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CONVERGING EUROPEAN TRANSITIONS

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Abstract

The immediate effect of the current emerging markets crisis is to underscore a lesson from the inter-war period which could well spread from the tariff escalation to non-tariff barriers like exchange controls. Liberalization and globalization must be better managed to prevent protectionist pressures from taking over. Avoiding contagion by reverting into trade and financial protectionism could well prove as ultimately futile a beggar-thy-neighbor policy in the late 1990s as it was in the early 1930s.

Managing the emerging markets crisis means therefore allowing for a more effective regional and global response to threats of contagion of national crises through coordination mechanisms among monetary and fiscal authorities like the ones found in the EU. These mechanisms rely on shared economic and societal values, and the ten central European applicant states (CEAS) which expect EU membership in the years ahead should adapt them among themselves through the Central European Free Trade Association (CEFTA) or equivalent.

If national policies respect property rights and keep markets open to international trade and investment, taking into account the nation's capacity to transform, economic growth will follow. This basic policy rule has immediate implications for the transition from plan to market in the CEAS. These economies have experienced a substantial fall in their perceived standard of living, and the ability to recover through accelerated growth is even more decisive in countries where European values have once been held than in emerging markets without such memory. In effect, the tradition may have been forgotten by decades of inadequate policies to the point that the new economic regime may not be sustainable.

While no EU member state experienced comparable restrictions on their civil and property rights, Greece, Portugal and Spain had to change their economic regime through a series of structural reforms where the pressure of qualifying for Economic and Monetary Union (EMU) played a crucial role. The fulfillment of the convergence criteria for the euro is not part of the enlargement negotiations but the needed change in the economic regime of the CEAS is already monitored by world financial markets, in the attempt to anticipate whether stability will be sustained after membership - and at what cost in terms of social cohesion.

In an environment of global policy convergence, the main effect of EU enlargement on growth and investment will depend on the progress of transition rather than on geographical proximity, or even on any order of entry into the EU. The progress depends, in turn, on macroeconomic stability and structural reforms. Accordingly, macroeconomic policy sustainability serves as a guide for the timing of a convergence program to macroeconomic stability including a catalog of structural measures capable of improving corporate governance, fighting corruption and promoting national cohesion. The structural dimension is specified in the form of principles of good government at the public and corporate levels which reflect the standards found in all mature democracies and currently promoted by international organizations such as the EBRD, the World Bank or the OECD.

Some of the CEAS are in the middle of the current EU group in terms of the budgetary institutions, suggesting that they are better fit for fiscal consolidation and, hence, for EU membership than Greece, Portugal or Spain might have been in the 1970s. While there is still much room for improvement, some of the CEAS are close to policy sustainability and to EU procedures and performances, on both macroeconomic, structural and institutional grounds. The fact that CEFTA gathers six of the ten states and that others may join before EU membership also helps set them apart from other transition economies and indeed from previous applicants who had not been members of EFTA - such as Greece or Spain.

1. Introduction

The "second world" vanished at the turn of the decade, provoking numerous changes in state boundaries and drastic political, economic and social transformations spanning two continents. There were equally drastic changes in the disciplinary boundaries between "comparative systems", "development studies" and "growth theory" and a new field appeared, called "transition economics". Endogenous growth theories, the balance between history and expectations and the recognition of the role of institutions in maintaining policy credibility were brought to bear in the renewed attempts to understand why growth rates differ among nations and regions. In particular, the question of convergence between a club of about ten "mature democracies" and all other so-called "emerging markets"¹ has widened to include transition economies.

Nearly ten years after the rebirth of multiparty democracy in Poland and Hungary, the failure of soviet-style economic institutions has been felt by the population together with a frustration about the merits of free initiative, especially because it is seen as delivering excessive inequality. This realization is accompanied by awareness that redistributive taxation is less effective than previously thought. Citizens have become more sensitive to threats of increasing taxes to pay for the allegedly universal benefits of social protection. In spite of several instances of popular resistance to social security reform, fiscal policies have been subject to closer scrutiny over the last few years. In spite of the current financial turmoil, the stable economic and financial environment is expected to prevail in the US and across the European Union (EU).

The sustainability of policies without tax increases is now required for their credibility in electoral as well as in financial terms. The reward to sustainable and credible policies at the national level is the ability to carry out enduring reforms. Put in another way, the signal that markets look for when unsustainable policies are spotted is the willingness and ability to start reforming, so as to avoid more taxes - today and tomorrow. Conversely, a comprehensive and effective multi-annual fiscal adjustment strategy (MAFAS) is a condition for global convergence of living standards. In a way, such MAFAS replicates the convergence programs that all EU member states, beginning with Italy and Portugal in late 1991, adopted in the run-up to Economic and Monetary Union (EMU).

Openness to international markets for goods, services and assets has also become a criterion for convergence. As emerging markets sought to attract foreign investment in an increasingly globalised competitive environment, the protection of property rights, which requires an effective judicial system and the respect of civil rights, also became a criterion for real convergence. Convergence is now seen as a policy, a matter of choice for national governments.

Given that public choice differs from individual preferences, not all societies will manage to agree on the institutions which will allow them to develop and grow. In the limit, the question for domestic wealth owners becomes one of comparing the risk and return characteristics of various investment strategies for their firms. Their residence may give them a home bias relative to other international investors - but if the investment climate deteriorates too much, either because of macroeconomic instability or because of widespread corruption or both, they and their capital will move out. Where lifetime poverty is pervasive and there are no commercial traditions, let alone democratic institutions, the

¹ The club does not even include all founding members of OECD. For example, Greece is still in the [Morgan Stanley Emerging Market Index](#) and Portugal graduated from it in 1998.

pressures of global business may be even more difficult to reconcile with the aspirations of civil society. Yet reforms promoting property rights and open markets would put the economy onto a converging path, keep domestic capital at home and attract foreign investment.

In a European economy formerly tied to the "second world", this would be a *converging European transition*. In this regard, the transition economics followed here differs most from comparative systems for it suggests that there is little hope for a national economy to grow if its policies do not somehow respect property rights and keep markets open. Instead, the assumption is that the same basic rules apply across the board but they must be adapted to the particular historical and geographical circumstances, including the nation's capacity to transform².

This global policy convergence has already begun in the EU where multilateral surveillance procedures and convergence programs have been implemented to facilitate progress towards a medium term orientation of macroeconomic policy. Given price stability and sound finances, EMU should in turn allow a better functioning of labor and capital markets³. In this regard, appropriate budgetary procedures continue to be an important responsibility of member states or of their local authorities. For the MAFAS to serve as an effective commitment technology, it must be based on appropriate budgetary procedures.

Will global policy convergence impact on the so called transition countries in Eastern Europe and the former Soviet Union? The category, which basically coincides with the countries of operations of the European Bank for Reconstruction and Development (EBRD), comprises the Commonwealth of Independent States (CIS), former Yugoslav republics, Albania, Mongolia and 10 central European applicant states (henceforth CEAS), with which the EU Commission negotiated accession partnerships earlier this year⁴. The few underdeveloped countries in Africa, Latin America and Asia - including China - where ownership of capital by domestic residents remains outlawed do not belong to the category. When policies are not promoting growth and convergence, structural reforms are necessary. In this regard, the difference between transition and development becomes again relevant. Given that transition economies have experienced a substantial fall in their perceived standard of living, the ability to recover through accelerated growth is even more decisive than in an emerging market without any such memory. The nature of social protection may be difficult to change without threatening social cohesion⁵. This will be especially poignant in countries where European values have been traditionally held, as is the case of the CEAS. In effect, the tradition may have been forgotten by decades of inadequate policies to the point that a change in economic regime may be required for transition to be sustainable.

While no EU member state experienced comparable restrictions on their civil and property rights, there were periods of non-democratic government in Greece, Portugal and Spain which were only partly compensated by open trade and outward migration. Civil liberties were restored in the mid 1970s but, at least in the case of Portugal, property rights were not

² This was Kindleberger's classic indicator for the ability of a national economy to capture the gains from international trade. The "comparative systems" literature was often agnostic with respect to property rights. Early awareness of the importance of the incentive structure appeared in Koopmans and Montias (1971).

³ This assumes that the so-called euro holdup problem is overcome. See my 1997, with an application to Portugal and note 15 below.

⁴ The documents are available in the DG1a home page.

⁵ This is developed in Kolodko (1998). See also my introduction to UN 1997.

duly protected until privatizations were allowed in the late 1980s. On the other hand, in democracies like Finland, property rights were strongly limited by state regulation during the cold war period. In the case of Italy, while civil and property rights were adequately protected, many public-private partnerships were tainted with corruption exacerbating the bias towards excessive public spending and taxation. All of these countries changed their economic regime through a series of structural reforms where the pressure of qualifying for EMU played a crucial role. They represent models for the converging European transitions analyzed in this paper.

The fulfillment of the EMU convergence criteria is not part of the EU enlargement negotiations. Nevertheless, the needed change in the economic regime of the CEAS is already monitored by world financial markets. The reason for this scrutiny is that the regime change requires that the MAFAS be credible because stability will have to be sustained after EU membership⁶. Sustainability also depends on avoiding excessive costs in terms of social cohesion.

The rest of the paper is in four sections and a conclusion. Section 2 discusses EU enlargement as part of the global environment, including the evidence for policy convergence worldwide. The main effect on growth and investment is seen to depend on the progress of transition rather than on geographical proximity to the EU. This is followed in section 3 by a macroeconomic framework for policy sustainability which serves as a guide for the credibility of the MAFAS. The timing of a convergence program to macroeconomic stability is deduced from a policy matrix. Section 4 specifies the structural dimension in the form of principles of good government at the public and corporate levels which reflect the standards found in mature democracies. The guidelines on *Sound business standards and corporate practices* promoted by the EBRD are emphasized. Section 5 adds the dimension of crisis management which has been brought to the fore since the Asian crisis of the Summer of 1997 and more intensely for transition economies since the Russian collapse of late August 1998. Section 6 concludes.

2. The environment for an enlarging European Union

In our interdependent world economy nation-states are confronted with global challenges⁷. They reflect the constraints coming from property rights and international exchange. But they also face constraints coming from expectations. Policies which cannot be sustained without future tax increases elicit negative reactions from voters and financial markets. The sustainability of policies without future tax increases is in turn required for their credibility. The protection of property rights of residents as well as of non-residents and the promotion of international trade in goods, services and assets is a significant signal that no surprise taxation is intended. Such signals may be required, even though the movement of people remains the exception rather than the rule, both nationally and internationally. The reason is that more and more people are exposed to realities beyond their immediate horizon in space as well as in time. The importance of market perceptions of national policies, alongside voter sentiment, is reinforced by personal mobility.

⁶ There is an obvious parallel for EU states. The "excessive deficit procedure" included in the EU Treaty served as an entry criterion for the euro whereas the commitment technology included in the Stability Pact agreed upon in late 1996 will ensure that the fiscal criteria are not violated.

⁷ This section draws on my1997a

Increased sensitivity to global trends means that interdependence has become a structural feature of the international system. It can no longer be ignored in the design of institutions which used to be purely domestic concerns, such as taxes, social security and other budgetary procedures, let alone their monetary counterparts. Moreover, it can make reform more costly or less enduring, to the extent that mechanisms of peer pressure and multilateral surveillance are weaker than free ride and regulatory capture.

This is why forms of regional association have emerged among developed as well as developing nations. It is fair to mention the EU as the most ambitious such association, but the North American Free Trade Association (NAFTA, including Canada, Mexico and US) and Mercosul (Argentina, Brazil, Paraguay and Uruguay) have also shown ambition. And there are cases in point in other continents, like the Southern African Development Community and the Asia-Pacific Economic Conference.

The global environment has become more turbulent for emerging markets as successive financial crises have undermined confidence in Asian economies, including Japan and Russia. In the current environment, the impact of EMU and EU enlargement on competition, trade and the overall investment climate may seem less salient than the changing prospects for the world economy. In any event, EMU and EU enlargement will strengthen the case for policy convergence and therefore increase the costs of divergence and of reversals in the transition in both the CEAS and the CIS.

2.1. Global policy convergence

Interdependence brings a tendency for convergence in economic, political and even in social behavior, as a means to preserve the society's values in a competitive global environment. In contrast to the global reach of the market, and the technological forces which make protection inefficient and inequitable, preferences between private and public goods used to be seen as local. This was supposed to rationalize severe spatial differences in the burden of taxation in the so called "first" and "second" worlds. The developing nations of the "third world" were supposed to chose the market or plan model based on preferences. No longer. In spite of the wide variety of institutional arrangements, there is widespread consensus that economic and social development is associated with policies of open economy and polity, whereas underdevelopment or stagnation stems from policies of economic autarky and political repression.

The demise of the former Soviet Union put an end to the ideological debate between market and plan. The balancing act between market and government failures under imperfect information is to be performed on a case by case basis. It cannot neglect history but it is also more and more determined by expectations. Expectations, in turn, include the tendency towards convergence so that they impose tighter and tighter constraints on inadequate policies.

Even though future generations are not represented in majority voting, greater awareness of the need to implement sustainable policies brings pressure on elected governments to clarify the intergenerational effects of current policies. This applies to the physical and cultural environment as well as to the provision of public goods and transfers through taxation. The awareness that excessive taxation, overt or hidden in the form of inflation, discourages saving and stifles growth is also rising. As growth prospects fall due to the absence of incentives to save and invest, so does employment, making future consumption lower and social deprivation higher. In due course these policies are bound to be corrected. Yet, without adequate institutions, there may be reversions into inadequate policies⁸.

⁸ The idea of reversible transition is developed in BET. See also note 22 below.

One of the crucial debates in economic and social development is on how to ensure that the poorer countries grow more rapidly than the richer countries, so that there may be convergence in living standards and an increasing cohesion in the world economy. If “the rich get richer and the poor get poorer”, the gap between rich and poor nations will tend to widen over time. Cohesion - be it global, regional or even national - will be threatened. Reforms will stall. In this debate, convergent countries form a club. Perhaps only countries with an adequate initial level of human capital endowments can take advantage of modern technology to enjoy the possibility of convergent growth. But Jeffrey Sachs and Andrew Warner (1995) suggest that looking at the initial level of human capital as the basis for long term growth potential is unduly pessimistic. Rather one should look at “reasonably efficient economic institutions” as the major requirement for economic growth and convergence.

Poor economic management stems from the absence of secure property rights, or from autarkic trade policies and inconvertible currencies. The failure to grow may be rooted in policies rather than in technology or human capital. Then the convergence club is better defined according to policy choices rather than initial levels of human capital. Moreover poor policy choices are not irrevocably linked to low levels of income. Sachs and Warner (1995) invoke a much quoted passage of Adam Smith in favor of this philosophy of a policy convergence club: “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and tolerable administration of justice.”

Using a sample of 117 countries covering approximately 90% of the world population as of 1985 for which data on policy convergence are available, they establish that countries with “appropriate policies” display a strong tendency towards economic convergence, with the countries with the initially low per capita income growing more rapidly than the richer countries. Countries whose policies related to property rights and to integration of the economy in international trade are deemed not appropriate do not display any tendency towards convergence.

With the single exception of Haiti, every single developing country (<\$4,000 per capita income in 1970) with open trading system grew by at least 2% p.a. from 1970 to 1989! No case was found, therefore, to support the frequent worry that a country might “do the right things” in terms of overall policy (both politics and openness), and yet fail to grow.

Having established sufficiency, Sachs and Warner (1995) investigate necessity. Are there many countries that “broke the rules” and yet achieved high economic growth? Of the seven cases they found (Botswana, Cape Verde, China, Hungary, Lesotho, Thailand and China, or 9% of the non-qualifying countries), only China was seen as a “deep puzzle”⁹.

The results are summarized in the following matrix. Expressing the number of cases as fractions of the total we see that sufficiency is clearly established (3/4 vs. zero) but that necessity is less cogent, at least if the six exceptions besides China are considered. The results can also be interpreted in terms of conditional probabilities, using a Rawlsian “veil of ignorance”. If a poor country found itself back in 1970 knowing the numbers in the matrix

⁹ It is worth quoting their explanation: “It is indeed true that China has violated most of the rules: obscure property rights, political repression, high black market premia on the yuan, extensive reliance on trade quotas. Nonetheless, China has experienced a boom. We believe that China’s success is strongly related to its particular economic structure at the onset of its market reform at the end of the 1970s. In particular, China was a very poor economy in 1978, with three-fourth of the labor force in peasant farming. The essence of Deng Xiaoping’s reforms at the end of the 1970s was to free the peasant economy from state controls, even while maintaining the state’s grip on the non-peasant state-owned sector (which covered just 18% of the labor force).” Sachs and Warner (1995) go on to argue that this “two-track approach” was sufficient to unleash China’s growth and labor-intensive export boom but that it “could still be stopped by macroeconomic instability characteristic of many economies part way between planning and a market economy”.

but not the specifics of the country would policy makers gamble on a China type path? Conditional on closed policies, the probability of growing at 3% would be less than 10%, whereas conditional on good policies it would be greater than 80%.

		APPROPRIATE	POLICIES NOT APPROPRIATE	TOT
GROWTH	FAST	10	7	17
	SLOW (<3%)	2	69	71
	TOT	12	76	88

SOURCE: Sachs and Warner (1995)

The rejection of the reverse causation ("slow growth leads to bad policies") is trickier even for countries where the policy regime was chosen early in the postwar era before a track record on growth had occurred because outward oriented policies in the OECD also involved security relations led by the US. Similarly, reacting against these policies was an imposition of Soviet policy in Europe and elsewhere¹⁰.

The comparison of transition economies with developing economies in Latin America, East Asia and elsewhere has suggested that coping with a volatile international environment is the main difference between emerging markets and mature democracies. In addition, over the last few decades, especially since the oil crisis of 1973, mature democracies have clustered in three regions, the North America, Europe and Japan¹¹. The response to crises is often more drastic at the periphery than at the center because of policy is supposed to have higher credibility in mature democracies with a higher credit rating and more transparent public and private partnerships. Lower ratings go together with less transparency, signaling to international investors the weaker financial reputation and the higher perceived risk.

A particularly troublesome implication of the Asian crisis, to which we return in Section 5 below, is that the difference between the reputation of center and periphery has shrunk due to the continuing difficulties of Japan. The increased uncertainty about emerging markets typical of the current global environment also reflects the absence of an active transatlantic economic dialogue, to the extent that this weakens further the chances of coordinated policy responses¹².

The requirement of a sustainable transition is therefore an environment where economic growth and investment do not threaten social cohesion. This explains why the objective of "ever closer union among the peoples of Europe" calls for converging European transitions,

¹⁰ The rejection of excessive taxation being based on a perceived threat to property rights or mobility assumes that the welfare state is an insurance contract entered voluntarily by risk averse individuals under the same Rawlsian "veil of ignorance" Ex-ante, the welfare state is actuarial, since no difference in individual risk has yet emerged. But pooling is impossible ex-post, when the risk has become a certainty. References in my introduction to UN 1997

¹¹ For example the G7 summits have been organized along these lines and civil society associations like the Trilateral Commission too

¹² This was noted e.g. by the Trans-Atlantic Economic Dialogue, a new international forum coordinated by the Brookings Institution and CEPR which held its first meeting in Leesburg, Va on June 25-27, 1998

during which national ideas of Europe converge with each other as standards of living also converge.

This convergence does not rule out a specific timing and sequencing of reforms depending on the initial conditions and the capacity to transform. Indeed it may prevent a single path which might attain the terminal condition faster but could not be sustained thereafter. This is perhaps the most relevant lesson of the apparent demise of the Asian values, where economic efficiency was deemed independent of social cohesion and majority voting. While an appeal to European values may not be called for, converging transitions would seem to follow from the global environment and good government.

In other words, given a global environment favorable to growth, converging transitions impinge on policies in each and every one of the CEAS but also in each and every one of the member states. The current EU enlargement reflects this by supplementing the usual state by state accession procedures with group surveillance procedures issue by issue, which have been called *structured dialogue*.

2.2. Union deepening and widening

The 1992 EU Treaty listed criteria for EMU that constrained fiscal policies to fulfill certain criteria. With the agreement on the Stability Pact and the creation of the European Central Bank in July 1998, the conditions for a stability-oriented single monetary policy among the 11 states belonging to the Eurozone are likely to be met on time. Even when some EU currencies like sterling are still floating against the euro, budgetary policies and procedures in all 15 EU member states will continue to be subject to tight multilateral surveillance. This will reduce the room for maneuver of national governments to for reforms designed to reduce the resort to the government budget in financing the welfare state.

The sequence of reforms involved is likely to be resisted by national electorates, making it harder for rival political parties to sustain the effort over the medium term. Nevertheless, these reforms are needed for European firms to remain competitive in global markets, especially in light of the depreciation of the yen and of several other Asian currencies. International financial markets and the rating agencies have shown to be sensitive not just to macroeconomic stability but also to the business climate and even the track record of reform.

This is where the observance of good government at national and union level becomes relevant. To see how it can be promoted, it is useful to derive from the basic values of European integration, the implication that, for the foreseeable future, the domain of most reforms will remain the democratically elected national governments.

The ability to balance efficiency and transparency in the decision process has determined European construction as a sequence of moves towards deepening and widening. Whatever the timing of such moves, efficiency gains have always been reinforced by the observance of three values, which may be called European even though their scope has been considerably wider, and notably includes the Americas. The three values are: proximity to the citizen (abbreviated as P), national legitimacy (abbreviated as L) and democratic accountability (abbreviated as A). The first value contains itself a double perspective. On the one hand, a higher entity must not take on functions that could be satisfactorily performed by a lower entity. On the other hand, when the lower entity is not capable by itself of performing the functions that satisfy its needs, it is helped by the higher entity. Thus, proximity and solidarity strengthen each other. For example, in the budget sphere, centralisation may be needed lest the spending bias of lower entities overwhelms the commitment technology available.

Having accomplished the first value, we should seek to reinforce majority rule at the national level. It is the starting point to ensure legitimacy at Community level. In union institutions all member states appoint representatives. National legitimacy is only guaranteed with the maintenance of the principle of equality of member states, which requires unanimity for Treaty revisions. From this fundamental principle of European construction, untouched since 1957, results the principle of non-exclusion: no member state can be excluded from participating in the process of union deepening. This principle gives the nation-state a presumed advantage in satisfying proximity to the citizen.

On another plane, it may be said that the *structured dialogue* which goes alongside enlargement widens the principle of non exclusion to the point of giving the same expectation to each one of the CEAS.

Next to legitimacy, comes the value of democratic accountability. Accountable decision-makers are increasingly required at the union level, but are equally essential at the national level. Bureaucratic unaccountability and mixed institutional competences confuse public opinion. They may reflect deep-seated corporate governance problems, corruption or both, as discussed in Section 4 below. They display a negative image of Europe which its sceptics rapidly take advantage of. Everyone must know who has taken each decision and how they did it.

The simultaneous enlargement and deepening of the Union implies a permanent negotiation among nation states. As a result, a balance among proximity, legitimacy and accountability (P, L, A) helps implementing the principle of non-exclusion of a country that fulfills standards previously agreed by all members and that reveals the political will to belong in the core. While enlargement has always been unanimous, the *structured dialogue* with the CEAS suggests that the principle of non-exclusion may also be widening.

During the revision of the EU Treaty which is currently being ratified, there was a debate over the feasibility and desirability of flexible European integration¹³. These have been observed in the EU Treaty, about both the single currency and the social charter. They can also be found in the eight-member Schengen agreement dealing with the free movement of people and set to interact with the cooperation in matters of justice and internal affairs. In other words, it may be similarly useful to distinguish several groups of countries within an enlarging EU. The Nordic countries provide one illustration as do the members of the CEAS with which the *structured dialogue* procedures have been in place for about four years. These procedures are supposed to prepare accession negotiations - always a bilateral process between the applicant and the union - in a multilateral framework. They show that flexibility can have a positive effect on the need to combine union deepening and widening. This is reinforced by the Central European Free Trade Association (CEFTA), which, in one form or another, has been in existence since 1992.

The method of European construction fostering international interdependence by cooperation among all levels of government, instead of defensive measures involving some form of protection against foreign competition, is based on peer pressure but the threat of sanctions is also contained in the 1996 Stability Pact.

2.3. Regional Integration

¹³ This type of integration was discussed by the Portuguese parliament as I describe in my 1995. See also CEPR 1996. This multilateral surveillance can be interpreted along Rawlsian "veil of ignorance" lines to the extent that it is based on the principle of non-exclusion as I show in my introduction to UN 1997. See note 10 above.

The increasing integration of several countries into key international institutions has been one of the most important signs of progress in political and economic transition¹⁴. The Czech Republic, Hungary and Poland (with Slovakia, all founding members of CEFTA) have already joined OECD and received additional confirmation of their progress through the invitation to join NATO in 1999.

The EU decision at the Luxemburg summit of December 1997 to accord priority in membership negotiations to the same three plus Slovenia (who joined CEFTA in 1996) and Estonia confirmed that these countries are multi-party democracies and market-oriented economies. Among the remaining, so-called pre-in countries, Romania joined in 1997. Latvia and Lithuania share with Estonia membership a number of Baltic organizations, which does not preclude CEFTA membership either.

An enlarged EU will represent an event of outstanding significance for Europe as a whole and a landmark in the process of transition. The scale and scope of the challenges in meeting the conditions for accession to the EU, particularly in the areas of environment, health and safety standards for products and processes as well as the financial sector, are becoming more clearly defined. The requirements of membership embody a large number of very detailed and demanding obligations. Some of these require the strengthening and adjustment of public institutions, for instance regarding the regulation of product standards or of competition. Others will have strong implications, particularly for infrastructure, enterprises and financial institutions. In infrastructure, there will be emphasis on integrating transport and communication systems to ensure the smooth functioning of the single market.

For enterprises, EU rules for health and safety of processes in the workplace and environmental standards will be of particular significance, with major implications for restructuring and investment.

Accession will imply that enterprises must conform with the stringent standards of the EU on the safety of products. Investment requirements for municipal services (such as the treatment of waste and water), for power generation and for heavy industries (emission standards) would appear to be especially large.

Financial institutions will be expected to perform to higher standards of financial strength and transparency than at present. They will have to demonstrate that they are well-regulated by government while at the same time showing independence in their allocation of credits.

Financial systems are also expected to play a greater role in funding small and medium-sized enterprises than they do at present as they are an important factor in stimulating innovation, competition and growth.

The openness of the single market is amplified by the move to EMU. The euro will play a major role in fostering trade relations across the continent and world-wide, as a means of international payment and as a foreign exchange reserve. The recent decision of Greece to join the Exchange Rate Mechanism (ERM) was seen as a step towards joining the EMU in future. Advanced transition countries share this awareness that the ERM code of conduct will help associated countries earn policy credibility just like it did to Ireland, Spain, Portugal, Italy and Finland in the past.

EMU may also enhance the attractiveness of the CEAS relative to Russia, Ukraine and smaller open economies in the CIS like Belarus and Moldova that have common borders (Latvia, Lithuania, Poland and Romania), because these will in time border the EU itself. Countries in the Caucasus (Armenia, Azerbaijan, Georgia) are instead betting on their being points of passage between Europe, Turkey, the Middle East and Central Asia.

¹⁴ This is discussed in the 1997 **Transition Report** of the EBRD

Georgia, it is said, wants to model its development policy after Chile's. Now Chile, a strong reformer for the last two decades, has been orienting its trade and investment to the Pacific basin and was hoping to become a member of NAFTA. In the wake of the Asian crisis its prospects have deteriorated and it is now willing to be part of Mercosul, where the Atlantic dimension has so far dominated. Similarly, one of the distinguishing features of within CEAS is the membership in CEFTA, which roughly coincides with the "fast track" accession (the two exceptions are Estonia, fast track but not in CEFTA, and Slovakia, CEFTA but not fast track).

Difficulties in policy coordination across the Atlantic and the lack of Japanese regional leadership during the Asian crisis were already noted. Of course coordination difficulties have been prominent within the EU, and may have prevented the CEAS to go further in their own coordination efforts. CEFTA, which now includes six CEAS, and might widen further to include Bulgaria and the three Baltic states, remains one of the distinguishing features in the transition countries. In effect, integration among CIS states has stalled. No committee to resolve conflicts within or between members states exists. Some states object to efforts to vest the CIS with the authority to take binding administrative measures and emphasise instead the purely consultative role of the institution. Progress on the creation of a customs union between Belarus, Kazakhstan, Kyrgyzstan and Russia, as well as a separate federation between Belarus and Russia has also been slow.

2.4. The effect on investment

Hans Peter Lankes and Anthony Venables (1996) stress that the effect on growth and investment applies across the board because its focus is on their attractiveness to foreign direct investment projects rather than on their association to the EU - or lack thereof. In spite of the heterogeneity of the projects in terms of size, function, technology, location and control mode, some patterns emerge. The main ones pertain to function and control mode.

The function may be predominantly market access motive (being close to consumers) or predominantly cost motive (being at a low cost production). Projects in distribution or local supply are more concerned with access than export oriented projects, which in turn tend to be more closely integrated in the activities of the firm, and somewhat more upstream.

The control mode is also relevant as licensing or joint venture projects differ from establishing a fully owned subsidiary. The choice depends on the need to gain access to local contacts and information about markets as compared to the need to safeguard technology and product quality. Wholly owned projects tend to be both more export oriented and have more of their output transferred within the firm.

Countries with perceived political stability and low perceived risk levels are not only more likely to receive larger flows of foreign direct investment but also less likely to have projects postponed or abandoned. The greater security of supply makes these countries more likely to have projects that are relatively export oriented and that are integrated in the sales orientation of the firm.

This also makes such projects more likely to bring with them the benefits of technology transfer, quality control and the development of marketing channels. They certainly seem to be more in line with the comparative advantage of the host economy. The implication of the analysis by Lankes and Venables (1996) is that the progress in the transition will be as if not more important than the proximity to EU markets in determining the flow of foreign direct investment and the type of this investment.

Given the Russian crisis of the Summer of 1998 and the fact that reforms have stalled in some of the CIS countries makes EU enlargement the only expected development in Eurasia which embodies open market and free trade policies aside from the ongoing process of CIS

countries joining the WTO. Of course, open policies in relation to these countries are not only vital for the advancement of their transition but also for the development of the EU economy itself, its growth potential and the welfare of its consumers¹⁵.

3. Sustainability of macroeconomic policies

Global financial markets call for accelerated macroeconomic stabilisation. Nevertheless, the legacy of the old regime must also be taken into account: when there is no private sector, monetary policy is simply the provision of finance for public investment. Essentially fiscal and monetary policies are the same thing.

As the transition unfolds, privatisation creates a private sector and the distinction acquires macroeconomic significance. Fiscal policy gradually emerges as the concepts of public expenditure, tax revenues, government budget, and public debt become operational. With the creation of a central bank, and the withdrawal of the central bank from automatic financing of the budget deficit, monetary policy emerges as the provision of credit to the private sector. During the transition, the countries are expected to introduce market-oriented policy-making institutions in which the distinction between fiscal and monetary policy is clear, and the use of these policies in maintaining internal and external balance can be analyzed in the usual fashion.

These national economies do face an external constraint along the entire transition path. Their foreign debt cannot become so large that international financial markets perceive that they cannot service it. Their export earnings must be sufficient to finance imports and debt service as the economy becomes increasingly marketized. Therefore, signs of internal imbalance, either excessive budget deficits or unacceptably high inflation, may be taken as indicators that a currently satisfactory external situation could become unsatisfactory in the future, as the internal imbalance spills over to the external sector.

3.2. A macroeconomic framework

The problem of how to evaluate macroeconomic policies and, possibly, recommend policy changes, without a quantitative macroeconomic model has come up in the course of the evaluation of World Bank structural adjustment programs. A framework that combines a model of policy assignment and debt sustainability criteria can deal with the problem¹⁶. A version of this framework seems useful for analyzing the macro policies of CEAS with reference to something like a convergence program to macroeconomic stability and a catalog of structural measures designed to remove the macroeconomic and microeconomic obstacles to growth.

Development of a quantitative model is precluded both because the structure of the CEAS is changing rapidly, and because of the lack of sufficient data. Instead, the model of external and internal balance with high capital mobility and a fixed real exchange rate that assigns fiscal policy to internal balance and monetary policy to external balance can be used. The instruments for stabilization are the MAFAS and a well-defined exchange rate regime.

In their approach to external balance, the CEAS should adopt a Pre-Pegging Exchange Rate Regime (PPERR) that entails essentially no active nominal devaluation aimed at real

¹⁵ As mentioned in note 3 above, the so-called euro holdup problem suggests that the reforms needed for the success of the EMU may not materialize.

¹⁶ The text follows Branson, de Macedo and von Hagen (1998)

devaluation as the country converges toward EU membership¹⁷. In their approach to internal balance, the CEAS should adopt a MAFAS. Both of these policy paths are meant to bring the economies to the point of accession to the EU along as smooth a convergence path as possible. In general, PPERR and MAFAS would be forms of credible policy that stabilize the economy as it enters the world market. The PPERR avoids the "inconsistent trio" of fixed exchange rate, free capital movements, and independent monetary policy by freeing monetary policy to be targeted on external balance, represented by a suitable reserve position. The MAFAS then sets fiscal policy to maintain internal balance, as represented by a low rate of inflation. The arithmetic of debt sustainability can be used to determine the appropriate primary deficit that is consistent with a non-growing ratio of debt to output. Thus the fiscal adjustment can be consistent with low inflation and a non-growing debt ratio.

The commitment of the CEAS to eventual EU membership gives them clear terminal conditions, including either a fixed nominal exchange rate or joining a single currency. Thus while an early devaluation in order to establish external balance may be necessary, at some point along the path they will adopt the PPERR, limiting the movement of the exchange rate by following the "ERM code of conduct". The introduction of PPERR also requires a successful move to full currency convertibility, a part of the code of conduct which took ten years to achieve and was followed by the crises of 1992-93¹⁸.

The extent to which movements of target variables and instruments correspond as expected since the beginning of the transition could be taken as a test of how far along they are in the transition. Which countries are close to the point at which they can adopt MAFAS and PPERR, and which may require front-loaded structural adjustment, in the form of deficit reduction procedures or real devaluation, before adopting MAFAS and PPERR?

Ask first if the economy is in external balance, both in terms of the current stock of foreign debt, and in terms of the current flow in the current account deficit. Then ask if the fiscal position seems consistent with internal balance, taking a large fiscal deficit as an indicator that a current state of external balance may be threatened in the future.

For external balance, check whether net exports of goods and non-factor services, as the flow measure, corresponds to the real effective exchange rate as expected. In particular, does the trend in net exports suggest the need for a real devaluation prior to adopting a PPERR? In assessing the trend in net exports, also look at the dynamics of foreign debt. If the current ratio of foreign debt to exports is not increasing, then the country is likely to be able to sustain the debt path in the absence of structural change with negative consequences for the current account.

As a measure of internal balance, look to the inflation rate, with the budget deficit as the corresponding policy instrument. The aggregate budget deficit is a necessary, but not sufficient indicator for internal balance, for institutional, measurement and structural reasons.

3.3. A policy matrix

¹⁷ Drabek and Brada (1998) caution that a premature PPERR has implied unstable trade policies in some of the CEAS. Membership in CEFTA goes the other way but is may not have been enough of a stabilizer.

¹⁸ This is discussed in my 1997b. The conditions for capital account liberalization have been the subject of much debate since the onslaught of the Asian crisis. The recent decision of Chile to relax its controls on inflows has been especially controversial since these controls were seen as very effective. See Cordella (1998), De Gregorio (1998) and my 1998.

A policy matrix such as the one presented can be used in the assessment of the sustainability of the transition. Across the top we ask is external balance sustainable, and have the answers "Yes" and "No" defining the two columns. Down the side we ask is internal balance sustainable, with the answers (Y and N) defining the two rows.

We put external balance across the top to signify that we have a clearer view of that than of internal balance. The main importance of the internal balance indicators are to suggest that countries in the lower off-diagonal box are likely to slide to the right if internal balance is not achieved. It also seems likely that it is easier to move down in the matrix, with internal balance threatened by inefficient budgetary considerations and political pressures than it is to move up.

Countries in the upper diagonal box are already on or close to a convergence trajectory toward accession to the EU in terms of both external and internal balance, and are in a position to adopt MAFAS and PPERR. Countries in the lower diagonal box are out of balance on both dimensions, and are candidates for an EU loan or an IMF/World Bank structural adjustment program to get close enough to the trajectory to consider MAFAS and PPERR.

		Is External balance sustainable?	
		YES	NO
Is Internal balance sustain- able?	Y	<i>success</i>	←
	S	MAFAS +PPERR	↑ MAFAS? +REAL DEVALUATION
	N		↓ <i>failure</i>
	O	PPERR? +EXCESSIVE DEFICIT PROCEDURE	EU LOAN/ IMF WB ADJUSTMENT PROGRAM

SOURCE: Branson, de Macedo and von Hagen (1998)

Countries on the off-diagonal boxes in the policy matrix are in balance on one front but out of balance on the other, with some discrete adjustment needed to get close to the convergence trajectory. Countries in the upper off-diagonal box may require a discrete real devaluation to restore external balance before adopting PPERR¹⁹. They may want to adopt a form of MAFAS that creates the resource freedom to ensure that the devaluation has the intended effect. Countries in the lower diagonal box may require a front-loaded application of a kind of "excessive deficit procedure" (as called for by the EU Treaty and the Stability Pact for member states) as part of their MAFAS. Their PPERR may allow for some real appreciation as the excessive deficit procedure takes hold. Successful adjustment in either off-diagonal box moves the country to the upper diagonal box, close enough to the convergence trajectory to sustain MAFAS and PPERR.

Failed adjustment leads to the lower diagonal box and the need for an adjustment program with outside assistance and conditionality. Based on the latest available data on current

¹⁹ This is consistent with the findings of Drabek and Brada (1998). See note 17 above.

account and government balance, it would seem that Slovenia is the only one in the top diagonal box, whereas Estonia, Slovakia, Lithuania and Romania would fit in the lower diagonal box. The Czech and Latvian cases would seem to be in the upper off-diagonal box and Bulgaria, Poland and Hungary in the lower off-diagonal box. Looking at foreign debt and inflation performance as further evidence of sustainability would improve the Czech, Latvian and Polish cases, move Lithuania to left and Slovakia up. The accompanying matrix illustrates the pattern, where the question marks underscore whether it is the sustainability of internal or external balance (respectively IB and XB) that seems most vulnerable.

	SUSTAIN	EXTERNAL	BALANCE
SUSTAIN		YES	NO
INTERNAL	YES	SLOVENIA POLAND (IB?) CZECH REP (XB?) LATVIA (XB?)	SLOVAKIA (IB?)
BALANCE	NO	HUNGARY BULGARIA LITHUANIA (XB?)	ESTONIA ROMANIA

3. 4. Structural reforms

The emphasis on policy making institutions reflects the realisation that governance problems can distort the development of human capital, damage the structure of emerging organisations, and shape the evolution of linkages between government and business with potentially long-term and severe consequences for the path of the transition and the type of economy and society to which it will lead. These various considerations underlie indicators such as those that have been developed by the EBRD and have appeared in the **Transition Reports** since 1994²⁰. The assessment of the sustainability of the transition by means of the policy matrix must therefore be supplemented by the credibility of the program of structural reforms.

Fiscal consolidation will involve major structural changes in the budget. Aside from further improvements in the tax system, measures are likely to be taken on the expenditure side. An example is the very high level of publicly-provided pensions, with liberal provisions for retirement. In several of the CEAS, the flow of public pension payments is well above 10 percent of GDP. Using a discount rate of 10 percent to capitalize this stream, pension debt is 100 percent of GDP. Thus something structural is likely to be done about pensions, as well as many other fiscal issues. Fiscal consolidation may in turn require some form of social contract to be effective, and it will change the future fiscal position.

²⁰ Six indicators are calculated and divided into the categories of enterprise reform (three series: large scale privatization, small scale privatization and enterprise restructuring), market and trade reform (two series: price and trade and foreign exchange liberalization) and banking reform. In 1995, three new series were added, "competition policy" and "capital markets". The indicators assume a rating of 4* for most mature democracies. The variation over time and across countries is of course much greater in the CIS than in the CEAS.

In a situation in which the public-private distinction is still emerging, there are conceptual and practical problems in measuring the public deficit, and even worse, the public debt. There is a substantial overlap between monetary and fiscal policy, as much of credit creation finances public sector activity early in the transition. Thus in the early stages net domestic credit creation may be the best measure of fiscal policy, rather than the budget deficit. Unfortunately, data on credit creation are only available since the beginning of the transition, so it is difficult to make any comparisons across the beginning. As the private sector and central bank develop, the focus will shift to the budget deficit as the measure of fiscal policy. It would be good to have a measure of the weight of the private sector in the economy as a way of weighting the two measures.

The lack of clear distinction between private and public sectors and the lack of data make it impossible to assess public debt sustainability. The existence of substantial arrears among public enterprises, the financial system, and the government, with gross debt probably much greater than the net debt, make assignment of debt to sectors conceptually difficult, even if we had the data. The existence of unmeasured future claims on the government, such as the pension problem, mentioned earlier, add to the conceptual difficulty²¹.

The CEAS are developing countries with changing structures, so the MAFAS and PPERR must be flexible enough to accommodate structural change. They are also in a sense competing with each other not to fall behind on the path to accession, and choosing whether it is in their interest to further coordination among themselves or rather to avoid fall into the next round of applicants.

The fraction of output which comes, or should be expected, from the private sector is a rough indicator of transition but the real issue is one of establishing partnerships between the public and private sectors. These partnerships should build on the comparative advantages of the public and private sectors. They will take different forms in different areas where the government is likely to be involved in a fundamental way, including particularly health, education, pensions and infrastructure.

These areas underline the importance of developing and maintaining the right kind of partnership. In particular, public-private partnership should never be confused with collusion between special private sector interests and the government to the detriment of the public at large (so-called *crony capitalism*).

It is crucial for the government to lead by example in promoting – in both the public and private sectors – the behaviour that is consistent with a well-functioning market economy.

4. Governance and growth

Good governance involves establishing government institutions that allow markets to work well and to deliver and protect living standards and the rights of its people. In the last instance, it depends on the establishment and functioning of institutions that are neither governmental nor private enterprise, such as political parties, voluntary organisations, religious groupings, labour unions and the media, known as civil society. Under the old regime, such institutions were focused narrowly on the interests of those in power, and civil society was stunted.

Institutional arrangements for credible fiscal policy-making based on the strategic dominance of the Minister of Finance over spending ministries are conducive to stable

²¹ Perhaps the CEAS governments have a good opportunity for the introduction of a system of generational accounting as their budget processes emerge. See Auerbach and Kotlikoff (forthcoming).

public finances. They are another indicator that the newly established institutions of the market require the reform of the administration of government if they are to flourish. The independence of the central bank is a signal of the government's commitment to eschew the inflation tax to which international financial markets give a high visibility. Central bank independence is therefore equated with the government's commitment to fiscal consolidation and its desire to achieve a good financial reputation.

The growth and flourishing of civil society have been impaired when social problems are exacerbated by the change in economic regime. In many transition countries, falling incomes, dislocation of employment and reduced or badly directed social transfers have led to increased poverty. Along with rising poverty have come increases in health problems and social maladies, including dramatic increases in deaths from heart disease, higher suicide rates, and the spread of infectious diseases. The deterioration in the provision of public health services and higher stress may also be explain the drop in life expectancy which has been observed. These circumstances are of course familiar from developing countries. Observing them during the transition may generate expectations of reversion that prove self-fulfilling, especially if the emerging markets crisis continues to spread ²².

4.1. The Budget Process

A basic problem in all transition economies is to achieve effective control over the government budget²³. Since the transition is from a state of central planning and strong involvement of the government in the production sector, achieving control over the budget is connected with the problem of reducing and restructuring government expenditures and strengthening the government's system of tax revenues. This means that fiscal reform necessarily involves major distributional conflict. Economic analysis predicts that distributional conflicts jeopardize reform programs, as the fight between differing groups within society over the allocation of the reform's costs and benefits leads to postponement and to solutions of reciprocity, i.e., political outcomes that hold some good for everyone, but an inefficient outcome for society.

Institutional structures can help avoid such inefficiencies. Of course, institutions do not make the distributional conflicts disappear. However, by defining the rules of the game they structure the ways in which the opposing parties can present and defend their claims. Institutional rules divide decision-making processes into individual steps and determine which steps are taken when they assign roles and responsibilities to the various actors, and, by regulating the flow of information, they distribute strategic influence and create or destroy opportunities for collusion. A basic claim of political economy is that institutional rules have systematic effects on the outcome of the decision making processes they govern. The budget process is the set of institutional rules relevant in the context of budgetary policies and, therefore, in the context of fiscal reform. Formally, the budget is a list of revenues and expenses conveying what the government expects and is authorized to do during a certain time period. The budget process, in the broadest sense, is a system of rules, both formal and informal, governing the decision making process that leads to the formulation of a budget by the executive, its passage through the legislature, and its implementation. To assure the stability, consistency, and efficiency of the government's financial policy, the budget process should be the principal and effective locus of conflict resolution between competing claims on public resources. Informal decision-making and

²² The idea of reversible transition is developed in BET

²³ The approach is described in Branson, de Macedo and von Hagen (1998) which is followed in the text.

agreements outside the budget process, "non-decisions" (i.e., the lack of nodes of deliberate decisions in the process), and the use of off-budget funds are all sources of failure of the budget process.

The stark differences in fiscal performance among the EU governments can be explained to a large extent by differences in budgetary institutions²⁴. The decentralization of the budget process, i.e., the degree to which geographical, sectoral or other special interests dominate over the common interest of the government in budgetary decisions, as the main cause of weak fiscal discipline. Specifically, they show that countries with a low degree of centralization of the budget process have systematically higher ratios of public spending, and deficits and debts, to output than countries with large degrees of centralization. Countries with a centralized budget process are able to achieve a higher degree of macroeconomic stabilization and are less prone to credit-rationing. All this evidence suggests that appropriate design of the government budget process can be an important element of a fiscal strategy aiming and fiscal stabilization. Reform of the budget process would thus be critical in a macroeconomic reform strategy.

4.2. Taxation

A part of the budgetary process, taxation is an even more prominent example of government activity where good governance is crucial for the functioning of a market economy²⁵. Raising revenue is, of course, fundamental for macroeconomic stability and the provision of basic services and social protection. Under the old regime, the taxation system was not of over-riding importance since the government could command resources directly. In a market economy most of the resources used by government must be raised in some shape or form from the private economy. The challenge is to do this in a way that keeps distortions and disincentives to a minimum and takes account of the taxpayers' ability to pay. There is no area where the interactions of institutions, policies and behaviour are more important.

Taxation is one of the biggest problems facing foreign investors in a number of transition countries. If taxation is to operate in a way that allows private enterprises to function effectively, it should be even-handed, predictable and based on reasonable definitions of profit, output or income. In practice, this is not so and the result is widespread discretion by both ministers and revenue officers and a plethora of special deals and exemptions. This in turn results in a shredding or demolition of the tax base, still higher rates on those who do pay, large distortions of competition and the allocation of entrepreneurial energies (or covert payments) to securing special privileges.

Investment, be it foreign or domestic, does not need special deals, discretionary or otherwise, and governments should not see the promotion of investment as lying in tax privileges. The main factors stimulating investment in a market economy are the stability, transparency and predictability of markets and the prospects for growth. Investment and growth will be fostered, therefore, both by the transition itself and by macroeconomic stability.

²⁴ The importance of individual elements of the budget process, such as veto powers or committee structures, for fiscal performance has long been studied empirically in the context of American state governments. Only recently an emerging literature considers the impact of the budget process on the fiscal performance of national governments on an international scale. In contrast to the American literature, this new approach, pioneered by Jurgen von Hagen, is based on comprehensive characterizations of the budget process, summarized in numerical indices describing the quality of a process.

²⁵ This is discussed in the 1994 **Transition Report** of the EBRD

What is required from the tax system is predictability, simplicity and a broad base, taking into account sensible economic concepts such as enterprise profit or value added. Such a structure allows the reasonable rates which are required to strike a balance between revenue and disincentives. The establishment of an effective tax system is central to good governance.

4.3. Fighting corruption

It is now generally acknowledged, and with hindsight easy to understand, that the first stages of privatisation led to a rough and often violent struggle for the appropriation of assets being divested by the state. Even when this consisted of a democratic distribution of vouchers, there still remained thereafter the process of shaking down these shares holdings into structures of control. Corruption and bribery, already deeply entrenched in the planning culture, took a new lease of life with the transition to market economy.

Data assembled from opinion polls of businessmen are published for many countries as corruption perceptions indices. Even though the international comparability of the numbers must be very limited, they correlate well with the credit ratings. There is a kind of virtually corruption free group which only includes AAA rated countries and the equivalent of a "speculative" group which includes Russia but also Mexico or Turkey.

There are only four CEAS for which the corruption perception index produced by **Transparency International** is available. This has a scale of one to ten and can therefore be easily compared with the rating on the same scale presented by **Euromoney**²⁶. The comparative results are in the accompanying table.

It is not enough to understand and somehow measure and compare corruption across countries. Fighting it must be part of the reform strategy. In other words, the government itself must look for institutions, policies and actions that minimise the opportunities for arbitrary, self-interested or corrupt bureaucratic interference.

COUNTRY	CORRUPTION	RATING
CZECH R	5.2	6.3
HUNGARY	5.2	4.4
POLAND	5.1	4.6
ROMANIA	3.4	2.6

Source: [Transparency International](#) and Euromoney

There is much that sound institutional and policy design can achieve in promoting responsible behaviour and limiting corrupt practices. Government structures should, as far as possible, limit the number of licences and permissions required and the discretion of civil servants over the ordinary economic activity of entrepreneurs and consumers.

It is when permissions or discretionary decisions start to permeate throughout the economy and society that bureaucratic interference develops and the potential for corruption grows. This results in markets that do not function well and where entrepreneurship, investment and growth are inhibited. Where permissions or discretion are unavoidable, as they will be in a number of important areas of activity, openness and transparency will guard against the misuse of power.

²⁶ The ratings were taken from Dornbusch and Giavazzi 1998

Organised crime and protection rackets also pose serious problems for business transactions. With the heavy "tax burdens" of organised crime, investment is driven away - towards more law-abiding societies.

4. 5. Enterprise performance and sound business practices

Growth through innovation, driven by opportunity and competition, carries the strongest lessons for the transition countries. It is not simply technology that changes output, but the whole method of work in terms of market-driven methods of organisation and production. Restructuring investment will thus come from the process of competition, but real competition must be underpinned by hard budget constraints. A company facing competition without privileged access to special funding will be forced to change and adapt if it is to survive. The speed, effectiveness and social and economic costs of that adaptation will, of course, depend on how the processes of competition and finance function. These in turn will be closely influenced by the policies, institutions and behaviour which develop during the transition.

The balance across sectors has already shifted towards the structure of comparable middle-income countries, with a move from the over-sized manufacturing sector towards services which were neglected under the old regime.

At the level of the individual firm, competition and hard budget constraints have a powerful influence on performance, particularly where these are combined with effective corporate governance and limitation of bureaucratic interference. Where budget constraints have remained softer, enterprise adjustment has lagged.

Sound practices are in the long-term interests of an enterprise devoted to the profits of its shareholders. They may be expressed in terms of those practices that maintain and develop good and honest relationships with customers, suppliers, workers, those who supply finance, neighbours, local and central government, and anyone else who interacts with the enterprise.

Indeed, the only effective method of long-term profit maximisation is the implementation of these practices and that a stable and predictable business environment encourages and rewards this long-term perspective.

Recent years have shown great interest in codes of sound business practices, often specified in terms of checklists which should be followed. While the precise form of codes may be the subject of argument, the broad principle of maintaining and developing good and honest relationships with those interacting with enterprises is broadly accepted²⁷.

5. Crisis Management

There were three waves of financial crises in the 1990s, the last one of which is still on²⁸. The first wave broke in September 1992 over the ERM and was solved one year later, after the fluctuation bands were widened. The second wave followed from the attack on the Mexican peso in December 1994 and had ripple effects in 1995 in both South America and Central Europe. The third began in Spring 1997 with a minor attack on the Czech *koruna* resulted in its devaluation. However, the Thai baht floated in the Summer of 1997, reversing

²⁷ The guidelines on *Sound business standards and corporate practices* promoted by the EBRD are the most influential but work by Daniel Kaufman at the World Bank, and initiatives at the OECD, the UN and WTO may also be emphasized.

²⁸ This section adapts my 1998.

an implicit dollar peg which had been pervasive in the fast growing East Asian economies, and Malaysia, Indonesia and Phillipines also experienced attacks on their currencies. Perceptions of financial crisis began to form.

Currency and banking crises spread to other Asian economies in the Fall, threatening the role of Hong Kong as a financial center ruled by, but separate from, China. The Republic of Korea, like the Czech a recent member of the OECD, suffered a combined currency, banking and debt crisis. Japan, a mature democracy and a prominent member of the G-7, was seen as part of the problem. China, whose transition to market and to democracy has yet to begin, was seen as capable of keeping financial stability in the region.

The prevailing perception was of an emerging markets crisis which hurt the borrowing capacity of Asian, Latin American and Central European debtors. The continued weakness of the Japanese currency exacerbated the negative impact of the financial turmoil on Asian growth throughout the Spring of 1998. South Africa followed while Russia floated the rouble and defaulted on its debt in late August²⁹.

Among the large emerging markets, only Egypt seems to have escaped a speculative attack on its currency whereas Brazil has so far succeeded in keeping its dollar peg. The fear is that this emerging markets crisis will spread from the Pacific to the Atlantic and hurt growth prospects in the EU and the US.

As mentioned at the outset, almost all but a dozen mature democracies qualify as emerging market economies, so that the notion hides a lot of different national and regional circumstances³⁰. If the notion of emerging market encompasses too many varieties, that of financial crisis is often misused. The term applies best to a combination of currency, banking and sovereign debt crisis with strong negative effect on the national economy³¹.

With the definitions of emerging markets and financial crisis in mind, we turn to the appropriate level of policy response, which may still be national, regional or global, depending both on contagion mechanism and on the availability of instruments and institutions.

Contagion patterns are not well understood, but geography and hegemony seem to play a role³². Both are at work, for example, when it comes to the economic policy autonomy of Hong-Kong relative to China - neither a market nor a transition economy or to the role of Japan - not an emerging market and yet it is part of the Asian problem, rather than helping solve it³³.

The recent turmoil in Russia has a strong domestic component and threatens to reverse the transition process. The sequels of a debt moratorium and of currency inconvertibility, let alone a bank run, will remain economically and politically hazardous for some time to come, especially due to the lack of a North Atlantic economic dialogue. The informal apportionment of responses to financial crises emerging markets to the major mature

²⁹ Brinkman 1998 deals with the attack on the rand in Spring and Summer 1998 and compares it to the 1996 episode. Belanger 1998 shows the deteriorating situation in Russia. See also Dornbusch 1998c.

³⁰ Even among Thailand, Malaysia, Indonesia and Korea as documented in Ito 1998. While China does not qualify as emerging market, Dornbush 1998b asks whether it is next in line for a devaluation, an option we strongly rejects.

³¹ This is the definition proposed in Portes 1998

³² Glick and Rose (1998) have a trade explanation which might account for the geographic fundamentals discussed in the text. Another hypothesis might be hegemony, along the lines of the "superstar model" popularized by Paul Krugman in connection with income distribution within professions.

³³ Krugman 1997b emphasizes this point

democracy in the same continent suggests a pattern of contagion reminiscent of "the Monroe doctrine" and probably inadequate in today's global markets. Nevertheless, possible effects in Brazil, or in Latin America, would no doubt be seen as primarily calling for a US response. Instead, given Russia's status as former hegemon in Europe and parts of Asia, perceptions of crisis elicit stronger responses by the US and by the EU, hopefully in a coordinated fashion.

The so-called architecture debate features a reform of the system of international relations and its main institutions, which for the most part were established half a century ago. The reflection of regional cooperation arrangements such as the EU is one of the issues in the debate where the geographic/hegemonic pattern of contagion matters. The role of Japan acquires special salience because it was seen as the major player in South-East Asia, where the current crisis originated. Now reforms of the international system have been resisted by the G-7 and by its members in the EU but they may now have a better chance if they are not overly grandiose. One reason is that markets' resistance to change is lower in times of crisis.

5.1. Economists' controversies

The main source of debate among economists hinges on the role given to fundamentals vs. financial panic. Because both are probably at work, interpretations often depend on a balancing of each factor³⁴.

If structural problems and policy inconsistencies make it inevitable that a combination of currency, banking and debt crises will lead to a financial crisis with severe real consequences for the national economy, then the root causes must be addressed, at the risk of encouraging moral hazard behavior³⁵.

But because crises are cumulative processes, which have a self-fulfilling character, their costs end up being much greater than called for by the fundamentals. Then prevention efforts make sense almost always.

One way to solve the debate between the two camps is to look for areas of agreement in what are causes of a financial crisis. The **list of favourite causes** still leaves a great deal of room for interpretation but it helps focus on the disagreement³⁶.

That bad shocks and policy mistakes make things worse is uncontroversial but the practical question is rather how the severity and duration of the bad shock and the irreversibility of the policy mistake make a difference to the perception of crisis. The attack on the Czech *koruna*, for example, was short-lived because devaluation was coupled with a temporary import deposit and measures to deal with the fragility of some of the financial institutions³⁷.

Financial fragility is seen as decisive in the combination of currency, banking and debt crisis. In that context, the maturity of capital inflows matters more than their size, because financial fragility comes from failures in the maturity transformation of short-term assets into long-term liabilities banks are suppose to provide.

³⁴ Krugman 1997a describes the "canonical model" of currency crises and adds in closing "But everyone agrees that a sufficiently credible currency will never be attacked, and a sufficiently incredible one will always come under fire." See also Krugman 1997b

³⁵ The interview to the US Treasury Secretary in the *New York Times Magazine* of 19 July used the word often.

³⁶ The discussion by Perotti of Velasco 1998 included a list followed in the text

³⁷ Drabek and Brada 1998 claim that the Czech peg lasted too long and led to an unstable trade policy. They also point out that before the crisis most economists viewed the currency experience favourably. Another cost of this policy was that capital account liberalization was conducted to alleviate exchange rate pressure even when it aggravated problems of corporate governance. This pattern is reminiscent of the recent relaxation of the import deposits in Chile. See references in note 17 below.

Another uncontroversial point is that financial liberalization and banking deregulation require improved prudential supervision, the question being how to achieve this supervision in global markets. In particular, does this require a new institution? Instead, can the BIS and the IMF substitute for the role of an international lender of last resort? The architecture debate continues on this issue.

There is again consensus on the statement that large and free foreign exchange reserves, and/or a flexible exchange regime reduce the probability of a crisis. Yet it may not be possible to agree on what finite level of free foreign exchange reserves and exchange rate flexibility averts a crisis.

The state of the architecture debate is that an international lender of last resort helps if it does not exacerbate moral hazard. For fundamentalists this is a bigger "if" than for those who hold that crises are self-fulfilling. Finally, both sides agree that a crisis always has a combination of causes.

A financial crisis comes in many forms - because it combines a currency collapse, with or without resort to exchange controls, a bank run or the threat thereof and a debt default or moratorium. Its **anatomy** often includes the expected bailout of private debts by the state, or by international institutions. Such expectations are easier to form in the presence of cronyism and with weak corporate governance, as emphasized in the previous section.

The converse of the previous point, that financial liberalization and banking deregulation require improved prudential supervision, is that capital account liberalization without improved banking supervision is also found in most crises. Over-investment is the mechanism through which the combination results in banking and currency crises³⁸.

Even in countries with high savings ratios, over-investment generates large current account deficits and real appreciation. If these deficits are financed by short term foreign currency unhedged liabilities and by the ever greening of bad loans, it is tantamount to making private debt into an implicit public debt.

Once the issue of anatomy is clarified, the **geography** of a crisis depends on the pattern of contagion. Suppose a financial crisis is going to occur in country X; will it spread and if so how³⁹? In the emerging markets crisis, the spread is global, from Singapore to Chile to Egypt.

But lessons can be learned from cases when the scope is regional, as in the ERM crises of 1992-93. At that time, Portugal and Ireland suffered currency attacks based on what was happening to the Spanish and British currencies, in what was described as "geographic fundamentals". These attacks were short-lived but they nevertheless led Ireland to request a realignment in January 1993 and Portugal had to partly follow several realignments of the peseta. Given that the ERM code of conduct is based on multilateral rules for exchange rate changes, fundamentals should be less of a geographic than of a policy problem. Yet this peculiar form of neighbourhood contagion was pervasive at the time⁴⁰.

³⁸ What Krugman 1997b and 1998a calls "Panglossian values". See also Corsetti, Perotti and Roubini 1998.

³⁹ Tornell 1998.

⁴⁰ One possible reason is that the financial reputation of these countries was not fully established as their regime change was quite recent (1987 for Ireland, 1989 for Spain and 1992 for Portugal). A related reason is that testing the ERM parity made sense when the real appreciation was perceived as excessive by export oriented firms and the government may have been sensitive to their pressure. The bet proved correct for Spain, who initiated two realignments during the ERM turmoil. The Portuguese response was to follow in part, so as to reinforce its own credibility without suffering the direct consequences of a competitive depreciation. See my 1997b for details. While consistent with Glick and Rose (1998) as quoted in note 31, this also suggests a role for hegemony in explaining contagion.

National policy responses to a large capital outflow may be a combination of allowing reserves to drop, increasing interest rates, and depreciating the currency. The relative importance of each one depends in turn on the particular circumstances of each country. May be depreciation is ruled out by an exchange rate arrangement, as in Brazil or is very costly in terms of financial reputation as was the case in Mexico and Korea, who had just joined the OECD, and in Russia, who had just been accepted into the G-7.

There may be constraints on the rise in interest rates that is politically or socially viable, and the increase in interest rates is more costly the weaker the banking system. Allowing reserves to drop, on the other hand, is less likely the lower the ratio of reserves to liquid liabilities. And if reserves are low, and cannot drop further, one of the two other alternatives, no matter how unpalatable, must be contemplated.

The exchange rate option will be more likely to be chosen the greater the real appreciation observed. But devaluation is a beggar thy neighbor policy to the extent that it attempts to restore competitiveness at the expense of trading partners and may elicit retaliation. It therefore needs to be coordinated.

The same is true of exchange controls, which almost always function as a devaluation in disguise. Even when they seek to prevent excessive inflows, they are often not matched by free outflows, or even by a relaxation of existing controls. This was true in Portugal in the early 1990s but can also be found in the Chilean experience⁴¹. The issue is then how can devaluations and exchange controls be coordinated at the regional or global level, to lessen their beggar thy neighbour character?

Systems like the ERM and its code of conduct come to mind, but they are difficult to adapt in the current world system. It may be, then, that the current crisis serves as a **coordinating device** by allowing responses that would not obtain in calm periods.

Even if they serve as coordinating devices, crises should be avoided. When crises loom, there is a great deal of interest in advance warning systems. Nevertheless there has been little progress in developing practical crisis **indicators**.

Foreign exchange reserves, for example, are still compared to imports with reference to the so-called "3 month IMF rule", without taking into account the exchange rate regime⁴². A better candidates for normalization, especially for inconvertible currencies, would be external debt. Under a fixed rate and free capital mobility, reserves should instead be compared to the broad money stock (M2). While reserve adequacy depends on the exchange rate regime, none of these average measures are satisfactory under uncertainty. Reserves should ideally be related to the volatility of the current account or of short term capital flows.

A high ratio of bad loans to total loans is another indicator which has been used in looking for evidence of a lending boom. The increase in real lending to private sector and state owned enterprises is in turn how a lending boom is identified. The usual criterion for internal balance, namely a sustainable fiscal position, was absent in the Asian economies but it remains a serious problem in the CEAS - let alone the CIS⁴³.

Real appreciation in terms of effective rates is another early warning indicator. There again, care must be taken to net out the equilibrium component of real appreciation which has accompanied any successful development experience.

⁴¹ Ricardo Ffrench-Davis 1998. See also Bartolini and Drazen 1997, Dornbusch 1998a, Cotrella 1998 and De Gregorio 1998 and note 13 above on the Czech experience.

⁴² Ghosh et al 1998

⁴³ Belanger 1998 and chapter V in the IMF **World Economic Outlook** 1998.

5.2. Market-informed views

Opinions commonly found among market participants do not allow us to pass judgement on the different aspects of the current emerging market crisis, but they help suggest some implications for policy⁴⁴. The following four market-informed propositions suggest that the surprise element was genuine.

First "investment prospects were good until the crisis hit". This would seem to dispute the over-investment story and it may reflect active involvement in the financing of such investments. Second "sentiment changed abruptly and turned inflows into outflows". This also shows the surprise element but it also underscores the severity of the crisis, to the extent that such reversals would be very short-lived otherwise. Third, "exposure was complex and opaque yet it was reduced very quickly". This proposition exacerbates the previous two points, to the extent that it shows panic, also a feature of the fourth observation, that "liquidation induced herd behavior".

Other propositions go more towards opinions on the state of the world and may therefore be more influenced by professional opinion. Thus "the crisis was like worldwide deflationary shock" and "confidence on unregulated globalized financial markets was damaged" imply views about what to do and whether or not economists are useful in sorting out the implications for policy⁴⁵.

In addressing this question, market participants often reflect a confusion between their opinions as businesspeople (who prefer to keep free markets, perhaps flexible exchange rates) and their views as market professionals⁴⁶. Similarly, they may accept to strengthen regulation and supervision, including risk management techniques, before further liberalization of the capital account⁴⁷. And the so-called Tobin tax proposal may also be acceptable on this market professionals perspective⁴⁸.

Indeed, the fact that top rated academic economists with policy roles disagree and markets care about it would seem to confirm that "these are not normal times".

There is widespread agreement between academics and market organizations such as the group of thirty that some improvements in orderly workouts are desirable and easy to achieve⁴⁹. Nevertheless, the traditional difference remains between national action on

⁴⁴ Rude 1998 and Sharma 1998 gathered the data in New York and Asia respectively.

⁴⁵ Leading columnists provide a more or less idiosyncratic combination of the two primary inputs. For example Wolf 1998 combines market sensitivities with citations from academic economists.

⁴⁶ For Rude 1998, the latter perspective might instead favor promoting orderly workouts and regional institutions like the "resolution trust".

⁴⁷ Dornbusch 1998b suggests mandatory value at risk reviews as called for by the Basle committee of the BIS. While developments in the technology may allow this, the concepts are still foreign to many financial institutions. See practical examples in my [risk.htm](#)

⁴⁸ Dornbusch 1998b quotes the literature including the original pieces by Jim Tobin. Krugman 1998b contrasts his views with those of other Charles River economists turned policymakers and sees evidence that these opinions are being more listened to than is typical in calm periods. A corollary of Murphy's law (called Blinder's law in Cambridge, Mass) is that *economists are more listened to when there is less agreement in the profession and when the issue is one where economists have less of a professional answer to provide*. See also Stiglitz 1998 and Radelet and Sachs 1998.

⁴⁹ For example the IMF should lend in arrears and there should be sharing or majority voting clauses in bond and bank loan contracts, allowing IMF to shelter countries from legal action (art 8.2b of Articles of Agreement). This list draws on the conclusions of the TAED meeting, on CEPR 1998, Portes 1998 and Eichengreen and Portes 1995.

private debt and international action on sovereign debt. In the absence of international enforcement, the “pre-nuptial agreement problem” makes these improvements less likely to be accepted outside of a broader set of changes in the international system.

Lastly, the current crisis has uncovered an unusual amount of disagreement within the Bretton Woods institutions. And if they do even appear to agree with each other, the IMF and World Bank may not be capable of influencing the architecture of the international economy.

6. Conclusion

Even in the absence of perceptions of crises, it should not be assumed that the practices described in the sections 3 and 4 are widely and immediately understood in the CEAS. It certainly has taken many decades for them to be established in the advanced democracies. However, it is crucial that governments, leading domestic firms, foreign investors, and domestic, foreign and international financial institutions take a lead in establishing these practices.

Some of the CEAS are in the middle of the current EU group in terms of the budgetary institutions, suggesting that they are better fit for fiscal consolidation and, hence, for EU membership than Greece, Portugal or Spain might have been in the 1970s. While there is still much room for improvement, some of the CEAS are close to policy sustainability and to EU procedures and performances, on both macroeconomic, structural and institutional grounds. The fact that the Central European Free Trade Association gathers six of the ten states and that the others may join before EU membership also helps set the CEAS apart from other transition economies and indeed from previous applicants who had not been members of EFTA - such as Greece or Spain.

The immediate effect of the current emerging markets crisis is to underscore a lesson from the inter-war period which could well spread from the tariff escalation to non-tariff barriers like exchange controls. Liberalization and globalization must be better managed to prevent protectionist pressures from taking over. Avoiding contagion by reverting into trade and financial protectionism could well prove as ultimately futile a beggar-thy-neighbor policy in the late 1990s as it was in the early 1930s.

Managing the emerging markets crisis means therefore allowing for a more effective regional and global response to threats of contagion of national crises through coordination mechanisms among monetary and fiscal authorities like the ones found in the EU. These mechanisms rely on shared economic and societal values, and the ten CEAS should adapt them among themselves through CEFTA or equivalent.

Over and above the parallels between the current emerging markets crisis and the Mexican devaluation of December 1994, the lessons from the crises in the ERM may thus be helpful in emerging markets to the extent that they were overcome by more effective coordination mechanisms among monetary and fiscal authorities, the so-called ERM code of conduct.

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