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**JVI ANNUAL LECTURE 2006**  
**"Globalization, Integration and Economic  
Growth:  
The Importance of Capacity Building"**  
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Ladies and Gentlemen,

Globalization and integration have been the driving forces of economic development and growth over the past 20 years. The challenge of the 21<sup>st</sup> century is to shape appropriate framework conditions to ensure that globalization benefits as many people worldwide as possible, and that it is sustainable - economically, politically, socially and environmentally.

European integration has witnessed important new developments over the past few years. While enlargement of the EU has made a milestone with the biggest enlargement round ever just completed, and two new countries about to join, progress regarding the deepening of the Union has been more mixed.

On the one hand, the euro was successfully introduced and has established itself as one of the two major world currencies, with a remarkable track record of price stability so far. The number of euro area countries is going to increase to 13, with Slovenia, from next January.

On the other hand, the EU's institutional development suffered a setback with the rejection of the draft EU Constitution. The EU Single Market, despite continuous progress, is still far from complete, and the Services Directive has been adopted only in a watered-down version. Progress in the new Member States toward joining the euro area is proving considerably slower than initially expected. It seems we are experiencing a period of consolidation in the integration process, which is not necessarily a bad thing, and may, if used appropriately, set the foundation for further progress in the future. Given its complexity and historical uniqueness, European integration has never followed, and cannot realistically be expected to follow, a linear path.

The growth effects of globalization and integration have been impressive. China and India are success stories of the substantial growth effects that globalization can yield, if only one is prepared to fully engage in the process. Central and Eastern European countries, notably the new EU member states, offer equally impressive examples of how societies and economic systems can be turned from centrally-planned into market economies over relatively short periods, and how integration can support sustained and substantial economic catching-up.

However, such success stories do not come out of the blue, just because trade and capital flows are declared to be liberalized. They are the result of the deliberate design of appropriate framework conditions, sweeping changes in the role and organization of the state and its institutions, an overhaul of the organization of society and its constituencies and an all-encompassing empowerment of citizens, who are ultimately the source of any value added in an economy.

The conditions required to generate sustainable growth are the subject of a flourishing economic research agenda around the world, in academia and policy institutions. While there are still many things we do not fully understand, there are a number of core ingredients, apart from trade and financial openness, which seem vital to make economic development possible and likely. These ingredients can be grouped into three categories: institutions, governance and knowledge. Together they determine how efficiently a country's resources are used and developed, whether the opportunities offered by globalization are used, or whether a country remains on the sidelines, or even suffers from globalization. Let me just list some of the central requirements for economic development and growth that seem particularly important for today's lecture.

First, political stability and the rule of law are indispensable. Efficient, stable and transparent governmental institutions must ensure the provision of vital framework conditions for businesses to thrive, for students to pursue education, for workers to seek and find adequate and motivating jobs, and for consumers and investors to make appropriate decisions.

A second requirement for sustained growth is macroeconomic stability. Stable money underpins the efficient functioning of the price mechanism and preserves the integrity of nominal contracts.

It is widely acknowledged nowadays that an independent central bank, whose primary objective is price stability, is best able to achieve disinflation at the lowest possible cost, and to maintain price stability on a lasting basis. However, the success of monetary policy crucially depends on a credible and transparent monetary policy and the market expectations and market confidence derived from such a policy. When markets form their expectations accurately and understand well the monetary policy strategy of a

central bank, they have no incentive to deviate from the set inflation path.

Referring to EMU as an example, the level of credibility the independent Eurosystem has earned from the very beginning in 1999 was comparable to the high credibility levels, which most stable European currencies previously already had. The ECB Governing Council has continuously monitored inflation expectations and has remained ready to act - if necessary - in a timely fashion on any changes in expectations. One of the most remarkable achievements of the first eight years of life of the Eurosystem, however, has been its ability to anchor and control inflation expectations. Despite substantial economic shocks long-term inflation expectations have remained stable and well anchored at levels around 2 percent.

However, a stability-oriented monetary policy by itself is not enough. Sound public finances are indispensable for lasting price stability and sustainable economic development. Explosive government budget paths eventually lead to economic, exchange rate and financial system crises, with dire consequences for growth and welfare. History has taught us that financial stability is a key prerequisite for favorable economic development.

Third, economic policies need to be oriented toward increasing a country's production potential. Supply-side oriented structural reforms are a complex and often politically difficult undertaking.

In this context, let me recall the Lisbon Agenda: Although some structural reforms have been carried out in the euro area, like the liberalisation of the electricity market and the progress in pension and labour market reforms, flexibility and dynamism could be improved in some euro area economies further. Indeed, recent research by the ECB<sup>1</sup>

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suggests that euro area countries typically have undertaken more comprehensive and far-reaching reforms than other OECD countries over the past decade.

However, comparison of reform progress across policy areas shows that euro area countries have generally not made more progress in reforming the "difficult" areas, where political resistance is strong, than other OECD countries (e.g. modification of employment protection legislation (EPL), i.e. relaxing the rules governing temporary contracts; extension of the working age while reducing incentives to retire early or reduction of automatic indexation of wages). Furthermore, there appears to have been a slowdown in the reform process in many euro area countries after the formal advent of the euro.

Thus, it is vital for an ongoing success of EMU to keep in mind that structural reforms are essential to raise factor productivity and potential output, to create new jobs and to achieve lower prices and higher real incomes! The need for reforms is clearly backed by the fact that euro area potential output growth seems to have moved to the lower bound of its previously estimated range of 2-2.5 percent.

Hopefully, the relaunch of the Lisbon Agenda and the newly instituted national reform programs will be implemented vigorously. The current economic upturn should be used both to implement structural reforms and to speed up fiscal consolidation, in line with the New Stability and Growth Pact.

Finally, it is a major challenge to maintain social cohesion in the midst of far-reaching reforms and accelerating global change. Governments that pursue

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<sup>1</sup> Duval, R., Elmeskov, J., 2006, „The Effects of EMU on Structural Reforms in Labour and Product Markets“, ECB Working Paper No. 596.

appropriate reforms, which serve their citizens in the long run, are always at risk of losing public backing for their reform policies along the way. Similarly, globalization is constantly at risk of losing support and indeed faces fierce opposition from some groups that are eager to conserve the status quo and accumulated rights of their respective constituencies.

Economists are right in pointing out that such opposition is often rooted in misconceptions about how growth, jobs and wealth are created. It is not a new insight that economic activity means an ongoing process of destruction and creation. Nevertheless, this process has been accelerated by globalization, implying increasing pressure on economic agents to readily adjust to rapidly changing conditions. It would be foolish to ignore that there are losers from globalization in the short run, as less efficient companies exit and their employees lose their jobs. It is vital to provide mechanisms to prevent these people from also becoming losers in the long run. Framework conditions need to be designed in such a way that jobs are created, people who lose their jobs can find another one within a reasonable time span, and the large numbers of people entering the labor market in emerging economies can successfully be absorbed into the global labor market. This is why appropriate structural reforms are even more necessary. Moreover, this is where education, skills and capacity building have a vital role to play.

Before I turn to this latter topic in more detail, let me note that quite manifestly the various factors for growth just mentioned are interrelated. For example, macroeconomic stability is hardly conceivable without political stability. Conversely, macroeconomic instability will eventually cause social unrest and destabilize the political systems of a country. Structural reforms may be supported by an appropriate macroeconomic environment (though it is, for

instance, hotly debated whether strong growth or, on the contrary, crises actually favor major reforms).

The difficulty therefore is where to start, which sequencing to follow, which complementarities to observe. Clearly, what is right for a country also depends on many factors specific to that country. At the same time, we can learn from the experiences of other countries.

The IMF has long-standing experience with these complex issues and continues to be an important partner and advisor when it comes to designing economic reform and development programs.

So, what is the role of capacity building in all of this? Let us first clarify what we mean by capacity building. Capacity building is defined quite differently depending on the specific context. For our purposes today, I define capacity building quite broadly as "the process and means of developing a country's human, scientific, technological, organizational, institutional and resource capabilities".<sup>2</sup>

It covers much more than training; it includes:

- human resource development: the process of equipping individuals with the understanding, skills and access to information, knowledge and training that enables them to perform effectively;
- organizational development: the elaboration of management structures, processes and procedures, both within organizations and between different organizations and sectors;
- institutional and legal framework development: in order to enable organizations, institutions and agencies at

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<sup>2</sup> Source: combination of various definitions by the United Nations, Economic and Social Council and by various non-profit organizations. See <http://www.gdrc.org/uem/capacity-define.html>.

all levels and in all sectors to enhance their capacities.

Importantly, capacity building is a long-term, ongoing process, in which all stakeholders participate.

In short, capacity building includes all measures that enable a country to ultimately pursue and organize its development efficiently and successfully on its own. It is help for self-help. The definition that I just gave you may seem unduly complicated and broad. However, to my mind, this definition appropriately emphasizes how many elements and processes need to function simultaneously for a country to thrive and benefit from globalization. There are many dimensions to capacity building - they all need to be present to ensure success.

Given the many aspects that are apparently necessary to permit economic development, capacity building may appear a huge, overwhelming task. And indeed, it is. One needs high-profile, credible organizations with sufficient numbers of highly skilled and experienced staff to achieve this objective.

Fortunately, there are a number of such organizations, and they cooperate closely to ensure complementarities and synergies in their endeavors to help emerging and transition economies with capacity building.

At the international level, these institutions include the IMF, the World Bank, the WTO, EBRD, OECD, the European Commission and the BIS. These institutions play a vital role in promoting free trade, financial development, globalization and economic integration. They also provide important analyses on ways to reap the maximum benefit from closer integration. Moreover, they provide various forms of technical assistance and training to emerging countries. These efforts are accompanied and supplemented by numerous activities carried out by national authorities, including

governmental organizations and central banks, around the world.

Why do central banks have an important role to play in economic and financial education, as well as in technical assistance and capacity building? There are various aspects to this. Let me start with economic and financial education.

Economic literacy contributes to an efficient allocation of resources. Better-informed people will make wiser decisions about their education, jobs, borrowing, savings, and so forth. Taken together, this allows achievement of higher economic welfare. Furthermore, a better understanding of economic issues should strengthen public support for economic reforms, which yield their benefits only over the medium to long-term. Finally, a basic understanding of economics should help safeguard public support for price stability and create better understanding of an independent central bank's monetary policy decisions.

Financial literacy has, on the one hand, a social dimension by helping individuals to make wise and prudent financial decisions and avoid mistakes. On the other hand, it should contribute to economic and financial stability.

As regards technical assistance and capacity building, the motivations for governments and central banks are multiple. First, there are obvious positive externalities: If partner countries develop favorably, this is also good for a country's own development. Providing technical assistance also enhances the supporting organization's own human and social capital.

However, more fundamentally, I am convinced that there is also the deeply rooted feeling that it is part of a public institution's mission to share knowledge and experience with colleagues in sister institutions from other countries. Clearly, for Austria and the Oesterreichische Nationalbank all the aforementioned reasons combine to create a

particularly strong commitment to share our knowledge and experience, especially with our Central and Eastern European neighbors, colleagues and friends.

The Joint Vienna Institute (JVI) fits ideally into this broader picture. With the fall of the Iron Curtain, a unique window of opportunity opened for the Central and Eastern European countries, the FSU countries and the reform countries in the Far East to rejoin the international economic and political communities. This meant establishing market economic structures as well as democratic political institutions. We felt then and know now that these were Herculean tasks.

At the Annual Meetings of the Bretton Woods institutions in Bangkok in 1991, Patrick de Fontenay, Director of the IMF Institute, Ammon Golan, Director of the World Bank Development Institute, Ferdinand Lacina, Federal Minister of Finance of Austria and Maria Schaumayer, President of the OeNB, discussed the challenges of the transition from a centrally planned to a market economy. They immediately saw the massive need for the training of officials from transition economies and agreed to promote the project of a joint training institute in Vienna. The project matured as a joint initiative of the Commission of the European Communities and five international organizations (the BIS, EBRD, IBRD, IMF and OECD). The Austrian authorities acted as host, had observer status on the Board and, together with the IMF, provided the infrastructure and most of the financing.

The Institute started up in September of 1992 as the Joint Vienna Institute, to provide instruction of the highest standard to help countries making the transition to market-based economies, whereby each of the participating institutions could offer their unique expertise.

Since then, the organizational structure, but not the dedication to teaching, has changed: the IMF and the Austrian authorities became primary members, while the EC and the BIS left the organization but continue to contribute to the teaching. On the other hand, the WTO joined the JVI as a contributing member. Specifically, I would like to mention the European Commission, which has contributed a number of courses related to European integration, a topic that has been very important for European transition economies.

Meanwhile, the JVI also moved to new and excellent premises here in Mariahilfer Strasse. The Institute has built up an excellent reputation and trained some 20,000 officials and participants from the private sector from all transition countries and I would like to applaud all those who have helped to make this happen.

On January 1, 2007, two more former transition economies will join the European Union, and will thereby switch, so to speak, from the recipient to the donor side, just as eight CEE countries did in 2004. I very much hope that their experience of transition issues will be reflected in the course curricula and that the course organizers will draw substantially on lecturers from the former transition countries.

From the points of view of Austria, Europe and the IMF, I feel that the Western Balkans are of particular significance to the work of the JVI.

For various reasons, the countries of this region could only begin their transition process later. Despite having made significant progress in economic reform, this region is still in the middle of the transition process.

As I pointed out earlier, training needs to go well beyond economics. We know of the importance of institution building, economic governance and the rule of law for

improving policymaking capacity, thereby raising growth prospects and improving macroeconomic stability. Browsing through the JVI Program 2007, I am happy to see that a good number of courses already cover these areas.

Finally, I would like to wish the JVI and its new director, Mr. Hochreiter, who until this August was a senior staff member of the OeNB, the very best. I am confident that the JVI and its member institutions will remain at the forefront of supporting the transition to a full market economy as well as maintaining the quality of its products and thereby upholding the high reputation of this fine training institution.

Let me summarize and conclude:

Globalization is both an excellent opportunity and a huge challenge. Importantly, it requires the building-up of knowledge and capabilities across all parts of the state and society. "Capacity building" is not just a buzzword - it is key to successfully reaping the benefits of globalization.

Central banks and international economic policy institutions have a vital role to play in this field. Their activities appropriately include special capacity building initiatives for officials and leaders who bear responsibility for the broad direction in which a country and economy is moving. In addition, central banks increasingly recognize the importance of economic and financial education for the public at large.

Only economically and financially informed citizens are willing and able to go along with far-reaching reform programs, to found their own businesses, to make efficient professional and financial decisions. Economically literate citizens will better understand the long-term benefits of price stability.

The Joint Vienna Institute is a success story of an institution specifically founded with the aim of capacity building for a specific audience. It filled an important niche when it was established. Over time, the Institute's focus has shifted, as the needs of its trainees have changed. In that sense, the JVI has all the prerequisites to excel further in the future: high-quality standards, user-orientation and flexibility in a changing world.