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CONVERGING EUROPEAN TRANSITIONS

by

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PREFACE

This Development Centre Technical Paper updates earlier work aimed at analysing and establishing benchmark procedures for identifying reform progress and policy sustainability in applicant countries to the European Union — some of which are already Members of the OECD. To the extent that they reflect a worldwide trend towards policy convergence based on the combination of open markets and the protection of property rights, these benchmarks apply to developing countries as much as they do to transition economies.

In this exercise, the EU is seen as a system of multilateral surveillance based on shared values of good governance and on peer pressure, visible in proposals for "flexible" integration. The European economy becomes a proxy for the global environment in which all economies have to operate. Though there are no formal procedures for being accepted into the global economy, as there are in the EU, the OECD and other international bodies, the link between policies aimed at good governance and "inclusive" globalisation is increasingly recognised.

The Development Centre's programme of work explicitly examines and concentrates upon this link. If those countries and economies variously described as "emerging" or "developing" can be helped to identify the types of policies which will best adapt them to the global economic environment, their capacity to operate within that context will be enhanced. This is the principal interest in this paper for such countries and explains its inclusion in the Development Centre's output.

The paper provides some tools with which economies can be analysed by comparing their positions on a governance and globalisation (G&G) matrix. The G&G matrix illustrates the "virtuous cycle" where market openness and the protection of property rights reinforce each other and sustain a process of convergence of living standards, the vicious cycles where protectionism and poor governance induce divergence, and how EU applicants move from divergent to convergent transitions. The assessment of the convergence potential of countries in Africa, Asia and Latin America would benefit from further research along these lines.

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RÉSUMÉ

Les attentes d'une plus grande convergence des niveaux de vie se sont répandues dans toutes les régions du monde, alors même que les marchés émergents et les vieilles démocraties s'efforcent d'attirer l'investissement étranger pour accélérer leur croissance économique. Dans cet environnement mondial de plus en plus concurrentiel, la protection des droits de propriété devient un critère de convergence, parallèlement à l'ouverture des marchés internationaux des biens, des services et des capitaux, et à la stabilité macro-économique. Au sein de l'Union européenne, des procédures de surveillance multilatérale et des programmes de convergence ont été mis en place afin de faciliter les progrès vers une orientation à moyen terme de la politique macro-économique. Ces initiatives fournissent également des repères aux marchés émergents, gommant la différence entre économies « en transition » et « en développement » : elles définissent en particulier « des processus européens de transition vers la convergence » pour les candidats à l'Union.

Sachant que les économies émergentes ont le sentiment que leur niveau de vie a connu un recul sévère suite aux crises financières de 1997-99, la capacité à renouer avec la prospérité via une croissance accélérée est devenue fondamentale. Même si aucun des pays Membres de l'UE n'a subi de restrictions de ses droits civils et de propriété comparables à celles imposées aux nouveaux candidats, l'Espagne, la Grèce et le Portugal ont toutefois modifié leurs régimes économique et politique par une série de réformes largement influencées par la nécessité de répondre aux critères de qualification pour l'euro. La satisfaction des critères de convergence pour la monnaie européenne ne figure pas dans les négociations relatives à l'élargissement, mais les marchés financiers mondiaux orientent déjà sur cette voie l'évolution des régimes économiques des pays candidats.

Dans un environnement de convergence des politiques au niveau mondial, un système judiciaire efficace, le respect des droits civils et la perception de la corruption sont aussi importants que les notations de crédit et les indicateurs macro-économiques (comme la balance des comptes courants ou le déficit du budget public). C'est pourquoi le principal effet de l'élargissement de l'UE sur la croissance et l'investissement dépendra des progrès de la transition plutôt que la proximité géographique, ou même de l'ordre d'entrée dans l'UE. Les progrès dépendront à leur tour de la stabilité macro-économique et des réformes structurelles. Aussi, la durabilité de la politique macro-économique sert de guide au rythme d'un programme de convergence vers la stabilité macro-économique, comprenant notamment un ensemble des mesures structurelles susceptibles d'améliorer le gouvernement des entreprises, de combattre la corruption et de renforcer la cohésion sociale. La dimension structurelle est précisée sous la forme de principes de bonne gestion au niveau des pouvoirs publics et des entreprises, sur la base des normes en vigueur dans les vieilles démocraties et aujourd'hui relayées par l'OCDE et d'autres organisations internationales.

Même si de nombreuses améliorations sont encore possibles, certains candidats se rapprochent de la durabilité politique et des procédures et performances de l'UE, que ce soit sur les plans macro-économique, structurel et institutionnel. La Zone de libre-échange de l'Europe centrale — qui rassemble sept des dix postulants — peut accompagner ses membres et les États baltes dans leur processus de transition, de la même manière que la Zone de libre-échange européenne a autrefois aidé le Portugal et la Finlande à s'ajuster.

Cela nécessiterait un renforcement de la surveillance multilatérale, sous la forme d'un dialogue structuré avec l'Union. De fait, les crises des marchés émergents de 1997-99 ont mis en évidence les menaces de contagion des crises financières, notamment en l'absence de mécanismes de coordination entre les autorités monétaires et budgétaires.

ABSTRACT[1]

Expectations of a broader convergence of living standards worldwide have spread at the same time as emerging markets and mature democracies seek to attract foreign investment in order to accelerate economic growth. In this increasingly competitive global environment, the protection of property rights becomes a convergence criterion, together with openness to international markets for goods, services and assets, and a stable macroeconomy. In the EU, multilateral surveillance procedures and convergence programmes have been implemented to facilitate progress towards a medium-term orientation of macroeconomic policy. These practices may also provide benchmarks for emerging markets, blurring the difference between “transition” and “development”: in particular, they define “converging European transitions” for EU applicants.

Given that emerging economies have experienced a substantial fall in their perceived standards of living after the financial crises of 1997-99, the ability to recover through accelerated growth has become decisive. While no EU member state experienced restrictions on their civil and property rights on the scale which the current applicants have endured, Greece, Portugal and Spain changed their political and economic regimes through a series of reforms where the pressure of qualifying for the euro played a crucial role. The fulfilment of the convergence criteria for the euro is not part of the enlargement negotiations but world financial markets are already monitoring changes in this direction in the economic regimes of the applicants.

In an environment of global policy convergence, an effective judicial system, the respect of civil rights and the perception of corruption are as important as credit ratings and macroeconomic indicators such as the current account or the government budget deficit. Then, 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 programme to macroeconomic stability, including a catalogue 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 standards found in mature democracies and currently promoted by the OECD and other international organisations.

While there is still much room for improvement, some applicants are close to policy sustainability and to EU procedures and performances, on both macroeconomic, structural and institutional grounds. The Central European Free Trade Area — which gathers seven of the ten applicants to the EU — may help its members and the Baltic states in their transitions in the same way that the European Free Trade Area once helped Portugal or Finland to adjust.

This would require enhanced multilateral surveillance, in the form of the structured dialogue carried out with the EU. Indeed, the emerging markets crises of 1997-99 underscored the threat of contagion of financial crises, especially in the absence of co-ordination mechanisms among monetary and fiscal authorities.

I. INTRODUCTION

The implosion of the “second world” provoked numerous changes in state boundaries and drastic political, economic and social transformations spanning two continents. It also changed the outlook for an increasingly diverse “third world”. The forces at work became clearer after successive financial crises in both “worlds” created perceptions of a reversal in the process of convergence between mature democracies and so-called “emerging markets”, a group hiding a lot of different national and regional circumstances[2].

Meanwhile, the disciplinary boundaries between “comparative systems”, “development studies” and “growth theory” also changed and a new field, called “transition economics”, appeared. Endogenous growth theories stressed the role of human capital while the role of institutions in maintaining policy credibility was increasingly recognised. These, and other analytical developments were brought to bear in the renewed attempts to understand why growth rates differ among nations and regions. In particular, the question of global convergence of per capita incomes has widened to include transition economies, some of which have already joined the OECD and NATO, while others are almost as poor as the least developed countries[3].

This paper looks at convergence, and therefore reflects developments in emerging markets from the perspective of the growing “club” of mature democracies. The emphasis, however, is on one specific manifestation of the process, involving the enlargement of the EU by ten countries in transition henceforth called “applicants”[4]. Summary macroeconomic indicators for the ten countries are reported in Table 1.

Table 1. **Applicants’ Macroeconomic Indicators (1999)**

Country	Current Account Def (% GDP)	Budget Deficit (% GDP)	GDP Growth (% P.A.)	Inflation Annual Average
Bulgaria	5.0	0.9	2.5	0.6
Czech R	2.4	0.6	-0.2	3.6
Estonia	4.6	4.7	-1.1	3.3
Hungary	4.3	4.0*	4.5	9.8
Latvia	10.0	4.0	0.1	2.4
Lithuania	11.0	7.0	-4.0	0.8
Poland	7.6	3.5	4.1	7.3
Romania	3.8	3.3	3.2	45.8
Slovakia	5.8	3.6	1.9	15.6
Slovenia	2.9	0.6	4.9	6.2

Sources: EC ECFIN DG web site *IMF.

Section II discusses EU enlargement as part of the global environment, including the evidence for policy convergence worldwide. Evidence on the role of property rights and open markets is presented, so as to motivate the “virtuous cycle” between globalisation and governance. For example, the effect on growth and investment is seen to depend on the progress of transition rather than on geographical proximity to the EU. Moreover, the values behind European integration are essentially the same as the requirements for sustained growth and development in emerging markets.

Section III specifies the structural dimensions of transition in the form of principles of good government at the public and corporate levels, reflecting the standards found in mature democracies. Corruption perceptions and credit ratings are presented as indicators of appropriate responses to the twin challenges of globalisation and governance in ways that are applicable more broadly to emerging markets.

Section IV presents a macroeconomic framework for policy sustainability — a guide for the credibility of fiscal adjustment which has been identified as one of the roots of convergence. The timing of a convergence programme to macroeconomic stability is deduced from a policy matrix and the effects of the financial crises in emerging markets observed in 1997-99 are brought in. The applicants are then ranked in terms of their progress in opening markets and in improving governance. While the scores are higher on the latter than on the former, they are hardly comparable. The results should only suggest that few applicants are in the "virtuous cycle", a result that would apply to a control group including mature democracies and emerging markets such as Korea, Portugal or Turkey who also do not score, unlike Greece or Mexico who do. Section V concludes.

II. THE ENVIRONMENT FOR AN ENLARGING EUROPEAN UNION

In our interdependent world economy, nation-states are confronted with the twin challenges of globalisation and governance. As a result both of past history and of expectations about the future, these twin challenges reflect the constraints resulting from international exchange and property rights. Policies that cannot be sustained without future tax increases elicit negative reactions from voters and the financial markets. The sustainability of policies without future tax increases is, in turn, required for their credibility.

The protection of the 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, because more and more people are exposed to realities beyond their immediate horizons in space and time. The importance of market perceptions of national policies, alongside voter sentiment, is reinforced by personal mobility.

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 taxes, social security and other budgetary procedures, let alone monetary systems, which used to be purely domestic concerns. Moreover, interdependence can make reform more costly or less enduring, to the extent that mechanisms of peer pressure and multilateral surveillance are weaker than free riding and regulatory capture.

The global environment has become more turbulent as successive financial crises have undermined confidence in emerging markets. In the current environment, the impact of the euro and of EU enlargement on competition, trade and the overall investment climate may seem less salient than the changing prospects for the world economy. Even for the applicant countries, the “virtuous cycle” between globalisation and governance does not hinge on faster EU membership but rather on the appropriateness of policies. Both the creation of the euro and the ongoing enlargement process do strengthen the case for policy convergence. Rather than turning a divergent European transition into a converging one, the euro and enlargement increase the costs of divergence for the applicants following inappropriate policies.

II.1. The Fiscal Roots of Convergence

More than a decade after the rebirth of multi-party democracy in Poland and Hungary, the failure of Soviet-style economic institutions has been felt by the population at the same time as the merits of free enterprise seem to have been overstated, especially because it is seen as delivering excessive inequality. This realisation is accompanied by an awareness that redistribution through high taxation is less effective than had previously been thought by economists and policy makers. 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, ensuring that a stable economic and financial environment continues to prevail in the United States and across the EU.

The sustainability of policies without tax increases now appears to be required for their credibility in both electoral and financial terms. The reward to sustainable and credible policies at the national level is the ability to carry out enduring reforms. Put another way, the signal that markets seek when unsustainable policies are identified is the willingness and ability to begin reforms, so as to avoid more taxes — today and in the future. Conversely, some guarantee against future tax increases is widely perceived to be a condition for the global convergence of living standards[5]. A guarantee of this sort is provided by a multi-annual fiscal adjustment strategy (MAFAS) — replicating the convergence programmes adopted by all EU member states, beginning with Italy and Portugal in late 1991, in the run-up to the euro. A comprehensive and effective MAFAS can be seen as an indicator of good governance.

Openness to international markets for goods, services and assets has become a criterion for convergence. But, as discussed below, it is not the only one. As emerging markets seek 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 becomes a criterion for real convergence. Convergence is seen as a policy, a matter of choice, for national governments. This is why globalisation and governance are twin challenges.

Given that public choice differs from individual preferences, not all societies will manage to agree on the institutions that will allow them to develop and grow. In the absolute, the question for domestic wealth owners becomes one of comparing the risk and return characteristics of various investment strategies. Their residence may give them a home bias relative to other international investors — but if the domestic investment climate deteriorates too much, either because of macroeconomic instability or because of widespread corruption or both, they and their capital will move elsewhere. Where lifetime poverty is pervasive and there are no commercial traditions, let alone democratic institutions, the pressures of global business may be even more difficult to reconcile with the aspirations of civil society. Yet only reforms promoting property rights and open markets could put the economy onto a converging path, keep domestic capital at home and attract foreign investment.

The transition and development economics followed here suggest that there is little hope for a national economy to grow if its policies do not somehow respect property rights and keep markets open. Of course, the assumption is that the same basic rules must be adapted to the particular historical and geographical circumstances, including the nation's capacity to transform. According to Kindleberger (1962), this capacity to transform best described 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, even though Koopmans and Montias (1971) showed awareness of the importance of the incentive structure.

This global policy convergence has already begun in the EU where multilateral surveillance procedures and convergence programmes have been implemented to facilitate progress towards a medium-term orientation of macroeconomic policy. Given that price stability and sound finances are ensured by the MAFAS, the euro should in turn allow a better functioning of labour and capital markets. This does assume that governments are not only willing but also able to carry out reforms which put their re-election at risk[6].

Moreover, the financial crises of 1997-79 dampened the difference between "transition" and "development". Given that emerging economies have experienced a substantial fall in their perceived standards of living, the ability to recover through accelerated growth became decisive.

For a MAFAS to serve as an effective commitment technology, however, it must be based on appropriate budgetary procedures. These continue to be an important responsibility of member states, or of their local authorities, and may require further adaptation as part of structural reforms in social security, health, education and other areas. Also, the nature of social protection may be difficult to change without threatening social cohesion. This was argued by Kolodko (1998) for transition economies, and is especially poignant in countries which were traditionally part of the European economy and society. In any event, tradition was forgotten by decades of inadequate policies to the point that a change in economic regime was 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 for by open trade and outward migration. Civil liberties were restored in the mid-1970s but, in the case of Portugal, property rights were violated by the revolution and this was only reversed after 1989, when the constitution was amended to allow privatisation. 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 regimes through a series of structural reforms where the pressure of qualifying for the euro played a crucial role. They show that the fiscal roots of convergence go beyond the budget deficit and include good governance and the fight against corruption, as detailed in section III below.

The fulfilment of the convergence criteria for the euro is not part of the EU enlargement negotiations. Nevertheless, world financial markets are already monitoring changes in the national economic regimes of the applicants. 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 membership. 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 Stability Pact ensures that the fiscal criteria are not violated. Appropriate budgetary procedures are explicitly called for in the Treaty.

II.1. Global Policy Convergence

Interdependence brings a tendency for convergence in economic, political and even in social behaviour, 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 that make protection inefficient and inequitable, preferences between private and public goods once were seen as local. This was supposed to rationalise severe spatial differences in the burden of taxation in the so-called “first” and “second” worlds. The developing nations of the “third world” had preferences for the market or plan models. This is no longer the case. 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 supporters of the market and those of the 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 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 is also rising that excessive taxation, whether overt or hidden in the form of inflation, discourages saving and stifles growth. As growth prospects fall due to the absence of incentives to save and invest, so does employment, reducing future consumption and increasing social deprivation. In due course, these policies will be corrected. Yet, without adequate institutions, there may be reversions into inadequate policies.

One of the crucial debates in economic and social development is about how to ensure that the poorer countries grow more rapidly than the richer countries, so that there may be convergence in living standards and 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.

Rather than claiming that only countries with an adequate initial level of human capital endowments can take advantage of modern technology to enjoy the possibility of convergent growth, Sachs and Warner (1995*a*) have suggested that "reasonably efficient economic institutions" are the major requirement for economic growth and convergence. This insight brings contributions from institutional and comparative economics to the vast convergence literature[7]. And it is relevant for the converging European transitions stressed here.

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[8].

Sachs and Warner (1995*a*) use a sample of 117 countries for which data on policy convergence are available, covering approximately 90 per cent of the world population as of 1985. They establish that countries with "appropriate policies" display a strong tendency towards economic convergence: countries with initially low per capita income grow more rapidly than richer ones. Countries whose policies related to property rights and to integration of the economy into international trade are deemed inappropriate do not converge.

Every one of the 88 countries with less than $4 000 per capita income in 1970 having an open trading system grew by at least 2 per cent per year from 1970 to 1989. The single exception is Haiti. 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. Jordan and Morocco are the only two qualifying countries recorded in the "slow growth" cell in the accompanying matrix, because they grew at around 2.5 per cent from 1970 to 1989. This is how Sachs and Warner (1995*a*) establish sufficiency: if a country follows appropriate policies, it tends to grow "fast"[9].

Then they investigate necessity: are there many countries that "broke the rules" and yet achieved high economic growth? They found seven cases: Botswana, Cape Verde, China, Hungary, Lesotho, Thailand and Tunisia, or 9 per cent of the non-qualifying countries[10].

Of those, China is seen as the only puzzle even though, according to Sachs and Warner (1995*b*), “it is essentially consistent with the importance of open trade”[11].

Expressing the number of cases as fractions of the total in Table 2, sufficiency is clearly established but necessity is less cogent, at least if the six exceptions besides China are considered. The results can 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 but not names of the specific countries, would policy makers gamble on a China-type path, assuming for convenience that it is unique, rather than a collection of different economic regimes? If they did follow closed policies, the conditional probability of growing at 3 per cent per year would be 8 per cent. On the other hand, conditional on good policies, the probability of high growth would be 85 per cent (the ratio of 12 to 14, the sum of the first column in the matrix).

Table 2. **Appropriate Policies and Growth**
(88 countries with less than $4 000 per capita income in 1970)

		Policies Appropriate	Not Appropriate
Growth	Fast	12%	8%
	Slow	2%	78%

Source: Based on Sachs and Warner (1995*a*). Growth deemed slow when <3%.

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 post-war era before a track record on growth had occurred. The bi-polar system of international politics implied that outward oriented policies in the OECD countries involved security relations led by the United States and that reacting against these policies was an imposition of Soviet policy in Europe and elsewhere.

The comparison of transition economies with developing economies in Latin America, East Asia and elsewhere has suggested that the capacity to cope with a volatile international environment is the main difference between emerging markets and mature democracies. In addition, mature democracies have clustered in the so-called trilateral regions, North America, Europe and Japan, generally including some of the countries at the peripheries[12]. The response to crises is often more drastic at the periphery than at the centre because 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 with less transparency, signalling a weaker financial reputation and higher perceived risk to international investors.

A particularly troublesome implication of the emerging markets crisis is that the difference between the reputation of the centre and periphery has shrunk. In Asia, where the trouble originated, this was due to the continuing difficulties of Japan. The chances of co-ordinated policy responses are further weakened by the absence of effective multilateral surveillance mechanisms in the G-7.

A sustainable transition requires 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, 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 dependent 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 principle, thought to be behind the "Asian miracle", whereby economic efficiency is deemed independent of social cohesion and majority voting. Once again, converging transitions must reflect a "virtuous cycle" between the global environment and good government.

II.3. Regional Integration

Forms of regional integration and association have emerged among developed as well as developing nations. It is fair to mention the EU as the most ambitious such association, and to acknowledge that both the European Community and the European Free Trade Association (EFTA) contributed to its current status since most EFTA members are now in the EU. The Central European Free Trade Association (CEFTA, an organisation which, in one form or another, has been in existence since 1992) may be able to perform the same role[13]. Outside Europe, the North American Free Trade Association (NAFTA, including Canada, Mexico and the United States) and Mercosul (Argentina, Brazil, Paraguay and Uruguay) have induced significant trade liberalisation among their members, changing traditional protectionist attitudes. The Southern African Development Community and the Asia-Pacific Economic Conference have not yet been vehicles for structural reform on the same scale, but the efforts continue.

An enlarged EU will represent an event of outstanding significance for Europe as a whole and a landmark in the process of transition. 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, involve 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 have strong implications, particularly for infrastructure, enterprises and financial institutions. In infrastructure, transport and communication systems should be integrated to ensure the smooth functioning of the single market.

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

Accession will imply that enterprises must conform to 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) appear to be especially large.

Financial institutions will be expected to perform to high standards of financial strength and transparency, demonstrating 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 fund small and medium-sized enterprises, as they are an important factor in stimulating innovation, competition and growth.

Difficulties in policy co-ordination within the G-7 have already been noted. Of course, co-ordination difficulties have been prominent within the EU, and may have prevented the applicants from going further in their own co-ordination efforts. CEFTA, which now includes seven applicants, and might further widen to include 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 member 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, in spite of political pronouncements to the contrary. Conversely, the creation of the euro may enhance the attractiveness to foreign investors of the applicants that have common borders with Russia, Ukraine and smaller open economies in the CIS like Belarus and Moldova, because these will in time border the EU itself[14]. It is clear from Table 1 above that Latvia, Lithuania, Poland and Romania continue to show some form of imbalance. The data suggest that the impressive growth record of Poland may threaten its external position, even though it is considered one of the cases where a “virtuous cycle” of globalisation and governance is taking place.

II.4. The Effect on Investment

The effect of EU enlargement on growth and investment applies across the board in applicant countries. It is their attractiveness to foreign direct investment projects rather than their association to the EU, which determines the effect. In spite of the heterogeneity of the projects in terms of size, function, technology, location and control mode, some patterns emerge. According to Lankes and Venables (1996), the main ones pertain to function and control mode.

The function may be a predominantly market-access motive (being close to consumers) or a 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 into the activities of the firm, and somewhat more upstream.

The control mode is also relevant because licensing or joint venture projects differ from fully owned subsidiaries. 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 are 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 the benefits of technology transfer, quality control and the development of marketing channels with them. They certainly seem to be more in line with the comparative advantage of the host economy. The implication of the analysis is that 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.

Aside from the ongoing process of China and CIS countries joining the WTO, EU enlargement is the only expected development in Eurasia, which embodies open market and free trade policies. Of course, open policies in relation to these countries are vital, not only for the advancement of their transition but also for the development of the EU economy itself, its growth potential and the welfare of its consumers.

The openness of the single market is amplified by the euro, which is bound to play a major role in fostering trade relations across the continent and worldwide, as a means of international payment and as a foreign exchange reserve. The decision of Greece to join the Exchange Rate Mechanism (ERM) in 1998 was rightly seen as a step towards joining the euro in 2000. Advanced transition countries share this awareness that the ERM code of conduct will help applicants earn policy credibility just like it did for Ireland, Spain, Portugal, Italy and Finland in the past.

II.5. EU Deepening and Widening

With the creation of the European System of Central Banks and the introduction of the euro, a stability-oriented single monetary policy has been applied to most of the European economy. Thanks to the Stability Pact, budgetary policies and procedures in all 15 EU member states continue to be subject to tight multilateral surveillance even when some EU currencies, including sterling, are still floating against the euro. This should encourage national governments to implement 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[15]. Nevertheless, these reforms are needed for European firms to remain competitive in global markets, especially in light of the volatility of the yen and of the depreciation of several Asian currencies. International financial markets and the rating agencies have been 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 EU 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 may be, 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 trilateral regions mentioned above. The three values are: proximity to the citizen, national legitimacy and democratic accountability. The first value contains a double perspective: a higher entity must not take on functions that could be satisfactorily performed by a lower entity; and 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 established the first value, we should seek to reinforce majority rule at the national level. It is the starting point for ensuring legitimacy at the Community level. In EU 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 an effective structured dialogue would widen the principle of non-exclusion to the point of giving the same expectation to each one of the applicants.

Next to legitimacy comes the value of democratic accountability. Accountable decision makers are increasingly required at the EU level, but are equally essential at the national one. Bureaucratic unaccountability and mixed institutional competence confuse public opinion. They may reflect deep-seated corporate governance problems, corruption or both, as discussed in the next section. They display a negative image of Europe, of which its critics rapidly take advantage.

The simultaneous enlargement and deepening of the Union implies a permanent negotiation between nation states. As a result, a balance of proximity, legitimacy and accountability helps in the implementation of the principle of non-exclusion of a country which fulfils standards previously agreed on by all members and which exhibits the political will to belong in the core. While enlargement has always been unanimous, an effective structured dialogue with the applicants would "widen" the principle of non-exclusion.

The revisions of the EU Treaty proceed in the current Inter-Governmental Conference (IGC). Meanwhile, the debate over the feasibility and desirability of what CEPR (1996), a report for the previous IGC, called "flexible integration" has become unavoidable[16]. Flexible arrangements are already in the EU Treaty, in connection with the single currency and with the social charter. They can also be found in the Schengen agreement dealing with the free movement of people and set to interact with co-operation in matters of justice and internal affairs. It may thus be similarly useful to distinguish several groups of countries within an enlarging EU. The Nordic countries provide one illustration, as do those countries constituting the applicants whose procedures for structured dialogue were in place for some years.

The method of European construction fostering international interdependence by co-operation 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 "excessive deficit procedure" and in the Stability Pact.

Structured dialogue procedures were supposed to prepare accession negotiations — always a bilateral process between the applicant and the union — in a multilateral framework. As flexibility helps to combine EU deepening and widening, the European Commission and CEFTA should strengthen these procedures.

In other words, given a global environment favourable to growth, converging transitions impinge on policies in each and every one of the applicants 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 issue-by-issue group surveillance procedures, which have been called "structured dialogue".

III. GOVERNANCE AND GROWTH

As already emphasised in section II.1, the fiscal roots of convergence go beyond the fiscal rules found in the EU Treaty and in the Stability Pact and pertain to the governance procedures themselves. 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.

III.1. Policy-making Institutions

The emphasis on policy-making institutions reflects the realisation that governance problems can distort the development of human capital and damage the structure of emerging organisations. By shaping the evolution of linkages between government and business, they have 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[17]. The sustainability of the transition depends, therefore, on the credibility of the programme of structural reforms, including fiscal adjustment.

Institutional arrangements for credible fiscal policy making based on the strategic dominance of the Minister of Finance over spending ministries are conducive to stable public finances. Such arrangements 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 have been 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 explain the drop in life expectancy that has been observed. These circumstances, familiar from developing countries, have a bearing on taxation and on the entire budget process.

Recent years have also shown great interest in codes of sound business practices, often specified in terms of checklists to 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 accepted[18].

The applicants have developing economies with changing structures, so the convergence process must be flexible enough to accommodate structural change. The applicants are also in a sense competing with each other not to fall behind on the path to accession, and choosing whether or not it is in their interest to further co-ordination among themselves if the price is to fall into the next round.

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, in particular, health, education, pensions and infrastructure.

In these areas the importance of developing and maintaining the right kind of partnership is obvious. 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. Moreover, sustainability also depends on avoiding excessive costs in terms of social cohesion.

III.2. Taxation and the Budget Process

Taxation is a prominent example of government activity where good governance is crucial for the functioning of a market economy. 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 economies. 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, whether 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.

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 for reasonable tax rates, which are required to strike a balance between revenue and disincentives. The establishment of an effective tax system is central to good governance.

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

Institutional structures can help in avoiding such inefficiencies. Institutions do not, of course, 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 to be 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 authorised 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 ensure 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 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 institutions[19]. The decentralisation 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 centralisation of the budget process have systematically higher ratios of public spending, and deficits and debts, to output than countries with large degrees of centralisation. Countries with a centralised budget process are able to achieve a higher degree of macroeconomic stabilisation 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 at fiscal stabilisation. Reform of the budget process is thus critical in a macroeconomic reform strategy.

Fiscal consolidation will certainly 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 applicants, the flow of public pension payments is well above 10 per cent of GDP. Using a discount rate of 10 per cent to capitalise this stream, pension debt is 100 per cent 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.

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. 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 from 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 net debt, make assignment of debt to sectors conceptually difficult, even if the data were available. The existence of unmeasured future claims on the government, such as the pension problem, mentioned earlier, add to the conceptual difficulty[20].

III.3. Sound Business Practices and Fighting Corruption

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 behind.

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. On the contrary, 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 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 perception indices. Even though the international comparability of the numbers must be very limited, they correlate well with the credit ratings[21]. There is a kind of virtually corruption free group which only includes top-rated countries (AAA from Standard & Poor's and Aaa from Moody's) while most emerging markets would be seen as "speculative" (BB/Ba and below). OECD membership led to a lowering of the spreads relative to mature democracies but only a handful of members have the top rating[22]. Mexico (BBB+/Baa3), Korea (A/Baa2) and some transition economies have recently received investment grades but, among OECD members, Turkey (B+/B1) remains "speculative". Table 3 shows the data for the ten applicants.

Table 3. **Corruption and Credit Ratings (1999)**

Country	Corruption Perceptions Index	Credit Rating S&P/Moody's	Credit Rating Number Index (0-10)
Bulgaria	3.3	B+/B2	3.3
Czech R	4.6	A-/Baa1	6.8
Estonia	5.7	BBB+/Baa1	6.5
Hungary	5.2	BBB+/Baa1	6.5
Latvia	3.4	BBB/Baa2	6.0
Lithuania	3.8	BBB-/Ba1	5.3
Poland	4.2	BBB+/Baa1	6.5
Romania	3.3	B-/B3	2.5
Slovakia	3.7	BB+/Ba1	5.0
Slovenia	3.4	A/A3	7.3

Sources: Transparency International, Standard & Poor's and Moody's websites.

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.

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 licenses 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.

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.

IV. 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 analysed 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 market-oriented. 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. The spillover becomes particularly acute in times of crisis, as discussed in section IV.2. It also qualifies the distinction between globalisation and governance used in section IV.3.

IV.1. A Macroeconomic Framework

The problem of how to evaluate macroeconomic policies and recommend policy changes without a quantitative macroeconomic model has been raised during evaluation of the World Bank's structural adjustment programmes. A framework that combines a model of policy assignment and debt sustainability criteria can deal with the problem. A version of this framework seems useful for analysing macro policies with reference to something like a convergence programme to macroeconomic stability and a catalogue 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 applicants 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 stabilisation are the MAFAS and a Pre-Pegging Exchange Rate Regime (PPERR) that entails essentially no active nominal devaluation but is aimed at real devaluation as the country converges towards EU membership[23]. Both of these policy paths are intended 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 policies that stabilise 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 applicants 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 "code of conduct" of the ERM, as in the cases of Denmark and Greece. 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 1992-93, as discussed below.

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 countries 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?

The sequence of questions is the following: 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.

A policy matrix such as the one presented in joint work with Branson and von Hagen (1998) 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.

In the matrix, external balance is across the top to signify its predominance relative to internal balance. The main importance of the internal balance indicators are to suggest that countries in the lower-left cell 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-left cell are already on or close to a convergence trajectory towards 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-right cell are out of balance on both dimensions, and are candidates for an EU loan or an IMF/World Bank structural adjustment programme to get close enough to the trajectory to consider MAFAS and PPERR.

Table 4. **A Macroeconomic Policy Sustainability Matrix**

Is external balance sustainable?

Is internal balance sustainable?		YES	NO
	YES	*success* ↑ MAFAS +PPERR	← ↓ MAFAS? +REAL DEVALUATION
	NO	→ PPERR? +EXCESSIVE DEFICIT PROCEDURE	*failure* EU LOAN/ IMF WB ADJUSTMENT PROGRAMME

Source: Branson, de Macedo and von Hagen (1998).

Countries on the top-right and bottom-left cells 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 on the upper-right cell may require a discrete real devaluation to restore external balance before adopting PPERR. They may want to adopt a form of MAFAS that creates the resource freedom to ensure that the devaluation has the intended effect. Countries on the lower-right cell 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 one of these two cells moves the country to the upper-left cell, close enough to the convergence trajectory to sustain MAFAS and PPERR. Failed adjustment leads to the lower-right cell and the need for an adjustment programme with outside assistance and conditionality.

IV.2. Crisis Management

The notion 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 economy. Depending both on contagion mechanisms and on the availability of instruments and institutions, then the appropriate level of policy response to financial crises in emerging market may still be national, rather than regional or global.

National policy responses to a large capital outflow may be a combination of allowing reserves to drop, increasing interest rates, and depreciating the currency. These responses include several different measures, with different effects. In particular, depreciation may be achieved through controls, which lead to multiple exchange rates, one or several of which may remain unchanged at the pre-response level. Moreover, they tend to be combined and the relative importance of each one depends on the particular circumstances of each country. Maybe outright depreciation is ruled out by an exchange-rate arrangement, as in a currency board. Or it may be very costly in terms of financial reputation, as was the case in Mexico and Korea, which had just joined the OECD, and in Russia, which 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 increased interest rates are 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. If reserves are low, and cannot drop further, one of the other options, 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-neighbour 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 co-ordinated. Co-ordinated systems like the ERM have a (sometimes unwritten) code of conduct but they are difficult to adapt to a world system without shared values. It may be, then, that, by allowing responses that would not obtain in calm periods, financial crises serve as a co-ordinating device.

As in the case of the exchange rate regime, exchange controls need to be co-ordinated, as they 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 experience, where the decision to relax its controls on inflows has been especially controversial since these controls were seen as very effective. Exchange controls were also reinstated in Malaysia in 1998/99, but their contribution to recovery was minor[24].

The issue of how devaluations and exchange controls can be co-ordinated at the regional or global level, to lessen their beggar-thy-neighbour character remains therefore predicated on handling the pattern of contagion.

Lessons on the pattern of contagion may be learned from 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 partly to 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 geographical than of a policy problem. Yet this peculiar form of neighbourhood contagion was pervasive at the time. 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 to be correct for Spain, which 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, as discussed in joint work with Catela Nunes and Covas (1999).

Geography and hegemony seem to play a role in contagion patterns, with some evidence pointing to the role of trade and to listings of country potentials that owe more to marketing than to fundamentals. Glick and Rose (1998) have a trade explanation which might account for the “geographic fundamentals”. Another hypothesis might be hegemony, in the sense of “winner takes all”. For example, in the competition among potential locations for international investment, the result may be that some markets are crowded and others deserted[25]. Both geography and hegemony are at work when it comes to the economic policy autonomy of Hong Kong, relative to China — not quite a transition economy —. The fragility of the Asian recovery in 2000 may also involve both geography and hegemony, given the role of Japan — not an emerging market and yet part of the Asian problem, rather than of the solution.

The turmoil in Russia in the summer of 1998 had a strong domestic component and threatened to reverse the transition process. The sequels of a debt moratorium and of currency inconvertibility, let alone a bank run, remain economically and politically hazardous, as reflected in both the credit ratings (CCC+/B3) and the corruption perception index (II.4). The informal apportionment of responses to financial crises emerging markets to the major mature democracy in the same continent suggests a pattern of contagion reminiscent of “the Monroe doctrine” and probably inadequate in today’s global markets.

IV.3 A Globalisation and Governance (G&G) Matrix

The framework summarised in section IV.1. above can be adapted to go beyond macroeconomic sustainability. To this end, the credit ratings are divided by the current account deficit to form an index of open markets or globalisation. There the benchmark is an investment grade (index of five or higher) and a current account deficit less than five per cent of GDP for a sustainable response to globalisation. If there is a surplus, the score is arbitrarily set at ten. The index of governance is obtained by dividing the corruption index by the government budget deficit and making an index of five and a deficit of four per cent of GDP the benchmark for acceptance of good governance.

Then, based on the data reported in Tables 1 and 2 above, and on the scores reported in the Appendix Table, where information on growth from Table 1 is used to raise Poland’s score, the pattern of appropriate responses can be read from Table 5.

Slovenia, Czech Republic and Hungary are then in the top-left cell (where Greece, Italy and Mexico would also fit, according to the memo items on the Appendix Table). Latvia, Lithuania, Romania and Slovakia are in the lower-right cell, where one might speak of a “vicious” cycle of inadequate responses to globalisation and poor governance.

Thanks to a very low budget deficit, Bulgaria fits in the top-right cell (together with Portugal) while Poland and Estonia are in the lower-left cell (together Korea, Russia and Turkey). This suggests that applicants have better scores on governance issues than on opening markets.

Some qualifications to the classification in Table 5 are in order: the type of indicator used to assess governance is based on polls which may be less reliable than the credit analysis carried out by the rating agencies. Moreover, there are no direct measures of the extent to which property rights are protected, which was the criterion introduced in section II.2 above. The criterion for the deficit is itself arbitrary, and simply tries to avoid copying the convergence criterion used in the Treaty, by leaving some room for the applicants to introduce a credible MAFAS.

Table 5. **The G&G Matrix**

		Appropriate Responses to Globalisation	
		YES	NO
Good Governance	Y	Slovenia Czech Rep Hungary	Bulgaria
	N	Poland Estonia	Latvia Lithuania Romania Slovakia

Source: scores listed in Appendix Table.

V. CONCLUSION

The "virtuous cycle" between globalisation and governance is not immediately understood in emerging markets, where instances of "vicious cycle" abound. This was illustrated by Table 2 above, where over three-quarters of developing countries followed inappropriate policies and grew slowly. It certainly has taken many decades for these practices 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 them.

Some of the applicants 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 applicants are close to policy sustainability and to EU procedures and performances, on both macroeconomic, structural and institutional grounds. EFTA helped Portugal or Finland adjust relative to, say, Greece or Spain by bringing together different EU applicants. The fact that CEFTA gathers seven of the ten applicants may also help its members and the Baltic states in their transitions.

In spite of the emerging-markets crises of 1997-99, there was no escalation of exchange controls. Avoiding contagion by reverting into trade and financial protectionism might have proven as ultimately futile a beggar-thy-neighbour policy in the late 1990s as it was in the early 1930s. The 1992-93 crises in the ERM also help in understanding convergent European transitions to the extent that they were overcome by more effective co-ordination mechanisms among monetary and fiscal authorities.

Both crises should, therefore, allow for a more effective regional and global response to threats of contagion. The co-ordination of monetary and fiscal authorities found in the EU rely on shared economic and societal values, and the ten applicants should adopt them among themselves through CEFTA or equivalent — no matter what the calendar for accession.

The scores obtained and the rough indicators of globalisation and governance suggest that both challenges are being met by the Slovenes, the Czechs and the Hungarians, but that the others need to step up their reform efforts. The stress should be on governance for Poland, on globalisation for Bulgaria and on both for the Baltic states and Slovakia. While tentative, these conclusions accord with intuition. The approach may thus become worthy of a broader application in the assessment of the convergence potential of countries in Africa, Asia and Latin America, if further research confirms these findings.

Appendix Table
Globalisation and Governance Scores (0-10)

COUNTRY	GOV	GLOB
BU	2.6	0.7
CZ	3.7	3.4
ES	0.9	1.3
HU	1.0	1.6
LA	0.7	0.6
LI	0.4	0.5
PL	0.8	0.8 *
RO	0.9	0.6
SK	0.7	0.8
SL	4.8	2.4
MEMO ITEMS		
Russia	0.4	10
Portugal	2.7	0.8
Greece	2.5	6.8
Italy	2.0	10
Mexico	2.1	2.1
Korea	0.7	10
Turkey	0.2	7.0

GOV =COR/DEF=1 WHEN COR=5 AND DEF=4
GLOB=RAT/CAB=1 WHEN VAR=5 AND =10 IF SURPLUS
* adjusted to over 1 for growth

Source: Tables 1 and 2 for applicants, IMF, EU, OECD for memo items.

NOTES

1. Earlier versions were presented at the meeting of the Macroeconomic Research Working Group of the European Centre for Parliamentary Research and Documentation, held in Lisbon (Portugal), 16 June 2000 and at the 5th Conference of the European Association for Comparative Economic Studies, held in Varna (Bulgaria), 9-12 September 1998. The author is President of the OECD Development Centre but the views expressed remain personal, as described in www.fe.unl.pt/~jbmacedo/transition.htm

2. The current membership of the OECD includes emerging markets. Even among the founding members, Greece is still in the Morgan Stanley Emerging Market Index and Portugal only graduated from it in 1998. In the IFC list, both markets were still emerging when the euro was launched. As discussed in the text, the different circumstances of OECD and emerging markets are reflected in the indicators of appropriate responses to globalisation and governance, in particular credit ratings and corruption indexes.

3. The category of transition countries in Eastern Europe and the former Soviet Union basically coincides with the countries of operations of the EBRD, comprising the Commonwealth of Independent States (CIS), the former Yugoslav republics, Albania, Mongolia and the ten applicants, with which the EU Commission negotiated accession partnerships. The few underdeveloped countries in Africa, Latin America and Asia where ownership of capital by domestic residents remains outlawed do not belong to the category. In spite of its accession to the WTO, expected in 2000, China is neither a transition country nor an emerging economy. See note 6 below.

4. The same principles apply to the other applicants, Cyprus, Malta and Turkey. Because of its focus on transition, the analysis excludes these three cases. See note 10 below and the Appendix Table.

5. The rejection of excessive taxation is based on a perceived threat to property rights or mobility. This 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. See my (1997).

6. In other words, the "euro hold-up" described in my (1999) is overcome. See note 13 below.

7. WTO (2000, p. 8) reviews these insights in a comparative table. The study, by Hakan Nordstrom, Dan Ben David and Alan Winters, was announced by an article in the *Financial Times* of 18 June by the director general Mike Moore, where reference was made to Sachs and Warner (1995*b*). See below.

8. Sachs and Warner (1995*a*) invoke a much quoted passage of Adam Smith in favour 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".

9. Sufficiency can be established by comparing the cells in the bottom row of Table 1. Alternatively compare 58 per cent (the ratio of 51 non qualifiers growing at less than 2 per cent per year to 88) to zero (the number of countries with appropriate policies which grew at 2 per cent per year or less.

10. Sachs and Warner (1995*b*) leaves out the property rights criterion and qualifies countries based on trade openness alone. Since Cape Verde and Lesotho are ranked "closed" and "open" Thailand does not qualify on property rights, there are four exceptions rather than seven. The simplification relative to their (1995*a*) may have gone too far, as the subsequent discussion, in particular by Stanley Fischer, illustrates.

11. Sachs and Warner (1995*a*), however, find China a "deep puzzle". Their explanation is common to both papers: "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-quarters of the labour 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 per cent of the labour force)". They go on to argue that this "two-track approach" was sufficient to unleash China's growth and labour-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".

12. The G-7 summits have been enlarged to Russia. Some of the other "systemically important countries" have gathered in "special dialogues" at the OECD or in groups similar to the G-7 such as the G-20. A civil society association like the Trilateral Commission, organised in national groups from the three regions, has also been enlarging. In the case of the European region, the process of enlargement has followed the rule of acceptance of the application by the European Commission. The North American and Japanese groups enlarged in 2000 to include Mexico and Korea, themselves recent members of the OECD.

13. Having been a founder of CEFTA will coincide with OECD membership for transition countries when Slovakia joins in 2000. Note also that, aside from Estonia, the so-called "fast track" accession (a category decided at the 1997 Luxembourg Council and subsequently abandoned) included CEFTA members and that the Russian financial debacle of 1998 hurt the three Baltic states more than the other seven applicants, all of them members of CEFTA. On the downside, CEFTA, like EFTA has not been able to go beyond trade in manufactures and deal with agricultural or financial services.

14. 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. Georgia, it is said, wants to model its development policy after Chile's. Now, Chile, a strong reformer for the last two decades with a very high credit rating, has been orienting its trade and investment to the Pacific basin and to membership in NAFTA. In the wake of the Asian crisis, it is now turning its attention to Mercosul, where the Atlantic dimension has so far dominated.

15. See note 6 above.

16. The assessment by the Portuguese parliament included the same idea, as described in my (1995). To the extent that it is based on the principle of non-exclusion, multilateral surveillance can be interpreted along the Rawlsian "veil of ignorance" lines used in note 5 above.

17. The indicators have appeared in the Transition Reports since 1994. Six indicators are calculated and divided into the categories of enterprise reform (three series: large scale privatisation, small scale privatisation and enterprise restructuring), market and trade reform (two series: price and trade and foreign exchange liberalisation) 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 applicants.

18. OECD endeavours such as the Convention on Combating Bribery of Foreign Public Officials and the devising of solutions to control and prevent corrupt practices within the public administration of member countries are worth emphasising. The role of private initiative in fighting corruption in developing countries is underlined in OECD Development Centre (2000). See also EBRD (1997).

19. 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 US 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 US literature, this new approach, pioneered by Jurgen von Hagen, is based on comprehensive characterisations of the budget process, summarised in numerical indices describing the quality of a process.

20. Perhaps the governments have a good opportunity for the introduction of a system of generational accounting as their budget processes emerge. See Auerbach *et al.* (1999).

21. For the data shown in Table 3, the correlation is 0.74. The transformation into numerical ratings is performed by Reisen (2000, p. 200). Dornbusch and Giavazzi (1998) use numerical ratings from Euromoney for four of the applicants.

22. Moody's provides a top rating for the eurozone and then does not rank its members. Standard & Poor's reflects a residual fear of reversal about some of the countries, and assigns ratings of AA+ to Belgium, Finland, Ireland and Spain and AA to Italy and Portugal. Except for Greece (A-/A2), the non-eurozone countries are rated AA or better.

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

24. Bartolini and Drazen (1997) stress the credibility effect of capital account liberalisation. Opposite positions on its desirability can be found in Dornbusch (1998) and Krugman (1998).

25. This competition is also called a "beauty contest" in financial circles. Paul Krugman (1994, p. 149) popularised the "superstar model" of the labour market along the same lines. He explains the fact that a larger number of people can bid for the services of the perceived best by "the reach and span of control of top lawyers, business executives and so on extended by modern telecommunications".

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