The Winning Essays

Introduction

The idea of establishing the biennial EIB Prize competition as a forum for innovative ideas and topical policy discussions has been amply vindicated by the four award-winning essays presented in this issue of the EIB Papers. It is not easy to provide a fresh look at the often thorny economic and financial issues currently facing European policy-makers, but this is what each of the essays attempts to do, with some success.

Philippe Martin *(first prize) raises the question* "Are European regional policies delivering" *and suggests that policy makers expect too much, because regional policies based on transfers to poor regions cannot, at one and the same time, decrease inequalities between regions, increase efficiency at the national and European levels and decrease inequalities between countries. Martin argues that these policies face a trade-off between equity and efficiency at the spatial level. An examination of the effects of agglomeration, innovation and labour immobility shows that regional policies have complex and often paradoxical effects. To achieve the desired results, therefore, the objectives of regional policies need to be defined more carefully.*

In "Hard currency and sound credit: A financial agenda for Central Europe"*.* **Francesco Giavazzi and Rudi Dornbusch** *(second prize) ask what Hungary, Poland, or the Czech Republic have to lose in giving up their monetary sovereignty through the establishment of currency boards. They argue that, despite the limitations of rigidity, substantial cost and loss of sovereignty, currency boards reduce the risk premium on public debt and enhance a country's international standing by providing transparent institutions. A sound financial system is the critical counterpart of a credible exchange rate arrangement, however, and an effective repair of Eastern Europe's shaky financial systems would require cleansing of the legacy of bad loans and keen supervision. Giavazzi and Dornbusch conclude that, despite transition difficulties, the EU's historic move to a single currency offers Central Europe a unique opportunity for change.*

Jordi Gual *(third prize) considers* "Deregulation, integration and market structure in European banking" *through an examination of the interacting factors affecting the establishment of a single EU-wide banking market. He finds that the structure of an integrated market will depend on the importance of entry barriers and on the presence of sunk costs. The impact of market growth on structure and concentration will depend largely on how companies compete, i.e. the extent to which competition in banking is based on sunk costs or variable costs will determine whether or not European integration will lead to an increased exploitation of scale advantages.*

Jens Verner Andersen and Jørn Henrik Rasmussen *(special topic prize) take up the challenge of* "Solving the unemployment puzzle in Europe"*. Their analysis leads to the conclusion that high unemployment levels in Europe are largely due to structural rigidities in labour markets. The "job miracle in Denmark", between 1993 and 1998, is offered as an example of the successful implementation of a balanced strategy of labour market reform within a framework of macroeconomic stability. Andersen & Rasmussen point out that a wide range of co-ordinated measures need to be put into place to fight unemployment, including those that improve economic incentives to work. In this context, they put forward the possibility of employment conditional schemes, such as the Earned Income Tax Credit (EITC) which, by giving a tax credit only if a person has a job, strengthens incentives to work without reducing the income of the unemployed.*

Three smaller prizes were also offered for submissions from entrants under the age of thirty. They have been published separately in the form of **Economic & Financial Reports** *and are available on request (see the inside back cover for ordering details).*

Hendrik Hassheider *considers the feasibility of* "Private sector investment as a means of financing Trans-European Networks" *on the basis of criteria for effective private sector financing and a comparative evaluation of theoretical models involving private sector participation. The public good and natural monopoly aspects of transport infrastructure are also taken into account. Hassheider comes to the conclusion that private sector involvement in the creation of transport infrastructure is possible in principle, but that certain conditions need to be met and a number of obstacles removed to attract private investors. A necessary first step, for example, would be acceptance of the principle that the "user pays" in the form of tolls, not only on new roads but also on existing highways. There are also complications inherent in improving the regulatory environment and harmonising legal frameworks, both mandatory if private investors are to assume long-term risk. Hassheider underlines that the most important aspect in mobilising private sector finance, however, is for Member States to abandon the belief that only the public sector can provide transport infrastructure.*

Daniel Piazolo *looks beyond the immediate benefits of transfers and the removal of trade barriers that EU membership would offer Eastern European countries to consider* "The credibility and growth effects of EU institutions for Eastern Europe." *He points out that, although candidates for the first round of the eastern EU enlargement have made considerable progress in macroeconomic stabilisation and microeconomic adjustment, institutional reforms still lag some way behind. In the process of transition, however, failure to implement institutional reforms can create serious doubts about a government's willingness and ability to bring transition to a successful conclusion. Credibility requires clear, enforceable rules that are administered impartially and the prospect of EU membership has already helped to provide clear expectations about the direction of future policies and the structure of revised economic and legal systems. Institutional integration will be* *advanced through full EU membership, which requires the implementation of the* "acquis communautaire"*. Piazolo then uses a growth model to illustrate the effects of an improvement of economic institutions and, on the basis of the regression results, derives an estimate of the potential growth bonus that could be realised in Eastern Europe through institutions improved as a result of EU membership.*

Carsten Sprenger *analyses* "Direct investment and the eastern enlargement of the EU"*, in terms of actual foreign direct investment flows, then models the potential for inward direct investment. Statistics covering actual investment in Eastern Europe since 1989 indicate that geographical proximity, existing trade relations and cultural affinity (e.g. a common language) all have a beneficial effect. Unsurprisingly, Eastern European countries with political and relative macroeconomic stability prove to be the preferred targets for foreign investment. Company surveys also show that the main incentive for such investment is the development of markets with growth potential, differences in factor endowment and lower labour costs being secondary considerations. EU entry could provide an additional stimulus for investment, but it would have to be accompanied by an expectation of reduced risks through the implementation of stable monetary and fiscal policy and effective institutional reform.*

Regional development, financial stability in Eastern Europe, the integration of banking structures, unemployment, public/private investment choices - these are issues of primary importance for Europe and, therefore, of priority interest to the EIB. They are also issues of great complexity and it is to the credit of the winning essays that they succeed in providing new insights into the policy options.

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