher wages in this economy also means that local producers need to charge a higher price for nontradables – as there is no productivity advantage in this sector. Clearly, international arbitrage can do nothing to prevent price differentials for goods that are not traded across borders. The overall price level – combining the prices of both tradables and nontradables – will therefore be higher in the economy with higher productivity. When the country with lower productivity in the tradables sector catches up, it will experience higher wage growth than the other country, but also higher price increases in the nontradables sector resulting in a higher overall rate of inflation.

In the euro area, countries that are relatively less industrialised invest more, grow faster, and experience a rapid increase in the prices of their nontradable output. While empirical estimates of inflation differentials due to this channel vary within a large range, they are by no means negligible.

A different source of short-run price dynamics is due to asymmetric demand shocks and misalignment. Germany for instance entered the euro with a currency that had not yet overcome the appreciation shock of 1992/93 resulting from German unification. As there is no option of nominal devaluation within the common currency area, adjustment may be helped through a so-called internal devaluation through fiscal policy (a reduction of employers' payroll taxes in exchange for an increase in taxes paid by employees or a reduction in government expenditure), but eventually requires lower inflation in Germany than in the rest of Europe. The lower the average inflation rate in the euro area, the lower the inflation rate in Germany required to restore equilibrium.

There are different ways in which a monetary authority could deal with the issues of creating more room for relative price adjustments, and reduce the risk of engineering near-deflation rates. In the course of the first few years of the euro, for instance, the ECB has been solicited to declare a lower bound on the medium-run rate of inflation, to complement the two percent ceiling. Recent official statements of the ECB seem to point at one percent as the inflation floor for monetary policy in the euro area.[4]

Among the possible options, the ECB could simply choose to set a higher target medium-term inflation rate. The change to accommodate the required dispersion in national inflation rates need not be dramatic. It could be enough to increase the medium-run average inflation target to 2.5 percent. This would be half a percentage point above the two percent ceiling, or one percentage point above the inflation rate that many observers believe is the ECB's de facto target (1.5 percent). Within the current ECB monetary strategy, the new objective would only require a modification of the definition of price stability.

Yet, while refinements in the ECB strategy can improve the macroeconomic outcome in the euro area, it is highly illusory to expect monetary policy to address and solve the region's most severe employment and output problems. This goal requires reforms removing rigidities and inefficiencies in the labour and the goods markets, and a fiscal policy that combines short-run flexibility with long-run discipline. Looking at easier monetary conditions and reforms as substitute instead as complementary policies would be very dangerous.

Consider the case of the German economy, which has grown at a comparatively low rate during the last twenty years and which has suffered from increasing unemployment for the last thirty years. German competitiveness has come under threat because its wage costs are higher than wage costs of most other competing countries. These problems may have been in part aggravated by the fact that, as previously mentioned, the conversion rate between the D-mark and the euro in 1999 was quite high. However, we should note that the trade-weighted real exchange rate of the D-mark is currently not above its value in the years around and before unification. As Germany's unemployment and wage problem is much older than only ten years, institutional factors must also have played a role in explaining the high wages. Among them the German system of industry-wide wage negotiations, repercussions from the welfare state whose wage supplements imply high reservation wages, and high labour taxes rank highest. It seems that fundamental institutional reforms centered on the labour market are necessary to solve Germany's problems. These reforms would be particularly effective if they were accompanied by a somewhat looser monetary policy by the ECB, allowing Germany to have a significantly lower inflation rate than the other euro countries and hence to change its relative prices without being exposed to the problems potentially associated with a very low inflation rate.

Fiscal policy

The current budgetary problems of some member states in the EU have focused attention on fiscal policy and the fiscal rules in the EU. A key issue is the need to combine long-run sustainability of fiscal policy with short-run flexibility, because fiscal policy is the only remaining stabilisation instru-

[4] See the discussion in Svensson, L. (2002), A Good Thing Could Happen at the ECB: An Improvement of the Eurosystem's Definition of Price Stability, mimeo, Princeton University, and references therein.

ment in the case of country-specific cyclical developments. Thus fiscal policy should play a larger role as a stabilisation tool than according to the conventional wisdom that has prevailed in recent years. The problems of using fiscal policy in this way are not due to technical ineffectiveness but to problems of political economy.

It would be most unfortunate if the failure of some EU member states to abide by the present fiscal rules would lead to their being scrapped. There is a continued need for fiscal rules at the EU level to ensure fiscal discipline. In view of the future strains on government budgets arising from ageing populations, the present "close to balance or in surplus" budget targets for the medium term should not be relaxed, although the targets should be set explicitly in cyclically adjusted terms.

It would be unwise to introduce a golden rule, according to which government investment can be financed through borrowing. The underlying rationale for a golden rule is that public projects are expected to generate a flow of tax revenues as high as the interest payment on the additional debt incurred to finance them. There is, however, no reason for this to be true: many public projects are desirable for reasons that are independent of tax-revenue considerations. Moreover, the classification of expenditure among different categories is arbitrary. Allowing budget flexibility via a golden rule is likely to cause massive re-classification to take advantage of the rule. This is not to deny that there may be sound reasons to allow for larger deficit financing of public investment – such as efficiency of the tax regime or intergenerational fairness, as also future generations will benefit from public capital. But experience shows that these good reasons are seldom primary concerns in the actual budget processes.

Recent proposals from the European Commission aim at increasing the flexibility of the EU fiscal rules through changes in the interpretation of the Stability and Growth Pact but without revisions of the Maastricht Treaty.[5] The proposed changes involve more discretionary decisions on the fiscal goals. The idea is to allow temporary deviations from the medium-term budget objective of "close to balance or in surplus" on a case-by-case basis if they can be justified in terms of growth-enhancing expenditure increases or tax cuts, or as a consequence of structural reform. The proposal is also to allow countries with a lower stock of public debt more long-term deviations from the medium-term budgetary goal.

These proposals by the Commission entail significant risks. A loosening of medium-term budget objectives without doing anything about the maximum deficit ceiling of three percent of GDP increases the risk that this ceiling will be breached, which is likely to cause more conflicts among member states. Also, the more complicated the rules become and the more discretionary judgements are involved, the greater is the danger that the credibility of the fiscal rules is undermined.

Instead, there is in our view a strong case for more fundamental reforms of the fiscal rules involving Treaty changes. These changes should focus on the excessive deficit procedure and the deficit ceiling, as they form the backbone of the rules. A simple and transparent reform would be to let the deficit ceiling depend explicitly on the debt level of the country: countries with low debt (less than 55 percent of GDP according to our proposal) should be allowed to run larger budget deficits than three percent of GDP. The lower the debt-GDP rating the higher the maximum deficit for these countries should be. This would serve both to give low-debt countries greater scope for stabilisation policy in recessions and enhance the incentives for long-run fiscal discipline, preventing pro-cyclical fiscal policies in booms.

Changes in the fiscal rules must not, however, accommodate the current budgetary problems of some countries. This would ruin the future credibility of any fiscal rules at the EU level. If France, Germany, Italy or Portugal were to breach the three percent deficit ceiling for more than a single year, sanctions must be imposed, as a natural consequence of earlier insufficient fiscal retrenchment, in the common interest of establishing credibility for the rules.

The present fiscal policy framework at the EU level suffers from the fundamental problem that the ultimate decisions on excessive deficits are political. The threat of sanctions has low credibility, as governments are likely to try to avoid political conflicts with each other. This is an argument

[5] European Commission (2002), Communication from the Commission to the Council and the European Parliament, European Economy 3, Brussels.

for transferring decisions on deposits and fines from the political level of the Council to the judicial level of the European Court of Justice.

Current events have shown that there are limits to how much fiscal rules at the EU level can achieve on their own. It would be impossible to uphold these rules if governments repeatedly came into conflict with them. This consideration suggests that one should rely much more on national institutions that are conducive to both long-run fiscal discipline and effective short-run stabilisation policy. One possibility would be to require the member states to adopt national laws on fiscal policy that set well-defined long-run sustainability goals, but also outline clear principles for the use of fiscal policy as a stabilisation instrument.

In this respect, economists have recently begun to discuss whether there are lessons for fiscal policy to be learnt from the recent development of monetary policy theory and institutions. A parallel could be drawn between delegation of monetary policy to independent central banks, and delegation of decisions about fiscal stabilisation policy to an independent fiscal policy committee. The underlying idea is to separate decisions aimed at stabilisation from other aspects of fiscal policy concerning distribution and social efficiency. Such separation would reduce decision lags as well as politico-economic risks of pursuing pro-cyclical policies and deficit bias. At the same time, it could help the government to define more clearly the political goals of alternative policy measures. Such a development has taken place in other areas of economic policy making in addition to monetary policy: examples include competition policy as well as market regulation and supervision.

The idea of delegation of fiscal policy stabilisation decisions may be unfamiliar to many people, and is not on the current political agenda. There is, however, a case for starting to think about the possibility of such a reform, and exploring the extent to which it would be compatible with generally accepted principles of democratic governance. Consistent with the principle of subsidiarity, national delegation could be seen as an alternative to the recent proposals of the European Commission, according to which it should be given greater discretionary powers in assessing fiscal policies of member states.

One idea would be for member states to establish an independent fiscal policy committee at the national level. A politically realistic way to move in this direction in the next few years is to set up independent fiscal policy committees at the national level that play an advisory role. Governments could be required to seek the advice of these committees before making their budget decisions and to use the committees' estimates of cyclical conditions, government expenditures and tax revenues as a basis for budget calculations. The task of these committees could be to propose how much the actual budget balance in a given year should deviate from the cyclically adjusted budget balance and to make recommendations on specific tax or expenditure changes with the aim of stabilising the business cycle. The general goal of such reform would be to lessen many of the problems that now hamper the use of fiscal policy as an effective stabilisation tool, such as long-decision lags, deficit bias, irreversibility of decisions, and confounding of objectives.

Subsidiarity

A reconsideration of the EU policies and the concept of subsidiarity is timely due to the coming enlargement and the current European Convention which will propose a constitution for the enlarged EU. The challenges ahead require careful consideration of the division of responsibilities for decision making of public sector activities. Analysis of economic efficiency provides a useful guideline for assessing which public sector tasks should be delegated to the competence of the EU and which tasks should be the responsibility of national governments of the member states. While there are reasons for using subsidiarity as the basic principle, in a number of tasks there are sound economic reasons for deviations from subsidiarity. These exceptions must be analysed case by case.

Maintenance and promotion of the single market is the most basic EU-level task. It involves not only the removal of obstacles to trade and economic integration but also activities, such as the design and implementation of an active competition policy, that facilitate the functioning of the single market. The EU involvement has both an internal and an external dimension. In fact, it should not be forgotten that regional free trade areas might lead to trade diversion rather than trade creation. To be consistent with its ultimate goal of promoting the welfare of European citizens, EU-level trade policy should be geared towards global free trade.

A second reason for delegation of specific tasks to the EU level of government arises from the existence of public goods, which have geographically widely dispersed benefits. Defence, foreign policy and internal security are public goods where common EU-level decision may be appropriate, though the forms of implementation could partly be national with the EU level having a coordinating capacity. Whether other public goods qualify for centralised provision is controversial, as in most cases benefits tend to be more concentrated locally.

A third reason for delegating public intervention to the EU level arises from the need to regulate economic activities that generate important spillovers or externalities across borders. This is the case for telecommunication networks, environmental concerns, aspects of standardisation and product quality, as well as the financial system. Also, the significance of spillovers and externalities must be assessed case by case. If the externalities involve only a few neighbouring countries, the EU function could be limited to coordination.

While management of fishing rights can be an EU concern because it involves management of a common property resource, it is difficult to extend the same argument to agriculture as a whole. A country or region should decide on its own whether to subsidise agriculture for aesthetic or environmental reasons, and implement its policy at the local level. Reforms of the EU agricultural policy that rely significantly on national policies should stay clear of providing nationally administered subsidies to production or exports as a way to promote competitiveness of national producers. If agricultural support moves to national level, the EU has a potentially important role in ensuring a level playing field and in defining food-safety standards.

The current activities of the EU accord rather poorly with economic principles. Nearly half of the EU budget is devoted to agricultural subsidies and guarantees. Structural funds and operations are the second largest item in the EU budget. The remaining significant items in the EU budget consist of external action, that is policies towards non-EU countries (for example, development aid and pre-accession strategy), international operations, research and technological development, and EU administration. While the EU budget is small in comparison to the budget of central government in federal states, the EU exerts great power through regulatory policies in different ways, including regulations, directives and decisions. The regulatory activity of the EU has grown significantly over the years. Agriculture and fishery stand out also in terms of the number of EU regulations: looking at five-year periods, about 40–50 percent of the total are in this area. In terms of EU regulations, matters concerning the single market and non-sectoral business relations (especially competition policy) are also significant. As discussed above, activities associated with agriculture are not natural EU-level tasks, with the possible exception of food safety. Agriculture and structural policies are largely redistributive in nature and as such they are not natural responsibilities of the EU-level government.

Decentralisation according to subsidiarity is likely to lead to competition between national jurisdictions, which can be good or detrimental depending on the nature of the activity. In general, beneficial effects can be expected from a yardstick competition, as countries try to imitate successful neighbours. However, in the case of factors of production that are mobile across borders, tax competition is problematic because it tends to drive tax rates down to a level that equals the marginal cost of providing public infrastructure. So, with fiscal competition, in the long run taxes on mobile factors become similar to prices or user fees for public infrastructure. But this means that the tax base for generating revenue towards the general government budget is likely to erode with the passage of time. Note that the revenue from taxes on mobile factors may not even cover the cost of providing the infrastructure. This is because tax competition equates tax rates to the marginal costs of producing the infrastructure, but in the case of public goods marginal costs are typically below average production costs. In that case, tax competition would result in a race “below the bottom”, whereby infrastructure is under-priced and the immobile factors are forced to pay for the services enjoyed by the mobile ones. Unless the distortions from tax competition offset other distortions, such as the tendency of local and national government to spend and tax excessively for political-economy reason, there are potentially large losses of welfare.

To prevent such outcome, tax harmonisation on the EU level might be considered. However, mere tax rate harmonisation will create a strong incentive at the country level to compete with each other through the provision of infrastructure goods, possibly resulting in overprovision of such goods. This problem can be avoided if the EU ban on explicit subsidies is extended to indirect subsidies through the provision of under-priced infrastructure. In principle, the cost of infrastructure should be covered with taxes on the benefiting firms and agents alone.

With deepened integration and increased mobility of capital and people, the welfare state will come under financial pressure. In a closed system redistributive taxation and the welfare state can be seen as insurance systems as they protect citizens who happen to experience unfavourable personal circumstances. With open borders, increasing factor mobility puts limits to this insurance activity since rich net-contributors to the welfare state of a country may be inclined to move to countries with a less-redistributive system, while poor people have the opposite incentive – to migrate to countries with a relatively more redistributive welfare state. This has and will continue to create problems: The migrants from Eastern and South-eastern Europe who have come to Western Europe after the fall of the iron curtain, and will continue to come in the foreseeable future, exhibit a highly differential mobility among European countries. This differential mobility is likely to trigger off a sort of deterrence competition among these countries.

One important source of difficulties is the adoption of the "residence principle" for migrant workers and employees in the EU, as regards the eligibility to social benefits and social security contributions. While people who migrate from one EU country to another for reasons other than work are excluded from the welfare system of the host country, people who migrate in order to work are fully and immediately included. Full and immediate inclusion implies full participation in the national redistribution system. This creates an incentive to migrate above and beyond the economic incentive from wage and employment differences. Moving away from a "residence principle" towards a "home-country principle" to define benefits and responsibilities for the migrants can in principle reduce distortions. Partially delayed integration, in which migrants are immediately entitled to contribution-financed social benefits but are only gradually entitled to social benefits that are funded from general tax revenues, may provide a practical solution.

Social standards in health, work and elsewhere are another aspect of modern welfare state. The coming enlargement will challenge these standards because of the differences across member states – especially between the current and future EU members. Economic analysis suggests that rapid harmonisation of work-related social standards would be detrimental in the coming EU enlargement, since it would enforce the same mix of pecuniary wages and social standards on virtually all countries, whereas a different mix may best suit local labour market conditions. Different countries are in very different stages of economic development and premature harmonisation of social standards would slow down the process of development. If instead countries are allowed to compete, these standards will rise in line with wages and living standards in the poorer EU countries. Instead of focusing on harmonisation in the coming EU enlargement it will be important to provide free access to new markets to the accession countries. This is the best way to facilitate the development process.

Redistribution among different EU countries raises difficult political issues and polarises opinions. Once again, it is important to take into account the major differences in the stages of economic development. These differences suggest that inter-jurisdictional competition could be beneficial, as in the case of social standards discussed above. Interpersonal and interregional redistribution is primarily a national responsibility. Deviating from this principle could involve huge welfare and efficiency losses in Europe. East Germany is a good example of the problems that may occur. The quick adoption of the west German welfare system in east Germany has had extremely adverse consequences, because east Germany's underdeveloped market economy turned out to be unable to generate jobs that could compete with the generous replacement incomes provided by the welfare state. Mass unemployment and a very poor growth performance were the result with little improvement in sight.

Financial architecture

Alternative models for reforming financial architecture in Europe will have profound implications for the degree of financial market integration, competitiveness in the financial industry, and financial and monetary stability. Reform proposals should be assessed in terms of their contributions to the welfare of European citizens, including the price they will pay for financial and payment services, the range of opportunity for insurance and portfolio diversification, and the reliability and trust of the financial institutions in the area.

The financial architecture in Europe is clearly in a process of deep change. In its present shape, there are at least three significant problems.

First, there are areas in which the present financial architecture arrangements are not adequate for financial stability. For instance, in the event of a crisis, there is no clear chain of command among the institutions potentially involved in any intervention. How would the euro system react to the threat of a major disruption like the one ensuing from the possible bankruptcy of Long Term Capital Management (LTCM) in the US in 1998? Who in Europe would have the responsibility to organise a rescue of a large financial institution, as did the president of the Federal Reserve Bank of New York in the case of LTCM? A response based on improvised cooperation may not be enough – it may come too late. Moreover, there could be misaligned incentives for national supervisors dealing with transnational firms, leading to too little interventions, as they do not internalise cross-border spillovers from the crisis of such firms. Conversely, national authorities may have strong incentives to provide excessive help to national champions. This view is in contrast to the conclusions of Brouwer's reports[6], according to which all these potential issues can be satisfactorily addressed with just a little bit more cooperation among supervisors in the various member states.

Second, to a large extent the present arrangements hinder European financial market integration. Legislation is slow, rigid, and lags behind market developments. Regulatory fragmentation prevents the emergence of liquid European markets (as arguably was the case in the failure of the London Stock Exchange and the Deutsche Börse to create iX). Protection of national champions and regulatory barriers avert the emergence of pan-European banks.

Third, the present arrangements hinder the competitiveness of EU financial markets and institutions. There is considerable uncertainty about the normative and regulatory framework in Europe. Market fragmentation resulting from regulatory barriers slows down and distorts the emergence of cross-national firms that may be able to compete at international level.

The current "official" view is that this state of affairs is not worrisome because European banking and financial markets remain segmented. In a framework of segmented markets, all that is needed is more cooperation among different regulators and authorities. This view may clearly backfire, as it justifies a slow pace of reforms and policies that do not remove obstacles to integration. Ultimately this may just be a way to endanger stability.

Many political-economy issues are at the heart of the problem, namely, the tension between economic integration and the lack of willingness to relinquish national political control. But while these political economy issues slow down the pace of regulatory and institutional innovations, there are important sources of systemic risk to which the European markets are exposed. The recent events have stressed the threat of terrorist action, and possible financial weakness associated with the current economic slow-down. Some European banks are heavily exposed to emerging markets and to particular sectors, such as telecoms, which have recently experienced deep crises. The process of consolidation within countries has led to the creation of many "national champions", which may create incentives for national authorities to provide excessive guarantees. At the same time, the expansion of cross-border activities may increase potential spillovers and externalities across countries, while creating incentives for underprovision of supervision and liquidity support by national authorities.

The present approach to reforms is gradualist, based partially on the so-called "comitology", consisting in delegation of powers to define rules to various committees. This approach has its limits, and may yield more costs than benefits in the long-term. It may be preferable not to wait for a major crisis to strike in order to put the house in order.[7]

There is good reason to endorse in general the well-intentioned recommendations of the commit-

[6] Economic and Financial Committee (2000), Report on Financial Stability, Economic Papers No 143.

[7] While we see advantages in delegating operational policy making to committees (we actually propose a fiscal policy committee in chapter 2), we find it inappropriate to delegate fundamental political and constitutional decisions.

tees and groups seeking to remove the obstacles to European financial integration. Yet the question is whether a more ambitious approach would be more appropriate. In particular, what prevents the immediate setting of clear procedures for crisis lending and management with the European Central Bank at the centre? Why not put a crisis framework in place now, and confront the fiscal issues related to the possible costs of intervention?

By the same token, a debate should be opened with a view towards evaluating the benefits of more centralised supervisory arrangements in banking, insurance and securities. In addition to the current decentralized regulatory competition framework, there are other long-run models that one could follow. In the first model, the ECB and ESCB might gain a larger role in supervision of banking, with the contemporaneous creation of separate specialised European-wide supervisors in securities and insurance. The second model consists of an integrated supervisor for banking, insurance and securities, a European Financial Supervision Authority (EFSA), whereas the ECB would have access to supervisory information in order to maintain systemic stability. Different models present different trade-offs between efficiency, accountability but also suitability to specific circumstances and features that may differentiate markets and financial institutions across regions. It may be important to note here that in neither of the two models above, supervision need be completely centralised at the European level. First, national supervisors will need to be involved in day-to-day operations. Second, national institutions could still have the supervision of entities that trade mostly within one national jurisdiction (under the home-country principle).

The door should be left open in the Convention on the Future of Europe to the necessary institutional changes to implement more centralised regulation, perhaps along the lines of one of the models above. At the same time, the EU-wide competition policy in the banking sector should limit help to national champions (which are "too big to fail"), and remove obstacles to cross-border mergers. Domestic competition policy should also be reinforced, as to keep in check local market power.

Reforms of the financial architecture are admittedly quite complicated, as technical aspects are strictly interwoven with legal and institutional aspects. Given the large interests at stake, the process of reform is the target of particularly strong lobbies, both private and public. It would be a great cost for society if the need to reconcile conflicting special interests resulted in a lower protection of European citizens against the many risks that an inefficient and vulnerable financial system entails.

Brain drain

Is Europe losing its most talented workers to the United States? Should brain drain be a concern of European policy makers? Chapter 5 documents brain drain and discusses potential policy responses. We find that migrants of European ascent are much more educated on average than their counterparts in both the US labour market and their home countries. Workers of exceptional ability – in various dimensions – are over-represented among European expatriates. Thus, they are much more likely to hold masters and Ph.D. degrees; they are more engaged in entrepreneurial activities; they earn more on average than US workers with similar characteristics; the density of unusually highly paid workers among them is higher; and European-born scientists in the US do better than average.

Reduced intellectual capital in Europe may be worrying for several reasons. In particular, intellectual workers are complementary to other workers. A greater scarcity of intellectual workers is likely to put downward pressure on the wages of the latter. Furthermore, the expatriates' secondary education, and often a large share of their tertiary education has been paid by the European taxpayer, who gets a lower return on his investment in higher education.

To be sure, the cumulated size of the brain drain does not currently exceed one percent of the workforce, suggesting that it is unlikely to have a very large impact on the *aggregate* intellectual capital of Europe. However, that conclusion may be reversed if one believes that the fraction could be much higher among top entrepreneurs and top scientists, and could increase in the future. Evidence suggests that these people could be much more important than suggested by their measured ability, because they are critical to business creation and growth. Potentially, the brain drain could then have damaging long-run implications for productivity and living standards in Europe.

While it is too early to draw definite conclusions about this view, the data we present are consistent with it. Our analysis suggests that the brain drain is a symptom of a more general problem, i.e. that the European institutional climate is detrimental to highly skilled individuals. In particular wage-setting institutions as well as personal and corporate taxation penalize top earners, which in turn discourages risk taking and favours the expatriation of exceptional talent. We suggest a number of measures to alleviate that problem. These include measures to:

(a) Increase the incentives for quality in public research institutions and favour exchanges between them and the private sector in order to foster the creation of clusters of excellence and high technology. In doing so, the government should however avoid a commitment to specific sectors and technologies in order to reduce inefficient rigidities in the allocation of funds and distortions in the allocation of talents.
(b) Increase intra-EU mobility, in particular by enhancing pension portability. For many reasons this will particularly favour highly skilled workers, who tend to be the more mobile. Hence this measure will be particularly helpful in creating a European-wide sizeable labour market for talented workers.
(c) Reduce top marginal tax rates, to offer attractive terms to top scientists and executives.

These recommendations can of course be desirable for reasons beyond the goal of reducing the brain drain. Brain drain just adds a motivation for implementing them.