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Towards a prosperous wider Europe

Macroeconomic policies for a growing neighborhood

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The map used for the cover illustration shows the EU and its neighbourhood. Different colours indicate different relations to the EU.

Legend:
Yellow – Core EU member states
Orange – Cohesion countries
Dark blue – New member states
Light green – Candidate countries
Light blue – Western Balkans (Stability Pact)
Light pink – Eastern Europe (Trade and Cooperation Agreements)
Light brown – Southern Mediterranean Countries (Euro-Med-Partnership)

The papers included in this volume were presented at the seminar "The macroeconomics of neighbourhood policy. Lessons from the past – options for the future" held in Lisbon on November 12, 2004.

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Introduction: Macroeconomic policies for a growing neighborhood

This volume emerged from an international expert meeting, "The macroeconomics of neighborhood policy. Lessons from the past – options for the future", held in Lisbon on 12 November 2004. The seminar was part of a larger project on the EU's neighborhood policy run by the International Policy Analysis Unit of the Friedrich-Ebert Stiftung (FES). The FES has long been active in promoting democracy and development in the "wider Europe", in particular since the collapse of communism in Central and Eastern Europe. It has endeavoured both to shape debates within the European Union (EU) on appropriate policies to assist its poorer neighbors and to advise partners in those countries on how to design appropriate policies to develop their economies (Dauderstädt, 1997).

More recently, two events have resuscitated interest in policies that could transform poor neighbors into prosperous ones. First, the attacks of 11 September 2001 have led the US to develop a new security strategy (The White House, 2002) that aims in particular to transform Middle East countries into democratic market economies. The EU has responded to the challenges of international terrorism and American interventionism by developing its own security strategy (EC, 2003a). Second, EU enlargement in 2004 has led the European Commission to think about a framework for the EU's relations with candidate countries that will not join the Union in the foreseeable future (EC, 2003b; EC, 2004). The FES has been involved in the European debates on these issues in various ways.

A first investigation (Dauderstädt, 2004) of traditional EU policies to assist its neighbors raised serious doubts about their effectiveness. The performance of most neighboring countries has been weak despite decades of cooperation and assistance under various regimes, such as the EU's Mediterranean policy, association agreements, trade and cooperation agreements, the Barcelona process, TACIS and PHARE, to name only the most important. The core of these policies has always been trade liberalization, aid and political dialogue. Further policies were aimed at promoting foreign direct investment and managing migration. In some critical cases of state failure, ethnic conflict and civil war, the EU has intervened more deeply and established protectorates. The most successful EU policy so far, however, has been to offer EU membership. That incentive has led to far-reaching political and economic reforms in the candidate countries.

However, even within the EU, poor member states have not always performed well. Membership is obviously no guarantee of catch-up growth. Regional and cohesion policies have had little effect (Dauderstädt and Witte, 2001). The fastest catching-up occurred in the 1990s thanks to Economic and Monetary Union which led to low real interest rates on the poor periphery (Greece, Spain, Portugal and, although it is a special case, Ireland). For about 10 years, low interest rates spurred on consumption and investment. High growth on the periphery has led to comparatively higher inflation which in turn has kept real interest rates low, while at the stagnating centre (for example, Germany and France) low growth and disinflation have kept real interest rates high, so dampening growth further (Bofinger, 2003, p. 4–7). For the new member states and neighboring countries, the challenge remains the same – albeit under different conditions – namely to achieve rapid growth in order to alleviate poverty and create the resources necessary for a stable society and polity. The causes of growth are varied and often impossible to create or promote from abroad. Given the poor effectiveness of most traditional approaches, this volume focuses on macroeconomic policies that foster growth. This does not mean that the authors disregard the importance of other causes, such as good governance, and social and cultural factors such as values, trust or religion.

The present volume will focus on the macroeconomic framework not at least because, on the one hand, it has been obvious that harmful macroeconomic conditions such as debt or financial crises have been responsible for major setbacks in the development of otherwise successful countries, as in the cases of the Asian crisis, the Czech financial crisis in 1996 and the Hungarian crisis in 1995. As a recent analysis of the employment effects of the international division of labour (Kucera and Milberg, 2003, p. 601–624) has shown, the subsequent lack of import demand on the part of the indebted poor countries has caused major job losses in the developed countries, notably Europe. On the other hand, the great successes of convergence and catch-up growth of the 1950s and 1960s occurred within a different macroeconomic order, the Bretton Woods system of fixed exchange rates and capital movement controls (Yousef, 2004, p. 91–117, Ellison, 2001). The idea that a more favourable international policy context would contribute to more rapid growth was also one of the origins of the Lisbon conference.

1. Nominal and real growth: indicators and processes

When one talks about catching-up the term usually refers to the convergence of gross domestic product (GDP) per capita. That indicator can increase when GDP grows faster than the population. It can also be achieved by a more rapid decline of population than GDP, as when poorer than average people leave the country or region to which the term "domestic" refers. This often happens in declining regions such as East Germany. Demography also influences per capita income by changing the dependency ratio. Fewer young and old people depending on breadwinners increase the average GDP per capita – and vice versa. However, true development requires growing prosperity for all and not depopulation or short-run demographic luck.

In international comparison (which is indispensable if one wants to measure catching-up between countries) another problem usually arises: the value of the goods and services produced in an economy is measured in the national currency at domestic prices. Changes in the exchange rate and inflation rate differentials (both can be taken together as changes in the real exchange rate) distort that comparison. Higher real exchange rates let countries apparently catch up while in fact the amount of goods and services each inhabitant has at their disposal remains the same (or even declines). Most comparisons therefore use purchasing power parity (PPP) which compensates for these distortions. With increasing income levels the discrepancy between exchange rate and PPP (Exchange Rate Deviation Index = ERDI) tends to diminish (see also Table 1).

Another distortion occurs when a large part of GDP goes to foreigners or when the citizens of a country receive a large part of their income from abroad. An outstanding example of the first case is Ireland where more than 20 per cent of GDP is earned by foreign investors, which has led to a decline in the share of wages in GDP from 77 per cent to 58 per cent during the last 20 years. Economies that receive large remittances from migrant workers are a typical example of the second case. Gross national product (GNP) reflects these differences. It represents the income of national households and enterprises rather than the value added produced in the relevant country: the GNP of Ireland, for instance, is 20 per cent lower than its GDP. While Ireland is a stellar success measured in GDP per capita at current prices, its performance measured in GNP per capita at PPP is much more modest, since so much of its GDP goes to foreigners and its inflation rate is higher than the EU average.

True catching-up means that the people in the poorer country obtain higher real incomes (that is, larger quantities of goods and services) which is best measured by GNP per capita at PPP. However, all processes of real catching-up are a mixture of nominal and real growth where nominal growth occurs through inflation and currency appreciation. The crucial factor is the balance between nominal and real growth. A thought experiment makes this clear: if one were to increase all nominal incomes by a certain factor or revalue the exchange rate by this factor, nominal income would correspondingly increase and the country would look statistically richer. That happened to East Germany after unification when it adopted the DM at a strongly overvalued exchange rate and then increased its nominal wages in DM almost to West German levels. Since real productivity increased much less, a massive trade deficit occurred as imports rose and exports declined with the collapse of competitiveness. Most industries exposed to international (including West German) competition collapsed.

Under normal circumstances, such fake catching-up would cause a devaluation of the currency which in turn would restore the former relative position of the country in international comparison, combined – unfortunately – with major disruptions of the real economy, including job losses. In the case of East Germany, however, such a development was partially prevented by massive transfer payments from West Germany which financed sustained import surpluses and a level of domestic absorption way beyond domestic production.

While precipitate nominal growth may be harmful, every catching-up implies not only real growth of output but also a real appreciation of the currency through higher inflation and/or nominal appreciation. A study by Artner and Inotai (1997) calculated that 75 per cent of all catching-up has been nominal in this sense. One reason why such nominal growth cannot be avoided is the Balassa–Samuelson effect (Europäische Zentralbank, 1999, p. 39ff., EU-ECE, 2001, p. 227ff.). When productivity in the tradables sector of a poor country increases, incomes rise there, too. In the other sectors of the

Table 1: The pyramid of poverty below the EU (in USD)

Region/country	Per capita income at exchange rate parity	Compared to the EU	Per capita income at PPP	Compared to the EU	ERDI[a)]
EU 15	21000	100	24000	100	1.0
8 new member states[b)]	4590	22	10900	46	2.3
Bulgaria + Romania	1730	8	6130	25	3.5
Turkey	2530	10	5830	24	2.3
Western Balkans	1770	8	6770	27	2.0
Ukraine, Belarus, Moldova	787	3	4700	20	6.0
Russia	1744	8	6862	29	3.9
Caucasus	623	3	2760	12	4.4
Central Asia	741	3	3480	14	4.7
Israel	16750	70	19630	79	1.2
Maghreb	1580	6	4260	17	2.7
Mashriq	1680	7	3550	15	1.9
Middle East[c)]	3152	12	6830	28	2.2

Notes: a) ERDI = Exchange Rate Deviation Index; b) without Cyprus and Malta (no data); c) Iran, Kuwait, Saudi Arabia, Yemen (others no data).

Source: World Bank, *World Development Indicators 2003;* for EU-15 the value given for EMU has been adjusted.

economy – notably (public) services – productivity can increase but much more slowly. Incomes in these sectors can keep pace with the rest of the economy only when the prices of these services increase, leading to a higher rate of inflation. More generally, the integration of markets gradually leads to more uniform price levels (law of one price), which in turn causes higher inflation in the poor countries than in the rich countries within the integration zone.

In the end, macroeconomic policy has to balance nominal and real growth carefully. Erring on the inflationary side has historically proved to be more harmful as adjustment crises destroy jobs, income, and capital. Erring on the other side (that is, keeping the national currency undervalued in real terms through lower inflation and/or a lower external value) will boost employment, exports and foreign exchange reserves. However, it will hold back nominal convergence because of real undervaluation. Correcting the latter error is also less painful as it implies more domestic spending, while correcting the former usually requires belt-tightening.

2. Macroeconomic causes and policies for growth

Growth results from five factors: on the supply side, (1) higher input of capital and labour and (2) increasing productivity; on the demand side, higher demand at home, in terms of (3) consumption and (4) investment, and abroad, in the form of (5) exports. These factors and the policies that promote them are closely linked, though not always in a mutually reinforcing way. Productivity increases will lead to higher growth only if demand picks up, too. Otherwise, the same output will be produced using less input, possibly causing unemployment. Promoting exports can require limiting domestic absorption.

Explanation of the causal links between growth and supply-side and demand-side factors is hard debated. Two major theories compete to offer different explanations with different policy recommendations:

1. Keynesians consider the demand side as more important. New demand results from monetary expansion by either credit creation within the domestic economy or export surpluses. This new money demands goods and services and thus provokes the expansion of real production and the use of additional capital and labour. In particular in a situation with unemployment and surplus capacity, the additional demand will not fuel inflation. The expansion will expand incomes, too, which permits higher savings to service the debt incurred at the beginning (in the case of domestic credit expansion). Deficit spending is thus a sensible policy in times of unemployment. Maintaining an undervalued exchange rate in order to boost exports is also considered useful. Wages

should increase with productivity to maintain sufficient levels of demand while interest rates should be low to stimulate investment.

2. (Neo-)classical economists focus more on the supply side. They argue that the use of more capital (stemming from prior higher savings) and more labour will produce higher output which will automatically meet the necessary demand because the factors used receive an income which is sufficient to buy the output (Say's law). The primacy of real savings implies that state budget deficits are considered harmful as they crowd out private investment and fuel inflation. Wages should be low in order to permit high profits which will lead to higher investment. Interest rates should be sufficiently high to stimulate savings.

Both theories have their strong and weak points. On the one hand, monetary expansion leads to nominal growth which, however, can be composed of growth in inflation and real output. Without sufficient supply-side capacities, inflation and/or imports will probably dominate. On the other hand, increased income (in particular, profits) will not necessarily lead to higher demand (in particular, investment). Instead, households might prefer to save or hoard the money, forcing enterprises to stockpile the unsold output or to reduce prices. The latter might lead to a deflationary vicious circle undermining consumption and investment. In any case, investment will not follow higher profits without the prospect of sufficient demand for the additional output.

In the long run, classical theories might be more pertinent as long-term growth depends on an increasing capital stock which also incorporates new technologies and permits the production of new products, so increasing productivity. Productivity is the key element. However, it depends less on macroeconomic policies, though full use of capacities increases productivity, too. It rather depends on structural change and microeconomic efficiency. Poor countries catch up with the productivity levels of rich countries by adapting to their patterns of production and consumption. Usually they shift labour and capital from agriculture into manufacturing and then into services. Specialization within the international division of labour will also increase productivity. However, to reap those benefits learning processes have to be organized which might be easier behind certain levels of protection, as Robert Wade argues in this volume.

In any case, structural change requires massive investment in new industries. Asian countries have guided capital into sectors they expected to grow. When these expectations are fulfilled, the successful enterprises can repay the loans and the financial sector and the state budget remain sound. The risk is obviously that misjudgement or too much bad money following good will create overcapacities and a debt crisis, which in turn endanger the whole economy. Expectations play a crucial role in this context. In open economies, the expectations of international financial markets also influence the fate of the national economy.

3. External determinants of growth in the wider Europe

Growth in the wider Europe depends not only on domestic policies but also on the international environment and the type of integration of the neighborhood economies in the world economy and with the EU in particular. Two ideal types of economy have to be differentiated which depend in very different ways on foreign trade and integration regimes: rentier economies and market economies. The former receive a large share of GDP from either exports of natural resources or transfer payments from abroad, usually aid. The dominance of these revenues in the national economy impedes the development of other economic activities, notably export-oriented production (the "Dutch disease"). State finances do not depend on tax revenues, which undermines the accountability of government and ruling elites. Both gain legitimacy by distributing the rent revenues among their clients rather than by democratic elections. This type of economy dominates in the Mediterranean, but also includes some Central Asian and Caucasus countries. Russia is virtually a rentier economy, albeit with other large economic sectors. The protectorates in Southeast Europe are rentier economies of a special type which depend on aid and the spending of protectorate agents living and working there.

The more or less "true" market economies are those countries which either joined the EU in 2004 or are candidate countries. These new member states and applicant countries are subject to constraints on their macroeconomic policies which are much more severe than those applying to the other countries of the wider Europe. All have to follow the rules of the international arrangements they have adopted (membership of IMF, World Bank, WTO and agreements with the EU), but EU membership and to some extent already candidate status involve a much stricter regime, particularly regarding trade policy, competition and industrial policies, monetary, and fiscal and exchange rate policy.

How do external integration and EU policies influence domestic growth? Let us consider five major policies: trade liberalization, aid, foreign direct investment, liberalising capital movements and euroization.

Table 2: Indicators of a rentier economy

Region/country	Share of commodities in exports	Share of taxes on trade in govt. revenue	Share of non-tax revenue	Share of import duties	Share of aid in govt. expenditure
EU-15	5	0	7	–	–
8 new member states[b)]	9	1.9	8.2	1.6	2.8
Bulgaria + Romania	18	3	16	3	6.3
Turkey	3	1	21	1.1	0.2
Western Balkans	11.2	10.5	14	6.8	1.3
Ukraine, Belarus, Moldova	10	5	12.3	4.7	13.7[a)]
Russia	62	13	15	5	1.5
Caucasus	62	8	5	7.5	82.7[b)]
Central Asia	57	7.7	11.3	7.6	66.8[c)]
Israel	2	1	13	0.7	0.3[d)]
Maghreb	42	12	9.7	12.7	1.1
Mashriq	34	19.3	26.3	23.7	15.1
Middle East	84	4.6	65.8	10.1	0

Notes: a) because Moldova (35 %); Ukraine 4.7 %, Belarus 1.1 %. b) only Georgia (lack of data). c) only Kazakhstan (4.6 %) and Tajikistan: 129 %! d) probably excluding military aid.

Source: calculations by Marius Kaiser on the base of data from World Bank, *World Development Indicators 2003;* note of caution: unweighted averages within each region/group of countries and incomplete data.

Trade liberalization

Trade liberalization is a major pillar of the internal Common Market of the EU itself and of all agreements and regimes offered by the EU to neighboring countries. The overall benefits and theoretical foundations of free trade have become more doubtful in the present global economic situation (Samuelson, 2004, p. 135–146, Milberg, 2004, p. 45–90). Trade policy has two components: (1) offering (preferential) market access to partner countries in the neighborhood; (2) requiring that these partner countries dismantle their own trade barriers. A variant of the second policy is to propose trade liberalization among several partner countries. The latter seems less self-serving as it offers more market opportunities to poor, less competitive countries rather than to the advanced economy. Let us consider both policies more closely.

1. Providing market access is certainly a potentially good policy. Clearly, it helps in the short term only if there is competitive production in the partner country which can be expanded to meet the additional demand created by the lowering of EU trade barriers. In the long term, it might provide an incentive to commence production of particular goods and services because of the better market access. Thus, it can lead to higher growth in the neighboring country. However, other measures could reduce the prices of these countries' exports in a much simpler way: for example, devaluation of its national currency (on the other hand, appreciation of the national currency, possibly as a consequence of increased exports, might reverse the impact of lower tariffs on the price in EU markets).
2. Trade liberalization on the part of neighboring partner countries is supposed to increase productivity and competitiveness. That desired outcome is expected to result from competitive pressures on the now exposed domestic producers and the lower costs of imported inputs. Both effects might be mitigated or reversed if higher imports lead to a decline in the external value of the local currency (that is, devaluation). However, there is no substantial evidence of trade liberalization leading to higher growth (Rodrik, 2001). Another side effect is the reduction of government revenue from customs duties. In many cases trade liberalization has led to higher budget deficits and increasing debt (Khattry, 2003, p. 401–421). Tighter budgets could lead to a decline in public spending and of the supply of public goods and services, which in turn could damage the competitiveness of local producers that rely on those inputs. More generally, taking the state out of

regulating trade might weaken its overall capacity to manage economic and social development (Rodrik, 2001). A developing state might need trade policy instruments to promote and protect learning processes of domestic producers, as Robert Wade points out in his contribution to this volume. Because levies on trade are also a source of rents (for example, by granting exemptions from import duties to special interests) and often feed corruption, it is also expected that liberalization will reduce those opportunities and lead to leaner and cleaner governance.

In the end, the weak effects of trade liberalization are hardly surprising. The overall welfare effects of free trade are largely exaggerated, and in any case not equally distributed (Weisbrot and Baker, 2002). The EU has been rather protectionist, and where market access has been offered, poor countries have seldom been able to exploit the opportunity. The major beneficiaries have probably been foreign investors able to take advantage of suitable locations and their trade preferences as intra-company trade makes up a large and growing share of international trade.

Aid

Aid is the second major pillar of all agreements and regimes offered by the EU to neighboring countries. EU assistance has been heavily criticized. Former British secretary of state for international development Clare Short called the Commission "the worst development agency in the world" (Santiso, 2003, p. 4–5). That assessment was by no means new, but rather coincided with a much older critique of aid, going back to neoliberal critics (Bauer, 1981). It is corroborated by large-scale studies by major donor agencies (World Bank, 1998, 2001). The poorer a country is, and the lower its Human Development Index, the less it benefits from aid (See Stephen Kosack's contribution to this volume and Kosack and Tobin, 2003). In fact, aid might often do more harm than good. If it is financial aid in the form of loans, it also increases the debt burden. Aid is also an additional source of rent income that feeds patronage systems. In the end, the productive use of aid depends largely on the cultural-political environment on the recipients' side. It has a positive impact when the recipient government is truly committed to development and has adopted appropriate policies (good governance) which it can make work not only within its immediate reach but throughout the country.

Foreign direct investment

Foreign direct investment (FDI) seems to provide a way out of the impasse of underdevelopment when market access cannot be used because of the lack of competitive domestic suppliers and aid is wasted. Foreign investors bring not only capital – which local entrepreneurs could also have borrowed – but know-how regarding production techniques, quality, marketing and management in general. A number of international success stories are based on attracting lots of foreign investment: Hong Kong, Singapore and – more recently and closer to home – Ireland, Hungary and other countries of Central and Eastern Europe. Although a high level of FDI seems to be a sufficient condition of rapid growth, it is by no means a necessary one (Mencinger, 2003, p. 491–508). The effects of FDI on successful development are often overestimated, particularly in poor countries (Milberg, 2004, Kosack and Tobin, 2003, Nunnenkamp, 2004, p. 99–118). Poor countries usually host the lower end of global commodity and value chains and are often unable to upgrade their position. "After their transition to capitalism, a number of Eastern European countries, for all their skill accumulation and proximity to the rich market of the European Union, saw their presence across commodity chains reduced to the low end" (Milberg, 2004, p. 78) In contrast, Japan, South Korea and Taiwan, for instance, largely forwent foreign investment during their catch-up development.

And perhaps wisely so. FDI carries a hefty price tag that might well be higher than borrowing on the international financial markets, though it is less risky, should an investment project fail to generate profits. Ireland proves this point, having relied on massive inflows of FDI which it attracted by offering low corporate tax rates, a cheap and well educated (English-speaking) workforce, decent infrastructure and a range of other business-friendly policies. Part of that attraction has been achieved by using EU regional aid cleverly. When these investments started to produce at full capacity, Ireland was transformed within a few years from one of the EU's poorhouses into its second richest economy, measured in GDP per capita. However, an increasing share of value added in Ireland – that is, its gross *domestic* product – has gone to foreign investors, reducing the share of wages in GDP to the unusually low level of 58 per cent (the – also declining – EU average is about 78 per cent) and putting its gross *national* product – that is, the income of Irish citizens – about 20 per cent below its GDP. Ireland's success thus remains above all the success of tax-avoiding foreign investors at the expense of other countries' and Ireland's tax revenues and Irelands' workers (Dauderstädt and Witte, 2001). Nevertheless, this strategy might be the best way out of poverty.

However, it would be difficult to replicate the Irish model for large countries without an English-speaking workforce and governance structures that learn even more slowly than the Irish, who needed almost 20 years after EU accession to start their economic miracle. The stock of foreign direct investment in Ireland amounted to 176 billion euros or 157 billion USD (UNCTAD, 2004a) in 2002 and employed around 150,000 workers (Forfás, 2004, p.4, UNCTAD, 2004a). This implies an average investment of 1,000,000 USD per job. The absorption of the seven million or so unemployed in the new member states would require new investments of seven trillion USD, almost equal to the current global stock of FDI (2003: eight trillion USD) and exceeding by far the total flow of FDI into the region since 1990 of about 120 billion USD – less than the Irish stock (UNCTAD, 2004b, p. 2–3, tables 1 and 2, UN-ECE, 2004, p. 205, table B.17).

Liberalizing capital movements

Free movement of capital is one of the four key elements of the EU's Single Market. Member states – including the new ones – have to open their capital markets, although many important technical problems, such as mergers, remain to be resolved. Candidate countries have to get ready by liberalizing their capital markets, too. More generally, most neighboring countries have to some extent liberalized capital movements by, among other things, allowing their citizens to hold their savings and incur debt in foreign currencies. National holdings of foreign currencies have increased substantially, as Hansjörg Herr shows in this volume. The impact of this freedom on growth is ambiguous, as several crises (Czech Republic in 1996, Asia in 1997) have shown. Currency competition, combined with open capital markets, has led to high levels of real interest rates in many poor countries with comparatively weak currencies (that is, virtually all currency areas except USD, euro, Yen, British Pound, and Swiss Franc) which in turn curtail economic growth.

The main advantage is obviously better access to capital (foreign savings) which improves one of the supply-side conditions of economic growth. If foreign investors overestimate the profitability and underestimate risks, the influx of capital can lead to asset price bubbles and inflation in general, which are difficult to control. Rising interest rates, a usual countermeasure implemented by national monetary authorities, might even attract more foreign capital. A subsequent implosion of the bubble often triggers a more profound recession than the fundamentals of the economy justify. A further disadvantage is the real appreciation of the national currency, either by the aforementioned inflation or by a stronger exchange rate, which reduces competitiveness and increases imports. The backlash, when foreign and domestic investors realise the decline of sales opportunities, can lead to capital flight. Since nationals, in such an open economy, can also move their savings into other currencies, capital flight can turn into a run on the national currency and exacerbate the crisis.

Adopting the euro

Countries and international financial institutions have recommended and tried various exchange rate regimes in order to prevent such crises. All regimes have their advantages and disadvantages. Historically, the Bretton Woods system of fixed exchange rates and state-controlled capital accounts has presided over a period of strong convergence and high growth on the European and Asian periphery. The collapse of the Bretton Woods system in 1972 coincided with the start of a period of lower growth and less convergence, though the causality remains an open question. In a fixed exchange rate regime, catching-up works through higher real growth plus higher inflation, while in a flexible exchange rate regime the nominal appreciation of the currency is possible and more important. Flexible exchange rates, however, bring with them the risk of overshooting and massive shocks to the real economy.

In the present system, most countries have, according to the conventional wisdom, the choice between flexible rates or a strong fix by a currency board or even the adoption of a strong currency like the USD or the euro instead of their national currency. Intermediate solutions like a peg are considered risky because they are virtually impossible to defend against strong trends in global financial markets. Different exchange rate regimes imply different roles for national monetary policy and different ways of managing the balance between nominal and real convergence. For the neighboring countries which usually trade chiefly with the EU the exchange rate vis-à-vis the euro is most important. As already mentioned, the intra-EU periphery (that is, Greece, Spain, Portugal, Ireland) has benefited substantially from joining Economic and Monetary Union, which has brought about low real interest rates. Adopting the euro is thus a very attractive option, though basically only for the new member states (except cases like Montenegro).

On the way to full euroization, there are certain risks, as Gabrisch in his contribution to this volume explains:

> *When the new member countries enter the European Exchange Rate Mechanism (ERM), their vulnerability to a financial crisis might increase. In recent years, exchange rate arrangements have preferred so-called corner solutions, such as floats and currency boards, and the risk of a crisis diminished. Adopting a new quasi-fixed peg regime – the ERM – will bring back some of the scenarios typical of financial crises in the past decade. Negotiations about central parity within the ERM might cause fears of last minute devaluation, and trigger off speculative attacks. Furthermore, the strong inflow of financial capital after ERM accession can lead to conflicts between fiscal and monetary policy objectives. The strong inflow might also impose new challenges to banking systems which are not yet effective in absorbing the inflow in accession countries. Finally, agents in accession countries might find it less costly and more convenient to make the changeover to the euro before official euroization takes place. Then currency substitution might cause instability of the exchange rate. The safe way of avoiding additional risks would be to speed up the process of official euro adoption for Slovenia, Estonia and Lithuania, which already participate in the ERM. The other countries should prepare for ERM entry by moving first to a currency board.*

Orlowski, also in this volume, largely concurs:

> *In the final passage toward the euro, currency board arrangements are perceived as the optimal policy strategy for the smaller candidate countries that have already adopted them. The larger candidates may opt for alternative policy solutions ranging from early unilateral euroization to modified versions of inflation targeting, all of which embrace the exchange rate stability objective to different degrees. Monetary policy adjustments ought to be tailored to individual countries' conditions in order to minimise the cost of relinquishing monetary autonomy in each case.*

The attractiveness of unilateral euroization underlines the need to promote growth in the neighboring countries by appropriate currency regimes that are supported by the monetary authorities of the natural anchor currency, the euro, that is, the European Central Bank and the EU itself.

4. Conclusion

National macroeconomic policies and international economic regimes, such as exchange rate and trade regimes, have a crucial impact on growth in the poorer neighboring countries. Unfortunately, traditional EU policies are not the most appropriate for promoting growth and cohesion in the wider Europe, including the new member states. Trade liberalization, compensatory aid in the form of regional policy within the EU or aid – usually loans to finance infrastructure projects – and capital account liberalization have seldom led to catching-up growth. In light of the contributions to this volume, these dire facts can hardly be surprising.

As Robert Wade argues, on the basis of East Asian successes, it is not the free play of market forces but the clever use of public policies by the developing state that leads to rapid growth. Stephen Kosack also stresses the fact that the usefulness of aid and FDI depends on the quality of economic governance in the recipient country. However, many of the neighboring countries are in a worse predicament. Contrary to resource-poor Japan, Korea, Taiwan, Hong Kong or Singapore they enjoy the easy riches of rent income from commodity exports (or foreign aid). Abdelkader Sid Ahmed shows why such economies are even harder to turn around and to transform into innovative and competitive market economies. Even economies that do not suffer from the "resource curse" face new challenges because of currency competition. Hansjörg Herr is afraid that, under the conditions of liberalized capital accounts, it will become less and less possible to establish a virtuous circle of credit expansion, investment and savings. Adopting the euro seems to be an attractive escape route for neighboring countries which should deliver lower interest rates and macroeconomic stability. However, as Hubert Gabrisch and Lucjan Orlowski point out, this option is currently reserved for EU member states and requires careful management of the transition.

Are there better policies? The answer is a qualified "yes". Some policies are probably better but face political resistance, either on the EU side or on the side of powerful domestic elites. Access without barriers to the large EU market would certainly help the partner countries in the wider Europe more than insistence on dismantling trade barriers on their side. Unfortunately, East Asian type trade management and industrial policies would probably fail without a profound change in the administrative and political culture of the neighboring countries. The EU could insist on more transparency – not to mention tighter democratic control – in the use of rent revenues originating from the EU, such as earnings from commodity exports. That option might carry more weight in the case of some African countries than vis-à-vis powerful oil exporters. Similarly, aid and FDI flows should be subject to political conditions requiring sensible public policies from the recipient countries. The most powerful effect could be expected from cooperation in the field of monetary and exchange rate policies. Both sides, the EU and the neighbors, should try to smooth out the process of nominal catch-up and to prevent crises due to the irrational behaviour of financial markets, such as overshooting or investment booms driven by herd instincts rather than cool analysis. Eventually, active growth policies in the EU are important in securing demand for exports from the wider Europe and to lubricate structural change towards a new division of labour.

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East Asia's development strategy: Lessons for Eastern Europe

Since the end of communist regimes in Eastern Europe, policy makers and policy analysts in these "transition" states have resolutely turned away from learning about East Asia's development experience. They have been very keen, on the other hand, to learn about Western European and North American experience – for this is the world they wish to join, or rather, re-join after the communist hiatus. With few exceptions, they understand the causes of the prosperity of Western Europe and North America through the lens of "liberal" economics – as due, in large part, to the combination of (a) liberal markets for goods and financial assets only lightly restrained by public regulation, (b) well-defined and well-enforced property rights allowing secure profit-taking by owners, and (c) the rule of law, which makes government, and all other economic agents, subject to a common set of rules. This is the combination they wish to copy, in the expectation that it will yield "catch-up" growth. To the extent that they pay attention to East Asia's catch-up experience, they understand it to validate the same model. To the extent that they acknowledge the existence of pro-active industrial and technology policy in either Western Europe or East Asia, they treat it as an aberration or decoration on the central thrust for largely free markets.

The last thing Eastern European policy makers and policy analysts want is a state that intervenes to alter the composition of economic activity within their borders; for this is what the communist state did, to disastrous effect. Therefore, a society organized around the free market is the only choice, they think. Hence the Eastern European consensus about catch-up development strategy involves:

a) market liberalization and accompanying institutional reforms, with a special accent on "getting the state back out" of the economy;
b) privatizing state-owned enterprises, and privatizing the provision of public services (water, power, health, education) to the extent possible;
c) becoming members of the European Union, or for those currently not eligible, entering a preferential trade arrangement with the EU;
d) attracting lots of foreign direct investment (FDI), in anticipation that it will produce for export sale and help upgrade the low quality of the existing capital stock;
e) attracting lots of aid (in the form of regional funds for the new EU members).

What is wrong with this consensus? Several things. First, liberalization exposes their producers to direct competition with China and other East Asian producers in sectors with diminishing returns. Second, FDI is not likely to be an important means of catch-up. Not much FDI has entered the region since 1998: between 1998 and 2003 Eastern Europe, the CIS, and ex-Yugoslavia received only three percent of world FDI. And most of that was motivated by domestic market sales, not by the use of low-wage, low-tax platforms for producing exports to high-income markets, because Eastern European wages are far above those in much of East Asia while labor productivity is no higher(Collignon, 2004). Third, in these conditions radical liberalization may yield immiserizing growth, a "race to the bottom" (working harder to stay in place).

On the other hand, some sort of delinking strategy based on integration among groups of near-by countries outside the EU is not a promising alternative, though regional integration may be useful as a supplement.

Sooner or later these bad choices may induce Eastern European policy makers and policy analysts to reconsider the thrust towards free markets as the route to catch-up development, and then to engage in a more open-minded way with the East Asian experience of the developmental state. The start of wisdom is to recognize that central planning is not the same as central allocation. Communism discredited central allocation. But central planning in the broad sense – public authorities intervening to alter the composition of economic activity within their borders, in line with an economy-wide exercise in foresight about the economy's future growth, in the context of a *capitalist* economy – has been alive and well in East Asia, and should – this is my subtext – be seen as an opportunity in Eastern Europe.

Though it must never be called "central planning", because the term is automatically illegitimate in the eyes of the powers that be. "Governing the market" sounds more acceptable.

In this paper I summarize my understanding of *some* of the roles of the state in economic development in capitalist East Asia (South Korea, Taiwan, Japan), first in the post-Second World War decades, then in the last decade or so. Fuller argument is given in the new edition of my book *Governing the Market* (2004). I wish to emphasize that (a) a lot of the sectoral industrial policies and programmes used in East Asia were of a rather modest kind, yet in aggregate probably very effective in accelerating the transformation of the economy into higher value-added activities; (b) they did not require sophisticated calculations and a highly skilled bureaucracy; and (c) other developing countries can and should adopt the same *norms* of industrial policy, even if with still more modest, blunter instruments.

This is to reject the view of an economist as sophisticated as Howard Pack, who concludes from his study of Japanese and Korean industrial policy from the 1960s onwards that the benefits to Japan and Korea were modest, even in the 1960s when the benefits were highest, and that,

> *Countries attempting to extract the benefits from an industrial policy that Japan and Korea obtained [NB: this implies that they did obtain some benefits] have to possess not only an exceptionally capable bureaucracy but also the political ability to withdraw benefits from non-performing firms … [Thus, developing] countries should be exceptionally cautious before embarking on such policies (Pack p. 1).*

If Pack is right, industrial policy should not be on the agenda of Eastern European governments. But he misses a whole swathe of East Asian industrial policy of a different kind to the big-scale, picking the winners kind that he concentrates on.

1. Why the liberal explanation of East Asia's catch-up is wrong

But first I need to give some indication of why I think the conventional liberal explanation of East Asia's catch-up growth is wrong – not entirely wrong but substantially wrong. Recall that the mainstream economics literature does present the catch-up as due in large part to steady liberalization of markets: first, liberalization of the trade regime, then, liberalization of capital movements in and out; both accompanied by a steady lightening of the hand of the state in the domestic economy, a steady deregulation and privatization of state-owned enterprises. All the attention is focused on the retreat of the state from the "import-substitution industrialization" phase, when the state tried to change the composition of economic activity.

In the conventional liberal explanation the liberalization of the trade regime receives central importance, as the key condition facilitating the rapid growth of exports. According to a major World Bank study, countries with "outward oriented" trade regimes have shown very much better performance on a range of indicators than countries with "inward oriented" trade regimes. The Bank concludes that the causality is from trade regime to economic performance, and that the correlation between outward orientation and better performance holds not just across countries but for one country across time: the cross-sectional evidence strengthens our confidence that countries will experience improved economic performance as they liberalize their trade regimes. But the argument is full of holes. To give just a few illustrations:

First, the World Bank study's conclusion that outward oriented trade regimes have better performance than inward oriented ones obscures a contrary finding. The study took two time periods, 1963–73 and 1973–85, and for each period classified 41 developing countries in terms of four categories of trade orientation: strongly outward oriented and moderately outward oriented, and strongly inward oriented and moderately inward oriented. The moderately *inward* oriented countries had better performance, by most measures, than the moderately *outward* oriented cases. The result that the Bank celebrates – outward oriented trade regimes have better performance than inward – comes from aggregating the two sub-categories. The "strongly outward oriented" cases have such good performance indicators, and the "strongly inward oriented" ones such bad performance indicators, as to reverse the results for the "moderately oriented" cases.

Second, the sub-category of "strongly outward oriented" includes just three cases, Hong Kong, Singapore and South Korea. They are all East Asian, which raises the possibility that their outstanding performance has more to do with "East Asia" than with "liberal trade". Moreover, the performance of the sub-category is mostly Korea's, which swamps the other two. Without the one case of Korea, the overall conclusion about outward oriented regimes having better economic performance than inward oriented ones would not hold.

Third, to describe Korea's trade regime in 1963–73 and in 1973–85 as "strongly outward oriented" is in any case a gross mischaracterization, given that the sub-category is defined as one where "trade controls are either non-existent or very low. … There is little or no use of direct controls and licensing arrangements". The study adds another criterion when defining the "moderately outward oriented" regime, namely, low variation of effective protection rates to different sectors of the economy; and we may presume that this criterion should also apply to the strongly outward oriented cases. There is plenty of evidence that these criteria do not fit Korea's trade regime in either period (see Wade, 2004, chapter 1 and 11).

One piece of evidence comes, ironically, from the *locus classicus* of the belief that Korea got rich by having a liberal trade regime, and it is worth citing in order to see how the liberal conclusion has been reached by selective inattention to data that would upset the liberal way of seeing things. The long-term World Bank consultant, Bela Balassa, coordinated an intensive study of the trade regimes of six developing countries based on data from around 1969. The study defined a liberal trade regime as having two basic characteristics: (1) low average protection; (2) low variation (or dispersal) around the low average – that is, uniform protection across all sectors. The study found that for Korea and Taiwan, the average level of protection of manufactures in 1969 was relatively low. This was the key finding that supported the picture of a liberal trade regime.

Strangely, the study did not draw attention to another finding that can be drawn *from the same data*. Dispersion of protection around the relatively low average was quite high. Korea and Taiwan did not have a uniform level of protection. Within manufacturing, different sectors had quite different levels of protection. The data in Table 1 illustrate.

Table 1: Trade Regimes, incentives to sell on domestic market or sell abroad, developing countries around 1969 (%)

	Taiwan	**Korea**	**Colombia**	**Argentina**
Effective protection to mfg	14	13	35	112
Intersectoral dispersion	23	47	56	35

Source: Wade, R., Governing the Market, tab. 3.2, p. 56, based on Balassa 1982.

It is likely that these differences were deliberate, the result of government intention reflecting the wider industrial development strategy (rather than accidental, or the result of cronyism). In contrast, where the level of average protection is high (Colombia, Argentina) it is more likely that a given degree of dispersion around the high average is not intentional but accidental.

In short, even the study regarded as the *locus classicus* of the image of East Asian capitalist economies as having liberal trade regimes provides evidence that disconfirms its own conclusions.

Furthermore, the conventional neoliberal explanation is wrong about timing, and therefore about the causality from trade liberalization to growth. Recall that it says that trade liberalization gave a strong propulsive boost to the growth of exports and thus to broader economic growth. Dani Rodrik has shown that this is not the observed sequence. One does not find a big improvement in incentives to export preceding the take-off in exports, but one does find a big improvement in investment incentives thanks in large part to government policy changes. First came a surge of investment (in the case of Taiwan, around 1958–60) while trade incentives remained largely unchanged, then rapid growth of exports, then faster growth, then accommodating liberalization of trade. "The lesson from East Asia is clear", says Rodrik. "[T]he three East Asian 'dragons' with low investment rates in the early 1960s – South Korea, Taiwan and Singapore – would not have been nearly as successful had their governments not given capital accumulation a big push by subsidizing, cajoling and otherwise stimulating private investors. The evidence from East Asia and elsewhere shows that investment booms produce economic growth as well as greater export orientation [and higher imports]" (Rodrik, 1999, p. 63).

The observed sequences in East Asia better fit the hypothesis that "as countries grow richer they liberalize trade" than the hypothesis that "trade liberalization propels countries to become richer". The priority to investment is not specific to East Asia: a step-up in investment seems to be a nearly-necessary condition of a step-up in growth rates. Rodrik concludes: "Countries that are able to engineer increases in their investment efforts experience faster economic growth". On the other hand, the cross-country correlation between decade-average investment rates and decade-average GDP growth rates (1950–1990) is not particularly strong (World Bank, 2000, figure 9).

What about the World Bank's *East Asian Miracle* study, published in 1993? It examined eight high-performing East Asian economies (not including China), and applied a range of tests to examine the impacts of industrial policy. About the impacts of *sectoral* industrial policy (targeted at specific sectors, such as chemicals or semi-conductors) the study says, "industrial policies were largely ineffective" and: "We conclude that promotion of specific industries generally did not work and therefore holds little promise for other developing countries" (p. 312, 354).

It also concluded that even had they been effective in East Asia, their administrative/political conditions are so demanding (for example, in terms of the sophistication of the calculations for identifying sectors for special promotion) that few other developing countries could achieve the same success. "[T]he prerequisites for success [such as it was] were so rigorous that policy makers seeking to follow similar paths in other developing countries have often [read, usually] met with failure" (p. 6). If this sounds like Howard Pack, quoted above, it is no accident; for he wrote the chapter in the *Miracle* about the impact of industrial policies.

I and others have shown why the *Miracle's* evidence is not convincing (Fishlow et al., 1994). To give just one reason: the problem of capturing "externalities", or spillovers from one sector to another. It turns out to be very difficult to track the effects of spillovers across sectors. Yet they are real. Some critics of industrial policy have used the lack of correlation between the amount of subsidies and protection given to sector X and the growth of productivity in sector X, or even to a negative correlation, as evidence of industrial policy failure – or even of "picking losers". But the test ignores the point that East Asian government gave various kinds of resource help to "infrastructural" sectors like steel and basic chemicals not mainly to promote productivity growth in those sectors but to have spillover benefits on the users of steel and basic chemicals.

The World Bank has been a leading proponent of the idea that East Asia got rich because it liberalized markets and followed the policy mix later called the "Washington Consensus". *The East Asian Miracle* was a Bank research report; and the Balassa et al. study was sponsored by the Bank, while Balassa worked as a defacto Bank staff member (de facto, because formally he was a long-term consultant). In appraising the evidence of these and other Bank studies, it is important to bear in mind that the staff see themselves as – like it or not – speaking for the organization. The External Affairs Department instructs staff (including research staff) as follows: "Crucially, staff contemplating a speech, article, opinion/editorial, or letter to the editor must realize that a disclaimer that the speaker or writer is expressing personal views is unconvincing and usually ineffective. It also does not exempt the staff member from following procedures, or from recognizing that they speak for the institution". (See Ellerman, 2004, p. 151)

To its credit, though, the *Miracle* study does recognize that its evidence is hardly conclusive. "… we cannot offer a rigorous counterfactual scenario. Instead we have to be content with … analytical and empirical judgements" (1993, p. 6).

2. East Asian industrial policies: (I) The catch-up phase

To think constructively about industrial policy, one has to distinguish at least three types. First, economy-wide "functional" policies, that include exchange rate policies, macroeconomic balance, competition policies (including average level of protection). Second, multisectoral "horizontal" policies, that include incentives for R&D, incentives for "small and medium enterprises", investment in port infrastructure, and the like. Third, sectoral policies, to promote specific sectors or subsectors or firms – the Proton auto firm in Malaysia, for example (See Barnes, Kaplinski and Morris, 2004). Most of the debate concerns the latter – did it matter in East Asia and could it work elsewhere? Immediately one can intuit how difficult it is to separate out the effects of the latter from the effects of the first two, because of the mutually-supporting relationships among them.

No industrial policy champion would claim that the third type, sectoral policies, can work with inhospitable policies of the first and second types.

Part of the problem of getting evidence specifically on sectoral policies' impacts is that the policies entered into the assessment tend to be of the kind, The Ten Year Plan to Develop the Petrochemical Industry. What this misses is a great deal of activity "below the radar screen", which may have rather small public expenditure costs but which in aggregate probably has had a powerful effect in raising the average level of technological and production capacity of East Asian firms.

Taiwan, for example, had an Industrial Development Bureau (IDB) comprising, in the 1980s, some 200 engineers and allied professionals, and a sprinkling of economists. Much of the work was organized by input-output chains. The specialists in the chain that included, say, glass, monitored carefully the imports of glass, the buyers of imports, the production capacity of Taiwanese glass makers. As part of their job they were required to spend several days a month, at least, visiting firms in their sector. (They were not allowed to have lunch with members of the firm they were visiting.) The aim of their monitoring and visits was to find opportunities to "nudge" the process of import replacement and export promotion, by using various kinds of administrative methods of "encourage" the big buyers of imports to switch from importing to local sourcing once they judged that domestic suppliers could meet the quality and price of imports, provided they had a long-term supply contract and some technical help.

In the case of a transnational company, Philips, importing specialized glass for its televisions, the IDB officials informed Philips of the potential for switching, indicated that they would look favourably on other Philips' requests if it saw its way to switching. Philips said no. Then Philips began to experience longer and longer delays in its applications to import the specialized glass, which had previously been granted immediately. Philips protested to the minister, who apologized profusely, said he would look into it. The delays continued. Eventually Philips got the message and switched. The domestic suppliers undertook the needed investment in quality, and later were in a position to start exporting (Wade, 2004, p. 285).

The point is that this sort of nudging of firms into higher value-added products – and jolting of transnational firms and domestic firms to establish domestic supply relationships – has been going on across many sectors, case-by-case, for many decades in Taiwan. It has required an honest, competent cadre of public officials with skills in engineering and finance – though not a particularly large one; and an array of instruments on which to draw, which may include some capacity to manage trade (as in the Philips example) but may also include a wide range of non-trade measures for encouraging and discouraging. It has *not* required the sort of subtle strategic trade calculations that seem to be required – according to conventional strategic trade theory – in the case of cutting-edge high tech industries in the advanced industrial economies.

There is no question that it is difficult to pin down the quantitative effects of this sort of below-the-radar intervention by public officials – whether positive or negative. All we can be sure of is that a great deal of it was going on over decades, all the time, with a dedicated cadre of public officials to do it.

3. East Asian industrial policies: (II) Forging ahead

Today Taiwan has reached the technological level of middle-ranking OECD countries – which is an astonishing, almost unprecedented achievement given its starting point around 1950. But it remains well behind the world technology frontier in most sectors. For all its commitment to WTO principles the state continues to exercise economy-wide foresight, continues to shape the composition of activity within its borders, does not let "the market" take its course.

Linda Weiss and Elizabeth Thurbon remark that "the practice of governing the market is not just about policy – GTM [governing the market] is also, and perhaps more importantly so, about the normative environment that sustains the *will* to govern the market, and the *legitimacy* of governing the market as perceived by actors in the polity. This is a point often overlooked in the mainstream literature …, which typically bases its claims on observed *policy* changes since the [financial] crisis [of 1997–98 – that is, claims that the Taiwan government has given up governing the market since the crisis]. The assumption is often that if a state has relinquished certain pre-crisis policies … it must also have abandoned a commitment to GTM and be acting in ways broadly consistent with the norms of competitive liberalism." (Weiss and Thurbon, 2004, p. 63). They relate that the entrance to the Industrial Development Bureau is emblazoned with a quote from Goethe, that captures the difference at the level of *norms* between a government role based on strategic economics and one based on liberal economics: "the most important thing in life is to have a goal, and the determination to achieve it".

The Taiwan state continues with the organizational structure of the developmental state:[1]

- A pilot agency located in the very heartland of the state and chaired by the third ranking political leader in the state (the vice premier), called the Council for Economic Planning and Development;
- An operational agency that does the "nuts and bolts" of industrial policy, the Industrial Development Bureau described earlier, located within the Ministry of Economic Affairs;
- Industry associations by sector, membership of which is obligatory, whose secretary is semi-appointed by the government and is responsible for *two-way* interaction between the member firms and the government (and hence not likely to let the association become a center of political resistance to government);
- Public R&D laboratories, notably the umbrella agency, the Industrial Technology Research Institute (ITRI), with a staff of some 10,000 scientists (by the mid 1980s) organized in more sector-specific labs; and an even bigger military-oriented counterpart.

The essence of the political process of national development is intense dialogue between these organizational components of the developmental state. Earlier,

1 On the organizational structure of the developmental state (with specific reference to Korea) see Chibber, V., *Locked in Place,* Princeton University Press, 2003.

the first two tended to call the tune and the others responded; since democratization in the late 1980s the balance of power has shifted towards the labs and the industry associations. In particular, much of the brainstorming takes place between ITRI labs and industry associations, which helps to build inter-firm networks with *reliable* collaboration between members.

Commonly, an ITRI lab incubates a specific technology (eg Radio Frequency Information Devices, a type of chip), gets it to pre-commercial stage, takes out patents, and then spins off a sort-of private firm, to which it gives the patents in exchange for equity. Often the senior managers of the firm are ex-ITRI, or part-time ITRI. This technique has been used for many initiatives, including the import-replacement of bottleneck components whose recurrent delays in importing are impairing Taiwan's entry into advanced sectors. In this and many other ways, the state helps to assume a large part of the risks of research and development of technologies to commercialization stage.

Emphasis is given to promoting *nationally-owned* firms, with limits placed on the operation of foreign firms (eg foreign service firms). All the time, the apparatus of the developmental state is looking for ways to maximize technology spillover from foreign firms (abroad or in Taiwan) into the heads and hands of local firms. Equally, however, the apparatus is actively involved in building up a large stock of Taiwan-owned firms operating abroad – building up *outward*-FDI – so that Taiwan is more of a reciprocal partner than if it were only playing the role of a periphery welcoming inward-FDI from the center. Taiwan's outward FDI in China is well known; but it has also built up a large stock in other developing regions as well as in the core regions of the world economy (Japan aside).

The underlying competitive strategy for the nation is based on recognition that its firms, being some way off the world technology frontier, must seek to capture second-mover advantages. Its firms are mostly unable, yet, to capture the brand-name advantages of first movers. They must be able to chase hot products developed by first movers, push up production of specified items quickly, and exploit scale economies before profit margins become paper-thin. For this strategy large firms, not networks of small and medium enterprises, are increasingly needed – large firms which are able to produce in large volumes and which are big enough to be of interest to first-mover firms as subcontractors (Ansden and Chu, 2003).

The government's role is to push on with industrial policy of *all three* of the types distinguished earlier. In particular, to promote "industrial complexes" or "urban economic commons" or "growth poles"; and to promote moves in many industrial and service sectors – but often with sector-specific and even firm-specific instruments – into higher value-added parts of global value chains (such as into manufacturing-related service industries, MRSIs, as part of which the Radio Frequency Information Device mentioned earlier was developed, see Weiss and Thurbon, 2004).

I have been talking about Taiwan. Singapore, Japan and China also retain major features of the developmental state. South Korea, on the other hand, has gone some way to dismantling what used to be a model of the type. The dismantling began in the late 1980s, with democratization and the discrediting of military rule – and by the same token, discrediting of bureaucratic rule. Like a swing in fashion, many Korean economists and public officials converted to neoliberal economics of a fundamentalist kind, with US-trained Korean economists in the role of modern missionaries. Their ideas acquired power from their resonance with the interests of the large Korean conglomerates, like Samsung, which by the late 1980s had reached the point of organizational and technological sophistication where they saw the state as more of an obstacle than a help. And the G7 states particularly focused on Korea with demands that it open its markets, to avoid "another Japan". By 1995 the Economic Planning Board – the pilot agency since the early 1960s – had in effect been abolished, and the capital market had been largely opened up for foreign borrowing and foreign financial service firms.

Yet even in Korea things are not what they seem to be. Norms of "governing the market" continue. That is, the government continues to have a legitimate role in steering and coordinating the strategies of the private sector – it coordinates a governance arrangement spanning government and autonomous but interdependent firms, though not (as before) a commander of specific outcomes.

Take telecommunications liberalization, as an example of gradual liberalization carried out in a way calibrated to retain a substantial presence of nationally-owned firms while facilitating their achievement of world frontier capabilities.[2] Before the early 1990s telecommunication services in Korea were provided by two public enterprises (Korea Telecom and Korea Mobile Telecom), backed by a history of heavy government regulation in equipment and telecom services. Then in the late 1980s and early 1990s a new technology, dig-

2 This account of Korea's telecommunication strategy is based on information in Whasun Jho "Liberalisation as a development strategy: new governance in the Korean mobile telecom market", Working Paper, Institute of Social Science, Yonsei University, Seoul, 2004.

ital mobile telecommunications, appeared on the world frontier. This promised a much higher demand for mobile services and accompanying infrastructure. The conglomerates wanted to diversify into telecoms. The US government pressed Korea to open its telecom market to US firms; as did the prospect of GATT/WTO membership. For all these reasons the Korean government had to privatize and liberalize the sector.

But the government recognized that telecoms would be a "leading sector" on a world scale in the coming decades, and that Korea had to maintain a strong presence of Korean-owned firms. The Ministry of Information and Communications (MIC) began to liberalize by privatizing the mobile carrier in 1993;[3] a year later licensed a second private carrier; two years later (1996) licensed three more private carriers. It allowed foreign telecom firms to invest in the private Korea firms; but only up to a limit of 33 percent of total equity. It also restricted the share of equity that could be owned by Korean manufacturing companies to less than 10 percent. It limited new entrants in their choice of equipment, favoring Korean equipment makers, which constituted an entry barrier for foreign firms; it also limited their technology standards to government-approved ones. The whole process was aimed at developing a strong indigenous telecom capacity before full liberalization, quite contrary to what the US government had in mind.

At the same time, a parallel project was under way to use a public-private partnership to do the R&D for CDMA (Code Division Multiple Access) digital transmission technology, especially because the leading foreign telecoms firms would not sell advanced technology to the Koreans. The Ministry formed a technology development network, with the government-sponsored Electronics and Telecommunications Research Institute (ETRI) linked to the former public telecom company and to a number of private Korean manufacturers, each with an assigned task. Much of the funding for this network came from the sale of shares in the privatized public enterprise. The proceeds were also used to subsidize the uptake of demand for telecommunications services, including internet access, making a virtuous circle between supply and demand. And a further loop was created by requiring new entrants into the service market to use products and standards developed in this R&D consortium.

As the new entrants proved themselves competitive, several of the measures used to incubate the Korean infants were eased; the limit on the share of equity held by foreign firms and by Korean conglomerates was raised to 49 percent in 1999, and the restrictions on the choice of equipment were also lifted. By this time Korea's signing on to the WTO telecommunications agreement in 1997 was also pushing in the same direction.

The overall results of this "phased liberalization" have been spectacular. Korea jumped from being a nobody in world telecommunications in the early 1990s to being a major player in the early 2000s. It has the highest broadband penetration in the world. The Korean telecommunications case illustrates the virtues of gradual liberalization orchestrated by the state in line with national development objectives, where those objectives give weight to national ownership in important sectors.

4. The theory of governing the market

It is one thing to say that governments in East Asia remain committed to governing the market; but is there any theory which might suggest why such actions might be effective at promoting rapid economy-wide development?

Conventional economic analysis stresses that any attempt by public agents to change the composition of economic activity away from that which results from well-functioning markets is bound to be ineffective, bound to thwart the expansion of comparative advantage along whose path sustainable development lies. Measures such as protection, or domestic content or export performance requirements, withdraw resources from more productive uses and reduce consumption. Export requirements, for example, may worsen the trade account by reducing the export potential of *other* industries.

But once the underlying assumption of perfect competition is replaced with an assumption of oligopoly – a small number of firms and barriers to the entry of competitors – the argument changes. In particular, the argument changes when there are increasing returns to scale such that only some of many potential production sites can be established, and when there are learning-by-doing economies which give advantages to firms which establish production early. In these conditions there is scope for states, not to "create" comparative advantage or "pick winners" out of thin air, but to shape and direct comparative advantage. These conditions occur frequently in the mid-tech industries of Eastern Europe and the mid-tech and high-tech industries of East Asia.

For example, states can intervene in order to accelerate the move of chunks of productive activity from exist-

3 Also in 1993 the government began to privatize the other public telecom company, Korea Telecom, but slowly. By 2002 it had sold 57 percent of shares of KT stock to the public, including foreigners.

ing high-cost sites abroad to host country sites, faster than "the market" would. Case studies of transnational corporations show clearly that corporations operating in conditions other than perfect competition – which is the normal case – are often *slow* to react to price signals at the margin, even when they are well-informed about profitable opportunities to shift locations. This is especially so when rearranging intra-firm operations as in re-locating production out of the core regions to a cheaper-labor site, or switching suppliers from a high-cost one at home to a cheaper one in a developing region – would incur substantial exit costs.

The case of automobile production in Mexico provides an illustration. Ford and Volkswagen established assembly and engine plants in Mexico in the 1960s, with a large part of production intended for export. From this experience it became clear to them and to other auto firms that big cost advantages were to be reaped. Yet by the late 1970s their investments remained relatively small, far from world-scale capacity and far from being integrated into their global sourcing network; and other major auto makers had not followed them in establishing Mexican plants. So in 1978–79, Mexican industrial policy officials, aware that US car makers were under competitive pressure at home from Japanese imports, decided to enforce a 1977 decree that linked access to the domestic market to exports: "if you fail to meet an escalating export schedule your domestic sales will be cut". The first to respond was General Motors, which in 1979 announced the biggest one-time investment in its history, to be placed in Mexico. Other auto makers soon followed GM's lead in announcing plans for major expansion of exports from Mexican sites, in order not to lose share in the Mexican domestic market. But this was 16 years after Ford and Volkswagen first began to show the cost advantages of Mexican sites!

> *They and the other auto firms had resisted international comparative advantage for a long time, and it took the "jolting" of Mexican officials to break their lock-in to exit costs and other intra-firm rigidities (Moran, 1991).*

The more recent case of auto production in South Africa provides another illustration. Here the government after 1995 introduced an export-import link system (similar to that in Mexico), such that an auto firm's access to the domestic market (with current sales of around 350,000 light vehicle units a year and expected to grow) was made conditional on export performance, either of finished vehicles or components in the value chain. In addition, several complementary programs – formulated and monitored by an auto industry development council, comprising representatives of assemblers, component makers, retailers, trade unions, government, plus a few academics – who met every six weeks – helped to improve business organization and labor relations up and down the supply chain. The whole programme was designed to harness the rivalry between the big three German auto makers, but also Toyota and Ford, to the benefit of the South African economy. Justin Barnes et al. show that the selective policies targeted at the auto industry were almost certainly effective by several measures of effectiveness, and that they did not require large public expenditures or a sophisticated bureaucracy making sophisticated calculations (Barnes et al., 2004).

5. Conclusions

The general point from all this is that there is a body of theory, or theoretical insights, at hand to support a strategy of governing the market in a developing country context (including Eastern Europe). The thinking is based on ideas of economies of scale, learning-by-doing, second-mover advantages, stickiness in location decisions of TNCs, and the arbitrariness of much of "comparative advantage" (Toner, 1999). And there is also some relevant empirical evidence, even if its conclusions about effectiveness are open to dispute – though no more so than the evidence which purports to show the fallacies of government efforts to change the composition of economic activity.

The case studies show that the task for industrial policy strategists in identifying products or sub-sectors for targeting is not necessarily difficult, at least in middle-income countries. It involves estimating domestic costs and quality of production, comparing them with import prices and quality, estimating demand elasticity, and so on, the same sort of calculations as transnational corporations make every day; and it involves understanding the bargaining tactics of transnationals and how to turn them to national advantage. In the Eastern European case it is important for industrial policy strategists not to think only of inward-FDI, but also of outward-FDI as a strategy – using banks awash with funds to make mergers and acquisitions and perhaps green-field investments in core economies. This perspective helps to shift thinking out of the center-periphery mindset where the periphery sees its salvation in obtaining resources from the center. Again, Taiwan and other East Asian cases show how the government can help to orchestrate these outward-investments in line with a national interest.

The more difficult task is not the policies themselves, but designing an industrial policy bureaucracy – even if not the larger developmental state, as above – which is motivated to achieve its intended objectives and operates with relatively little patrimonialism. But relatively meritocratic agencies like Taiwan's Industrial Development Bureau should not be beyond the wit of many Eastern European states to create and empower to do the same sorts of tasks as Taiwan's, even if patrimonialism remains in some other parts of the state.

In the end, the main obstacle to success lies at the level of the norms: the legitimacy of efforts by public agencies to change the composition of economic activity. Taiwan's Industrial Development Bureau emblazons the Goethe quote upon its escutcheon. The "international development community" and the transnational community of economists, on the other hand, take as their norm the sentiment captured in the remark of Sir Terence Burns, chief economic advisor during the Thatcher years: "if we can't make money by manufacturing things, we'd better think of something else to do", or the remark of Herbert Stein, chairman of the Council of Economic Advisors during the Reagan years: "if the most efficient way for the U.S. to get steel is to produce tapes of 'Dallas' and sell them to the Japanese, then producing tapes of 'Dallas' is our basic industry" (see Wade, 1992). Burns and Stein reflect the assumption that the competitive model is a reasonable approximation to the real world; the Goethe quote, as operationalized in Taiwan, reflects the assumption that the real world is better understood in terms of oligopolistic markets, where governing the market has potentially big payoffs.

Eastern European economists and policy makers believe Burns and Stein at peril to their economies' catch-up with the West.

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Abdelkader Sid Ahmed

Transforming Mediterranean rentier economies: Globalisation and convergence

Introduction

In May 2004 at the Dublin conference of foreign ministers of countries which had signed the Barcelona Declaration in 1995, the European Union reiterated its members' willingness to implement a strategic partnership in all areas. This new so-called "Neighbourhood Policy" vis à vis the European periphery – Eastern and Southern Europe – is being introduced in close proximity to the enlargement of June 2004. Almost 10 years after the Barcelona Declaration, this policy finds itself in a very different context: globalisation has become irreversible, the Asian financial crisis of 1997 has shaken the foundations of the Washington Consensus, and a new regionalism, followed by a new liberalism, are emerging, particularly within the Pacific zone – not to mention the expansion of the European Union. Once again, actors such as China, India and Brazil are making their voices heard and – particularly in Asia – are imposing new regional arrangements (APEC, for example).

In the face of all these changes, the most striking feature of the Arab region is its lack of change – structural reforms remain, at best, half-hearted. The region appears to be "petrified", incapable of imagining a new development model which would enable it to emerge from the semi-stagnation in which it has languished since the 1980s. Almost 10 years after Barcelona and six years prior to the proposed aim of a common zone of mutual prosperity, economic convergence – particularly with the neighbours to the North – is not in prospect. Due to the absence of productive and dynamic systems, efficient bureaucracies and strong elites, the Euro-Med partnership remains nothing more than an illusion. The economic liberalisation embarked upon within the framework of structural adjustment and the Barcelona Declaration has barely benefited the general population, its fruits having been appropriated by the countless special interests in the importing and exporting business linked to the ruling elites. The Arab world remains divided into four zones: Maghreb, Mashriq, the Gulf States and Sudan–Yemen at a time when real systems of regional governance are being implemented elsewhere. Foreign investment, negligible in volume, is still not going where it should, with adverse consequences for development, in addition to finance. Even worse, the massive capital flight unmatched anywhere else in the world, as well as a serious "brain-drain" – the exact reverse of the situation in East Asia in the course of its development – are imposing an even greater strain on the region. Hydrocarbons (i.e. oil and gas) have "oilified" the entire region either directly or indirectly – and bolster the social classes most impervious to reforms. Due to a lack of appropriate action by partners at different levels and dynamic systems of production, the Euro-Med partnership has not been in a position to promote a dynamic Euro-Med zone after the fashion of new regionalisms elsewhere and, even less, a monetary regionalism which would reinforce its stability in the face of dangers inflicted by monetary and financial crises provoked by the uncontrolled degradation inherent in the Washington system.

This powerlessness of the region, even with the aid of the European Union, to promote dynamic development reflects the current situation which is characterised, amongst other things beyond the colossal windfall gains from oil in 2004, by massive unemployment, particularly amongst educated young people, nearly stagnant growth, inefficient bureaucracies, legal and illegal emigration (particularly to Canada, Australia, and so on) of the educated, and a distancing from the European Neighbourhood Policy in all areas. Beyond Barcelona, the following question must be posed: what role can the European Neighbourhood Policy play?

This study attempts to respond to this question by:

- making as exhaustive an appraisal as possible of the situation on the periphery of the Mediterranean, broadened to include the rest of the Arab world, which should be taken into account particularly because of the international stake in oil and gas;
- trying to learn development lessons from past and present experiences in other developing countries, especially emerging countries;
- taking stock of the most recent economic, monetary, financial and institutional reforms and, more generally, various new forms of regulation.

Particular importance is attached to the Asian experiences, on the one hand because of their interest for the identification of possible "development paths", but also on account of the different solutions adopted in connection with the 1997 crisis.

Naturally, it is a question of identifying possible development and regulatory models adapted to the region, in addition to the necessary policies and instruments. The aim here is to identify elements of a growth strategy and of a correlated macroeconomic framework for the European periphery. We emphasise the means of transforming rentier economies within a globalised framework with a view to genuine economic convergence with the EU neighbours. It is also a question of creating a monetary, financial and fiscal order and developing macroeconomic strategies which could improve the regulation of rentier economies.

1. Transformation of Arab rentier economies: scope and limitations

Southern and eastern periphery of the Mediterranean

There are fundamental differences in the post-war period between the Arab periphery, which was still colonised or semi-colonised (with the exception of Turkey), the European economies which had been devastated by the war, and the Asian countries. Per capita income was very low on the Arab periphery, and technological and economic dualisms in Boecke's sense were very pronounced. Indeed, the expansion of European industry at the end of the eighteenth century, accompanied by the strong demand for raw materials (cotton and wine in a first phase, oil later) and for markets, was accompanied by the emergence of a periphery characterised by strong export sectors for these products and underdevelopment in the rest of the economy. Hence the increasing dualisms which Boecke analysed historically in relation to Indonesia. Unemployment, illiteracy, underemployment, pandemics, destitution, and so on, became worse in these economies, further aggravated by the appropriation of the most fertile land in the Maghreb, particularly in Algeria (as was the case in Rhodesia, now Zimbabwe) by a minority, thus confining the majority to the mountains (Boecke, 1953; Issawi, 1966 and 1982; Sabagh, 1997, Amin, 1974; Sid Ahmed, 1985–1996; Owen, 1981; Landes, 1998). When these countries became independent, their economies had all the marks of underdevelopment: extremely low savings, investment and income per capita; a lack of administration, local frameworks and, in particular, entrepreneurs; a range of structural dependencies: nutritional, technological, financial, and so on; and, last but not least, a lack of infrastructure beyond that constructed to satisfy the needs of the colonial economy.

A clear indication of extreme poverty is the fact that the per capita incomes of native Algerians were only 10 per cent of those of foreign minorities in 1965, a difference which was repeated in Morocco and Tunisia (Guillot, 1960). As early as 1931 Maurice Violette published L'Algérie vivra-t-elle? (Will Algeria survive?). In the same spirit, M. Louis Chevalier in a work published in 1947 – "Le problème démographique nord-africain" (The North-African demographic problem) – observed that in 1936 Algeria "did not have enough to assure the subsistence of a large part of the population". Concerning Libya, Higgins noted in 1959 that "if Libya [could] be brought to a stage of sustained growth, there is indeed hope for every country in the world" (Higgins, 1959, p. 26). Thus prior to 1950, the Arab countries experienced some of the lowest levels of socio-economic development in the world. The majority of these countries did not even have economic statistics for the first half of the twentieth century. Periodic epidemics, malnutrition, high mortality rates, adult illiteracy and a low percentage of persons in full-time education, were typical (Owen and Pamuk, 1998).

Development versus growth. The Arab exception

From the 1950s onwards, the majority of Arab economies adopted a development model characterised by a strong state and heavy emphasis on redistribution (Richards and Waterbury, 1996). Key features of this model included: similar economic and social policies, largely shaped by the preferences of the state concerning economic priorities; policies of industrialisation, substitution and importation; programmes of agricultural reform, nationalisation of domestic and foreign private enterprises and assets, educational development and house building; and the construction of infrastructure, health care and consumer subsidies.

These policies were accompanied by various protectionist measures in relation to the national economy (trade, local commerce, professional associations), as well as a one-party political system which, to varying degrees, left the state with a political monopoly. Generally speaking, social transformation, political mobilisation and revenue distribution (Algeria, Egypt, Syria, Turkey, Iraq) were left to the state. In Morocco, Jordan and the Gulf States, the state directly supported the emerging private actors. As observed by Ayoubi, however, although these differences explain the variations in

Table 1: Growth in output, capital and total factor productivity by region (per cent per worker)

Region	Decade	GDP	Physical capital	Human capital	Total factor productivity
Middle East and North Africa	1960s	0.0	5.4	0.7	3.4
	1970s	3.8	10.0	1.3	–1.0
	1980s	0.3	2.4	1.4	–1.5
	1990s	0.7	0.1	1.3	–0.2
Sub-Saharan Africa	1960s	2.8	3.6	0.3	1.2
	1970s	1.4	3.2	0.3	–0.1
	1980s	–0.9	0.6	0.7	–1.6
	1990s	0.4	0.7	0.6	–0.2
South Asia	1960s	2.1	4.0	0.6	0.2
	1970s	0.6	1.9	1.0	–0.7
	1980s	3.6	3.1	0.9	1.9
	1990s	2.7	3.3	0.9	0.9
East Asia and the Pacific	1960s	2.6	2.9	0.7	1.0
	1970s	3.7	6.2	0.9	0.7
	1980s	5.9	6.1	1.0	2.9
	1990s	7.0	8.4	0.7	3.2
Latin America and the Caribbean	1960s	2.7	2.9	0.5	1.2
	1970s	2.9	4.0	0.6	1.0
	1980s	–1.7	0.2	0.9	–2.3
	1990s	2.7	2.9	0.5	1.2
High Income/OECD	1960s	3.3	3.8	0.7	1.4
	1970s	1.5	2.2	1.5	–0.2
	1980s	1.6	1.9	0.2	0.7
	1990s	1.6	2.0	0.6	0.4

Note: Regional averages weighted by average labour force over period.
Source: Yousef, T. (2004)

the region's development experiences and all these policies featured the twofold interventionist and redistributive objective at the beginning (Ayoubi, 1995), the reasons for this fundamental policy orientation are to be sought in a variety of factors beyond what they share with the rest of the world (major crisis in the 1930s, state building under leaderships which retained control over many years). Particularly worthy of mention is oil revenue which played the primary role in the adoption and maintenance of this development model, as much in the exporting as in the non-exporting countries (Sid Ahmed, 1983, 2000; Al Nasrawi, 1986; Beblawi and Luciani, 1987; Chaudhry, 1997; Terry, 1997).

In the important oil-producing countries such as Libya, Saudi Arabia, Iraq and Algeria, oil revenue made it possible to create welfare states prematurely. In other countries – particularly Morocco, Tunisia, Syria, Lebanon, Jordan and Yemen – redistribution was facilitated by revenues from abroad such as workers' remittances and various types of aid from oil producing countries, including from private investors in these countries.

These factors shaping the social contract made the southern and eastern shores of the Mediterranean exceptional in terms of development trajectory. Whereas in the post-war period numerous poor countries adopted interventionist and redistributive policies, the Arab countries stood out – with the exception of the communist bloc – as regards state regulation of the economy, the importance of military spending and the role of social policy as an instrument of redistribution (Waterbury, 1994).

These differences concerned as much the economic, social and political changes which reshaped the political economies of the region – including the considerable military spending – as relations between state and private sector, but also the sharpness of regional conflicts (Yousef, 2004, p. 95). In the 1950s, 1960s and 1970s the region recorded quite remarkable economic performances and social development. In the 1950s and 1960s the leaders of the boom were Egypt, Jordan, Lebanon and Syria; afterwards, economic success was characteristic of countries with surplus capital: the Gulf States, Libya, Algeria and Iraq.

Table 1 presents regional economic performance in comparison with other regions of the world, as well as its determining factors on a percentage per worker basis.

Massive public investments were made in infrastructure, health care and education, whilst public sector companies invested in protected industries (import substitution). These investments made it possible to mobilise under-utilised capacities by stimulating industrialisation. For this reason, economic growth in the 1960s was 6 %. The oil boom took over in the 1970s, with one new aspect: the combination of a much more rapid rate of capital accumulation and negative productivity growth (Page, 1998).

Social indicators improved considerably with a massive expansion of public sector employment, migration opportunities and low open unemployment. At the end of the 1980s the region experienced a much lower rate of infant mortality, an increase in life expectancy, school attendance of almost 100 per cent, and an adult illiteracy rate which rose from 40 per cent to approximately 60 per cent. However, 5.6 per cent of the population lived on less than one dollar per day as opposed to 14.7 per cent in Central Asia and 28.8 per cent in Latin America (World Bank, 1995).

The strong growth rate of the 1950s through the 1970s reinforced the authoritarian state. As Vandewalle remarks, in exchange for economic security with a broad range of social services and a welfare state to varying degrees, Arab populations accepted the restrictions imposed in the political sphere (Vandewalle, 2003). Hence the governance gap observed in the region, which the World Bank attributes to the combined effect of oil and geopolitics, and also of conflict (World Bank, 2003). Since the end of the 1970s it has become obvious that the growth implied by the apparently favourable data did not reflect real development. In fact, the criteria proposed by Abu-Laban – administrative capacity, sustainability, stability, self-reliance, equity and empowerment – indicate that we are a long way from it. Briefly, the post-colonial administration was not in a position to respond to the different challenges presented by (1) population growth, with its attendant problems of schooling, urbanisation, imports and consumption, (2) an increase in state revenue and state spending and (3) an increasing need for regulation. More generally, Arab administrative systems turned out to be incapable of meeting the challenge of socio-economic development and creating conditions for citizen involvement (El Fathaly, 1983). Development cannot be reduced to the growth rates – however high – of economic and social indicators: the sustainability of growth is essential. Political and social systems have inhibited development in the following ways: excessive external dependence, a pyramid-shaped social class system (consisting of a very small upper class, a small middle class and a very large, deprived lower class), alienation, and the marginalisation of popular political participation (Barakat, 1997). Hence the conclusion drawn by many in the 1980s that unless Arab citizens could be involved in the development process there was little prospect of social transformation (Abu-Laban, 1986, p. 7). At the economic level, for example, growth is not tenable unless priority is given to local economic activity. A tenable growth strategy demands, amongst other things, a high degree of collective autonomy (self-reliance), popular participation in development programmes, greater emphasis on science and technology, an increase in employment opportunities and a fairer distribution of revenue (Sayigh, 1982, p. 136 and 137). The absence of coordinated and well-regulated change in the 1950s, 1960s and 1970s in a range of sectors in favour of forced industrialisation, which was supposed to be the solution to the problems of poor countries and to allow them to catch up with the rich countries, was called into question. The low level of interest in agriculture and the extreme emphasis on growth based solely on oil and gas were particularly attacked,. The combination of external exploitation and internal social structure explains the region's failure to develop political institutions and social dynamics and to reach a higher level of development in the 1980s.

In 1992 Sayigh wrote:

> *The widest measure possible of collective (regional) self-reliance in development – not in the sense of isolation autarky – but in the sense of the acquisition by the region as a whole of greater productive capability and its success in the mobilisation of its human and material resources, and in the upgrading of the quality of these resources. Underlying and accompanying this specification is the need to improve the position of the Arabs in the world economy and its pattern of division of labour; the need to quickly and substantially remove the state of dependency on the advanced industrial countries and their [multinational corporations], with all the [exploitation], imbalance, and inefficiency that … dependency carries with it; and finally the desire and ability to contribute to the design and operation of the New International Economic Order, along with other regions of the Third World.*

Equity was not evident at the beginning of the 1980s: developmental changes had hardly been fair in relation to different groups and classes. Sharabi estimates, for example, that considerable oil revenue was distributed on a very unequal basis: 2 per cent of Arabs are rich, 10 per cent enjoy middle-class living conditions, but the remainder "close to 90 per cent, struggle for mere survival – typical daily life in the Arab world … is characterised by misery in wealth, by underdevelopment in development, by weakness in strength" (Sharaby, 1983, p. 301). Indeed, nothing indicates that there has been a "trickle down effect" in favour of Arab women who, with the exodus of men to the oil countries, increasingly came to take over the role of head of the family (female-headed households). Nevertheless, development programmes targeting women did not aim to empower them. Generally speaking, throughout the 1950s, 1960s and 1970s these programmes did not aim to strengthen human resource potential, nor did they result in a fair distribution of rights and obligations amongst citizens.

In view of these criteria, no Arab country, not even the oil states with their spectacular economic growth in the 1970s, exhibited significant development in the 1980s. Indeed, in the latter period, there was a growing secondary dependence among non-oil-producing states, on top of the primary dependence of the exporting countries, which have no control over demand for their crude oil and therefore cannot insulate their economies against the effects of demand swings. Secondary dependence results from the decline in funds flowing from oil-exporting countries to other poor countries, particularly from migrant workers.

Crisis in the post-independence development model and its successors

With the first jolts in the oil market during the first half of the 1980s, jolts which from 1985–1986 onwards led to the collapse of oil prices, it became more and more difficult for the exporting Arab states to meet the various commitments made in the euphoria of increasing crude oil prices: subsidies of all kinds to all social groups, expensive industrial projects, exponentially growing foreign debt servicing, replacement of equipment which had become obsolete. It became difficult to import the goods and technologies necessary for new investment. As low crude oil prices persisted – with the exception of the Gulf War – until 1999–2000, the entire region sank into a major economic and social crisis. Growth plummeted in direct relation to the fall in crude oil prices, which underlines the extreme dependency on the oil and gas sector which had developed since 1973 in the region as a whole. The fall in prices led to a severe reduction in the number of migrant workers and in their remittances, but also a more competitive international environment. With the decline in oil revenue, the states endeavoured to safeguard wages, which at the same time increased public debt. The "domestic regulatory environment" discouraged private investment and formed an obstacle to the development of industrial sectors oriented towards exports, thwarting the integration of the regional economy in globalisation processes.

The major macroeconomic imbalances brought about a sudden fall in investment rates. The rate of accumulation of physical capital fell by 75 per cent in the 1980s (see Table 1). Almost every country experienced a decline in growth of total factor productivity.

Table 2 presents developments in the Middle East and North Africa (MENA) region in terms of accumulation, productivity and growth in relation to global developments in the 1990s (Dasgupta et al., 2002, p. 21). The MENA region is defined in the sense of the World Bank, including all the Arab countries, Iran, Israel and Malta. Table 2 does not show increases in GDP and total factor productivity in the 1990s, but the changes which took place in GDP, accumulation of physical and human capital and total factor productivity growth between the 1980s and the 1990s.

Improvements have taken place in the MENA economies: Syria has performed best, but the three "reforming" countries of Jordan, Tunisia and Egypt have also made progress. At the same time, due to the significant decline of accumulation in most of the region the change in GDP growth (in global comparison) was not translated into significant improvements in the allocation and efficiency of factors of production (in Jordan, Egypt and Tunisia, for example). This substantial decline in accumulation in the course of the 1990s may be explained by the fall in public investment. The other, more probable explanation is that the improvement of productivity and the "efficiency allocation factor" increased rapidly in the 1990s without stimulating a response from private investment (in Jordan, Egypt and Morocco, for example) (Dasgupta et al., 2002, p. 22).

It appears that the response of the private sector has been very slow. It is not clear why the reform process, which had a certain impact on productivity, did not also generate a response among private enterprises in export-oriented sectors. Dasgupta, Keller and Srinivasan blame institutional factors: overregulation, "red tape" and government corruption (Dasgupta, 2002, p. 22). Surveys of businesses and potential investors reveal the role of the three components of "institutional capability" – red tape, effective judiciary and corruption – in the attractiveness of poor countries for foreign private investors. States turned to the private sector to attract foreign capital in the face of the collapse of national production and investment. In order to avoid the type

Table 2: Change in MENA's growth between the 1980s and the 1990s (%)

Country	Change in average GDP growth per worker	Change in average physical capital accumulation per worker	Change in average human capital accumulation per worker	Change in TFP growth
Syria	2.54	–3.06	–0.80	4.24
Jordan	1.07	–6.27	–0.71	4.00
Saudi Arabia	5.69	5.20	–0.27	3.77
Kuwait	9.11	7.64	6.47	2.17
Egypt	–0.99	–5.65	–0.66	1.67
Tunisia	0.84	–1.45	0.09	1.37
Iran	0.88	–0.57	0.23	0.97
Algeria	–0.92	–3.80	–0.46	0.88
Worldwide	0.74	0.24	–0.18	0.75
Morocco	–1.23	–1.35	0.12	–0.77
Oman	–4.10	–3.33	0.52	–3.08

Source: Dasgupta, D., Keller, J. and Srinivasan, T. G., (July 2002).

of economic crisis which tends to accompany the high growth of debt, budget and balance of payments deficits, but also to find an alternative to their modernisation failures, these states turned to business elites. The aim was to restore confidence amongst the general population by means of apparent "economic prosperity" achieved by means of the massive importation of consumer-goods – for example President Chadli's opening up of the economy in Algeria and his famous anti-poverty projects – and foreign investment. Restrictions on imports, foreign investment and private sector economic activity were also removed. Thus a start was made on economic liberalisation in the 1980s (see Barkey, 1992; Niblock and Murphy 1993 and Nonneman, 1996) within the framework of an alliance between bureaucratic elites and "traders importing luxury and consumer-goods and in pursuit of foreign markets for public corporations and foreign investors in a number of sectors" (Ehteshami and Murphy, 1996, p. 159). These new social strata linked to import-export activities were thus the beneficiaries of this transformation of the bureaucracy into a bourgeoisie, in the wake of economic liberalisation, which Barkey interpreted as being "the state elite's attempt to broaden the base of their support, especially since the state itself has been unable to resume its traditional role as the engine of growth" (Barkey, 1992, p. 6).

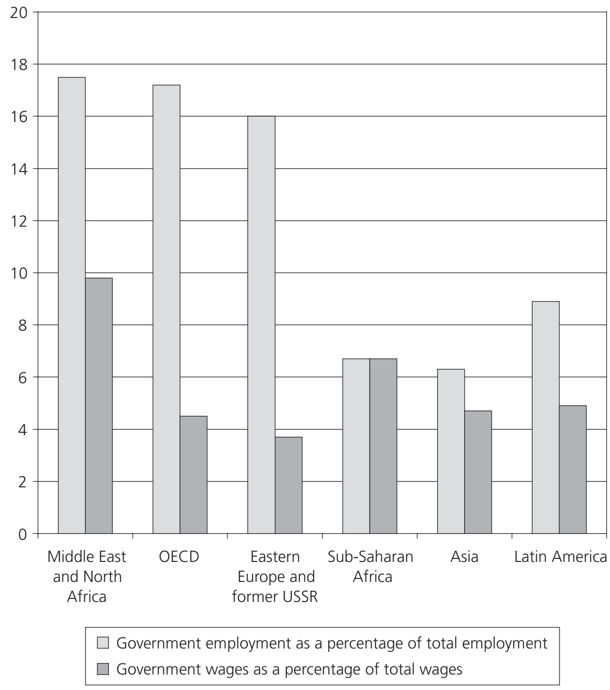
Thus the frequent acknowledgement that the states of the region which maintain their essentially rentier features are incapable of taking economic liberalisation sufficiently far to improve the living standards of their populations appreciably. On this basis, authoritarian responses to the break up of the "corporatist system could only lead to instability and chaos". The Arab strategy of economic liberalisation as a means of regime survival whilst strengthening the new business elites in alliance with the bureaucracy explains the slowness of economic reform and the region's exclusion from the general democratisation taking place in the rest of the world (Brumberg, 1995, p. 329).

In their study on civil society and democratisation in a comparative perspective (Latin America and the Middle East), Kamrova and More identify three "broad clusters of force" preventing the emergence of a democratic civil society in the region (Kamrova and More, 1998, p. 910). Despite the economic and social shocks of the 1980s, the states continued to hold the reins of power and did not succumb to the pressures of society. They were able to continue to "manipulate" cultural and social values in order to preserve popular legitimacy. By means of charismatic or patrimonial leadership, the link with Islam or populist clientism, the states survived and have successfully passed themselves off as guardians of the most important social values. Indeed, the rentier economy has permitted states to maintain mutually beneficial corporatist arrangements with certain social groups, thus reducing the demand for real political change and democratisation. Groups outside these corporatist arrangements are repressed (Cantori, 1995).

The Arab cycle of boom, bust and slow recovery (Yousef, 2004, p. 99) is explained by the dominant position of oil and gas in the economy. First analysed by Mahdavy (1970) and Amuzegar (1982), this topic was subsequently widened to include the North Sea in terms of the so-called "Dutch disease" (Corden, 1984;

Sid Ahmed, 1987–1990) and more generally the problems of mining resources (Roemer, 1979; Lewis, 1984; Beblawi, 1987), and more recently the so-called "curse of natural resources" (Auty, 2001; Ross, 2001). According to this last theory, countries with abundant natural resources suffer from a lower than average GDP growth performance. The inflow of external resources (positive external shock) which sets off the export of these resources increases the demand for non-tradable products, thus removing qualified workers, physical capital and entrepreneurial capacities from other sectors. This is also because the additional spending leads to a loss of competitiveness due to the real appreciation of the exchange rate. The tradables sector, particularly manufacturing and modern agriculture, are in decline despite economic growth. Countries with significant natural resources fall victim to "policy distortions" and "weak institutional structures", factors which seriously handicap the effectiveness of reforms aiming to reorientate economic activity and reduce public spending. This "curse of natural resources" in the present case is further aggravated by the past heritage of the hydrocarbon states. According to Luciani (1987, p. 65) there is an "allocation state" rather than a "production state", when income from oil and gas or other sources represents at least 40 per cent of total resources and (state) spending constitutes a substantial part of GDP. This heritage makes it difficult to abandon the "welfare programmes" established in the 1970s, as indicated by the riots in Egypt in 1977, in Morocco in 1983, in Tunisia in 1984, in Algeria in 1988, and in Jordan in 1989. The economic gains of "selective policy reforms" were often appropriated by the commercial elite who were close to the government.

Figure 1: Government Employment Around the World in the 1990s



Source: Schiavo-Campo, de Tommaso and Mukherjee (2003)

Challenges related to demography, employment and human capital

The Arab region is undergoing a demographic transition from high birth and mortality rates to low birth and mortality rates (Lee, 2003). From 1950 to 1980 the region recorded the highest fertility rates in the world, with seven children per woman (a demographic growth rate of approximately 3 per cent per annum). From the 1980s onwards, fertility declined, indicating weak demographic growth at the beginning of the third millennium (Rashad and Khadr, 2002). At its peak in 1985 demographic growth was as high as 3.4 per cent, falling to 2.2 per cent in the 1990s. Behind this tendency, amongst other factors, were improvements in sanitary conditions and women's education (Olnsted, 2003), but also later marriage, due to unemployment, lack of housing and so on. Former high rates of demographic growth led to an explosion in the working-age population: the 3 per cent recorded in the 1990s – as opposed to 2.1 per cent in the 1960s – was the highest rate in the world (see Table 3). This tendency should change from 2020 onwards. As well as being more numerous, young adults are also increasingly well educated. Following the efforts made to improve human capital, significant progress has been made in reducing the "gender gap" with regard to education and employment (Moghadam, 1998).

The significant increase in the quantity of educated labour in the 1980s, at the height of the economic crisis, brought about a serious deterioration in the labour market (Nabli and Keller, 2003). Unemployment rates of around 15 per cent (according to other sources far higher; see Yousef, 2004, p. 102) are among the highest in the world. First-time job seekers represent more than 50 per cent of the unemployed. This is also true of countries which export crude oil and previously imported manual labour.

This situation on the labour market reflects the inability of the former development model to draw demographic dividends from the supply of educated labour in the course of large-scale expansion. The total regional workforce amounted to 104 million in 2000 and can be expected to reach 185 million by 2020. It is thus a ques-

Table 3: Estimated and projected growth rate of total population and of the population aged 15–34, 1970/2000/2010

	1970–80		1980–90		1990–2000		2000–10	
	All	**15–34**	**All**	**15–34**	**All**	**15–34**	**All**	**15–34**
I. Mashriq								
Egypt	2.1	3.1	2.5	2.1	2.0	2.3	1.7	2.0
Iraq	3.5	3.4	3.5	3.6	3.3	3.8	2.9	3.3
Jordan	2.4	1.4	3.2	5.0	3.3	3.1	2.7	2.6
Lebanon	0.8	2.1	0.1	1.4	2.1	1.6	1.6	1.4
Sudan	3.0	2.7	3.0	2.9	2.9	3.1	2.7	3.1
Syrian Arab Rep.	3.4	4.8	3.5	3.7	3.5	3.6	3.1	3.8
Yemen	2.6	1.8	3.5	4.7	3.5	3.8	3.3	3.7
II. Maghreb								
Algeria	3.1	4.2	2.9	3.8	2.8	3.3	2.3	2.0
Libya	4.3	4.0	4.0	4.0	3.6	3.8	3.2	3.6
Morocco	2.4	3.9	2.6	3.2	2.3	2.4	1.7	2.0
Tunisia	2.2	4.1	2.5	3.4	1.9	1.9	1.4	1.4
III. GCC Countries								
Oman	4.1	4.1	4.2	3.1	3.7	3.8	3.6	4.5
Qatar	7.2	9.7	4.7	3.3	3.0	1.8	2.3	2.7
Saudi Arabia	4.9	5.5	4.1	3.3	3.8	3.7	3.6	3.9
Bahrain	4.6	7.4	4.0	2.4	2.8	1.6	1.9	2.3
Kuwait	6.1	6.1	3.9	3.5	2.6	1.5	1.8	1.8
UAE	15.2	16.7	4.5	–0.1	2.1	1.5	1.6	1.7
IV. Iran and Turkey								
Iran	3.1	3.9	3.4	3.2	2.3	3.3	2.4	2.3
Turkey	2.2	3.1	2.3	3.1	1.8	1.3	1.2	1.1
MENA	2.8	3.6	2.9	3.1	2.5	2.7	2.2	2.4

Source: United Nations (1993)

tion of creating 80 million new jobs whilst at the same time absorbing a significant part of those currently unemployed. In real terms this amounts to doubling the current level of employment over two decades. Employment in the public sector remains high despite significant cuts, as can be seen in Figure 1.

Public sector employment is very high by international comparison (industrialised countries and developing countries) and is reflected in the structure of the unemployed: high unemployment among young people with secondary or higher education compared with those with a lower level of educational attainment who cannot aspire to public employment. This reflects a situation in which a significant part of unemployment is due to the proportion of educated young persons whose CVs do not match the needs of the private sector who are waiting for a high-level post. This is because the education system is more preoccupied with preparation for public employment than the acquisition of qualifications in general which threatens to trap human capital in unproductive public employment, so limiting its contribution to economic growth (Yousef, 2004, p. 103).

The public sector cannot hope to absorb the unemployed. The oil sector by its very nature cannot absorb these job seekers either. It thus comes back to the private sector, the engine of growth, to respond to the challenges of high unemployment and low wages to boost employment in the region. However, this remains doubtful in a region in which the public sector still generates a third of value added and is involved in many strategic services, such as banks, telecommunications and transport. This situation does not seem to have changed much in recent years. Furthermore, it should be noted that the Gulf States, for their part, have succeeded in promoting a dynamic private sector, for example in fertilisers, cement, aluminium, tourism, commerce and manufacturing. With growth of 9 per cent per annum in real terms in the 1990s, the non-oil sector in the United Arab Emirates represented 70 per cent of GDP and 43 per cent of exports in 2000. This gave rise to an increase in employment of 8 per cent in the 1990s, leading to an unemployment rate of 2.3 per cent (Girgis et al., 2003).

Table 4: Quality of governance around the world

Region	Public accountability	Institutional quality
Middle East and North Africa	–0.78	–0.32
East Asia and Pacific	0.20	–0.11
Eastern Europe and Central Asia	0.37	–0.16
Latin America and the Caribbean	0.77	–0.09
OECD	1.89	1.38
South Asia	–0.29	–0.41
Sub-Saharan Africa	–0.41	–0.66

Notes: "Public accountability" assesses the level of openness of political institutions in a country; the degree and extent to which free, fair and competitive political participation is exercised, civil liberties are assumed and respected, the press and voice are free from control, violation, harassment and censorship; on how transparent and responsive government is to its people, and on how much accountability is found within the public sphere for 173 countries. 12 indicators from Freedom House (Political Rights, Civil Liberties, Freedom of the Press), Polity IV (Polity score, Regulation, Competitiveness and Openness of Executive Recruitment, Regulation and Competitiveness of Participation, Executive Constraints), PRS (Democratic Accountability), and WB-CPIA (Transparency and Accountability) are used.

"Institutional quality" assesses the risk and level of corruption and black market activity, the degree and extent to which certain rules and rights are enforced (ex. property rights, business regulations, procedures, and so on), the quality of the budgetary process and public administration, the efficiency of revenue mobilisation, the quality of bureaucracy, and the independence of civil service from political pressure for 173 countries. Ten indicators from PRS (Corruption, Bureaucratic Quality), CPIA (Property Rights and Rule-Based Governance, Quality of Budgetary and Financial Management, Efficiency of Revenue Mobilisation, Quality of Public Administration) and HWJ (Property Rights, Regulation, Black Market) are used.

Source: Yousef 2004, p. 98

Unfortunately, such favourable developments are only found in the Gulf States. In the rest of the region, half-hearted reforms and the general environment discourage entrepreneurship, restructuring and business creation. Small and medium-sized enterprises face great administrative obstacles and problems in gaining access to capital, insofar as the public banks continue to control the financial system (an average of 60 % of credits granted through the bank system) and tend to favour public enterprises, large industrial companies and offshore enterprises. These difficulties are aggravated by the "weak enforcement of property rights" and corruption. (see table 4)

Indeed, numerous kinds of inflexibility burden labour markets and hinder the private sector. One such burden is the social security systems – with the guarantee of life-long employment, generous pensions and other advantages – granted when the post-independence model was at its height. Job markets have barely been deregulated to encourage job creation, agreement having been reached with the employers in a number of cases to exclude new entrants. Hence the increase in informal employment and the precariousness of formal employment in the private sector. Even radical labour market reform would not guarantee the job increases required over the coming decades, as the Latin American example shows (Gill, 2002).

2. Globalisation and convergence: strategic elements in light of East Asian experiences

Strategies for convergence: defying or following comparative advantage?

We have already seen the difficulties encountered in making a transition to a market economy in those regional economies in which relative prosperity is paralysing reform. In other words, the relative softness of the budget constraints diminishes the urgency of reform. Indeed, many states have benefited from revenue generated outside the domestic economy: oil exports, remittances from expatriates and foreign aid (Luciani, 1994; Vandenvalle, 2003). In the past decade these revenue flows made it possible to alleviate the impact of stagnation and reduced the urgency of reforms, including those with an influence on sustainable development in the medium and long term. In this context the European proposal of a Euro-Mediterranean Partnership (EMP) in November 1995 as an attempt to establish a shared Euro-Med co-prosperity zone in 2010 appeared to be a "lifeline". Indeed, the Barcelona Declaration demands the promotion of balanced and sustainable socio-economic development. The objective of a shared prosperity zone by 2010 postulates the promotion of strong growth at unprecedented rates (in double figures, as in the Far East). There cannot be *convergence in real terms* with EU economies without strong and sustainable growth. In their study on the historical "catch up" of Puerto Rico, the so-called "fifth tiger", Baumol and Wolff identify three crucial factors in its success (Baumol, 1986; Wolff, 1996).

1. Investment: two factors influence increases in labour productivity: technological innovation and capital accumulation from savings (excluding accumulation from rents). Innovation and the international transfer of product development played a key role in Puerto Rico's productivity convergence, but also in the case of the other "tigers". Substantial capital accumulation influences the implementation and general application of innovations.
2. Education: the role of education is confirmed by Mingat for the Asian economies (Mingat, 1998).
3. The extent to which the economy has been opened up: this is important, not so much in relation to exports, but rather in relation to opening up to imports and new technologies. More recently, the conditions of convergence between developing countries and developed countries were analysed by Lin (2003, p. 277). He observes that since 1945 many governments in developing countries have adopted measures to industrialise their economies, but only a small number have succeeded in raising their per capita income to the level of developed countries, primarily in the Far East: Japan, Singapore, Taiwan, South Korea and Hong Kong.

The failure of the bulk of developing countries to converge with the developed countries in terms of economic performance is largely to be explained by their governments' "inappropriate development strategies". After 1945, most states elaborated development plans in which the accent was on the development of certain capital-intensive industries. In this way the optimum industrial structure of an economy is endogenously determined by its endowment structure. Often government industries are not viable in open competitive markets because they do not enjoy a comparative advantage. Therefore the state introduces a series of distortions into its external trade – in the financial sector, the labour market and so on – in order to support unviable companies. As a result, the economy becomes very inefficient due to the misallocation of resources, characterised by rampant rent seeking, macroeconomic instability, and so forth. Convergence does not take place. These states should centre their development efforts on "upgrading the endowment structure" rather than on "upgrading the technological/industrial structure". Once the endowment structure is "upgraded", companies will be led by their desire for profits and competitive pressures to "upgrade" their technologies and industries. Upgrading the endowment structure implies a rapid accumulation of capital – physical as well as human. Capital accumulation depends on economic surplus or profits, and on the propensity to save in the economy. If a developing country develops its industries according to its comparative advantages, its economy will benefit from the maximum economic surplus and from the highest propensity to save, thus obtaining "the highest possible upgrade in its endowment structure". With the pursuit of this strategy, a developing country will obtain even faster upgrades of its endowment, technological and industrial structures than developed countries, and so achieve convergence. Thus if the price structure reflects the abundance of capital, labour and natural resources, companies will choose their technology/industry according to comparative advantage. The price structure will reflect the relative abundance of each factor if prices are determined by competitive markets. The state should therefore monitor markets and ensure that they are functioning well. As far as Lin is concerned, the government is the most important institution in the economy. Its economic policies shape the structure of the macro-incentives facing companies. Lin distinguishes between two types of development strategy: (1) the comparative advantage-defying (CAD) strategy which aims to encourage companies which ignore the existing comparative advantages of the economy in their entry choice of industry/technology, and (2) the comparative advantage-following (CAF) strategy which aims to facilitate an enterprise's entry choice of technology or industry according to the economy's comparative advantages.

The first strategy (CAD), which constitutes the predominant model in developing countries, supports unviable companies by means of a whole series of distorting measures, affecting interest rates, foreign exchange rates, and other prices, not to mention administrative measures involving the allocation of resources at "distorted prices" to companies in priority industries, allowing them to adopt high technologies in advanced industries for which the economy does not enjoy a comparative advantage. This results in an unstable macroeconomic framework, unequal revenue distribution, an uncompetitive economy and an inability to converge with developed countries.

According to Lin, the CAF strategy is the better option: the optimum industrial and technological structure of an economy is endogenously determined by the economy's factorial endowment structure. Indeed, the CAF strategy will encourage companies in developing countries to specialise in industries in which the country has a comparative advantage and will facilitate the adoption of appropriate technologies by borrowing at the lowest cost from the advanced countries. The economy will be competitive. The endowment factors and the industrial and technological structure "will enjoy rapid upgrade" (Lin, 2003, p. 298). High growth rates will result and convergence will take place. In order to achieve this, the state must maintain markets which are free and open. Industrial policy should aim to facilitate "the firm's upgrading of industry/technology" by confining itself to sharing information, coordinating investments and compensating the "first movers" for their additional costs.

The experience of the four Far East "tigers", according to Lin, constitutes a good illustration of the merits of the "CAF strategy". At the outset these countries were very poor, their level of industrialisation very low, their foreign exchange reserves limited and their per capita income very low. They had to select a development path which was suitable for them. Right at the outset they implemented an "import substitution CAD strategy", renouncing heavy industry at this stage. Starting from their own factor endowment, they promoted labour-intensive industries, as well as exports, and developed "outward-oriented economies" in order to maximise their comparative advantages. In the developed countries – the United States, Europe and Japan – "labour intensive industries" were rapidly being replaced by "technology- and capital-intensive ones" due to the abundance of capital and rising wage levels. The four "tigers", however, had an abundance of cheap labour. Also, when the comparative advantages of the developed countries moved into "more capital- and technology-intensive industries", the "tigers" were able to capitalise on the dynamic opportunities. Via "trade linkages" and the opening up of their economies, "labour-intensive industries" relocated there from the developed countries. The tigers became very competitive and achieved rapid capital accumulation by maximising their comparative advantages. Hand in hand with the latter and the changes in comparative advantage, it was possible to gradually upgrade them in the direction of "capital-intensive and technology-intensive industries". They maintained growth for over 30 years and converged towards the developed countries. This strategy, according to some, may be explained by the limited supply of natural resources in these countries (Ranis and Syed, 1992), but also by their low populations (Lin, 2003, p. 293). The "CAD strategy" which the Arab region has pursued for decades is thus ineffective as well as expensive. It cannot be maintained for long without the availability of significant natural resources, such as oil and gas. The higher the quantity of natural resources per capita, ceteris paribus, the more the state will have to mobilise resources in order to keep the "CAD strategy" alive. For an economy with limited natural resources and a low population (Jordan, Lebanon and Tunisia, for example), such a strategy leads rapidly to economic crisis. Reforms and a change of strategy thus became necessary (Edwards, 1995).

The CAD strategy also leads to an increase in macroeconomic instability. A number of studies show that the volatility which ensues can affect long-term growth (Barro and Sala i Martin, 1997), thus delaying convergence. Indeed, such a non-viable strategy can only exist in connection with preferential loans, trade barriers, and so on. If the comparative advantages are not properly exploited, the economy cannot be competitive, "no dynamic changes" in comparative advantage can be achieved and economic performance is thus hampered. This, in turn, is reflected in a weak financial sector, crisis-prone external accounts, tax deficits, intolerable debts and a generally weak financial situation. The macroeconomic instability becomes unbearable. This was confirmed by the Asian crisis of the 1990s. Taiwan, Hong Kong and Singapore were slightly affected, whereas South Korea, Thailand and Indonesia were hit hard due to their different development strategies, close to the CAD strategy (Lin, 2000). The CAF strategy leads to sustained economic growth on the basis of labour intensive industries, with the creation of more jobs, rising wages and greater participation by poor population sectors in the prosperity provided by growth. This is the opposite of the post-independence model centred around more capital-intensive industries with poor job creation potential (Stiglitz, 1998). The major challenge posed by unemployment in the Arab region today and in coming decades can only be addressed by a strategy of this type. This also applies to improving revenue distribution and expanding markets. Taiwan has thus been able to develop on an equitable basis (Fei, Ranis and Kuo, 1979).

The accumulation of human capital is also essential in the CAF strategy. It influences the "upgrading of factor endowments" and thus the "rapid upgrading" of industry/technology. Thus the Taiwanese companies which had become innovative in the electronics sector experienced a "Positive Feedback Loop Innovation System" or POLIS in the whole of the economy (Khan, 2002, p. 299). Even if it results from imitating the industry and technology of developed countries it must be adapted to local conditions (compare South Korea: Kim 1997; Nelson 2004). Human capital growth makes it possible to boost a country's adaptation capacity. The reduction of the "industry/technology gap" with the developed countries is accompanied by a shift of mature industry/technology towards new frontiers (Caselli, 1999; Acemoglu, 1998) which are more uncertain. Human capital requirements increase with economic development because such capital becomes increasingly complementary to physical capital within the new technology frontiers. This assumes an accumulation of human capital hand in hand with the accumulation of physical capital in the convergence process; in other words, the accession to a knowledge society, as was the case with the "tigers", particularly Singapore which has been able to position itself as a "regional education and training hub" (Low, 1998, p. 34). Trade policies cannot provide the sole explanation for the export success of the Asian countries. The accumulation of human capital has made an essential contribution to the increase in labour productivity (Lloyd and Togushi, 1996, p. 10).

For the accumulation of capital, the optimum industry/technology structure is endogenously determined by an economy's endowment structure. In order to achieve the industry/technology structure of developed countries, a developing country has to reduce the gap between "factor endowment structures" (FES). The upgrading of the FES implies capital growth relative to labour. Capital accumulation depends on the volume of the surplus/profits generated by companies and on the savings rate of economic actors. By assuming the CAF strategy, a company in a given economy enters an industry where it has a comparative advantage and has adopted the "least cost technology" (Lin, 2003, p. 289). This guarantees maximum profit levels and maximum savings. The state, furthermore, does not distort the prices of factors and products, and does not create legal monopolies, which eliminates "rent-seeking activities" and the waste this involves. Such a company will have a tight budget and make a profit by improving management and competitiveness. The scheme is reversed with the CAD strategy with regard to the competitiveness, profit levels, rent-seeking activities and budgetary constraints of companies in priority industries.

Upgrading the endowment structure in an economy permits the upgrading of the industry/technology structure (Basu and Weil, 1998). The targeted industry/technology will have to be transferred from developed countries. The learning costs will be lower here than in the CAF strategy because the gap to be bridged between the new and the former industry/technology is smaller under the CAF strategy than under the CAD strategy (Barro and Sala i Martin, 1992). Furthermore, the protective rights (patents) in many technologies targeted in CAF will have expired or will be cheaper to acquire. The costs of acquiring technology will be lower under CAF than under CAD. The consequences are important with regard to external trade. Within the scope of a CAD strategy, the accent will be on the import of products for which there is no comparative advantage. Within the scope of a CAD strategy, any policy aiming to substitute capital-intensive manufactured goods by domestic production will not only reduce imports but repress exports, and take away resources from industries where there is a comparative advantage. (The recent study conducted by Weise and Jalalian proves the lack of convergence between South-East and Eastern Asia and Latin America: Weise and Jalalian, 2004, p. 303). Even exchange rates will be revalued to facilitate the development of priority industries, thus penalising exports. This has been the case in the Arab region, but also in Latin America and in India particularly, hampering economic performance in every case.

The CAD strategy, coupled with the encouragement given to companies to export more, does not prevent exports from being at a very low profit level. A company's survival indeed depends on protection of the market, preferential bank loans and other forms of support. With accumulated foreign debts and deficit-prone external accounts the economy in question becomes very vulnerable to external shocks. In practice, a CAD strategy encouraging exports is better than a CAD strategy encouraging import substitution, but its performance is absolutely inferior to a CAF strategy. More exports do not necessarily lead to greater GDP growth. Two examples: Taiwan has pursued a pure CAF strategy, while Korea has pursued a CAD strategy with an export option. Taiwan's performance in terms of growth, revenue distribution, macroeconomic stability, and so on, has been considerably better than that of Korea.

Theoretically, the most open countries are characterised by the strongest convergence tendencies (Dollar, 1992; Ben David, 1993; Harrison, 1996). International commerce is supposed to stimulate the diffusion of technology, knowledge and, more generally, human capital. It seems that, in order to be effective, this transfer first of all requires a minimum in terms of human resources in the host country, not only in quantity but also in quality (World Bank, 2000). Countries which rely on cheap, low skilled manual labour come up against a lot of difficulties in attracting foreign direct investment (FDI). This is equally true if they rely on their natural resources. In industries with high added value and great convergence potential, low manual labour costs only play a role – with minimum infrastructure and qualification levels – in a handful of low-technology activities: cheap garments for example, semiconductors having become highly automated with a strong capital component (Lall, 1998). The availability of skilled workers has thus become a direct requirement of multinationals, affecting the nature and indeed the volume of FDI (Zhang and Markusen, 1999), as confirmed by the study by Noorbakhsh, Paloni and

Yousef (2001). The considerable gap between the human capital available in developed and in developing countries respectively explains why the former attract the majority of American companies (Keller, 2004, p. 774). As another major determining factor, alongside human capital, in the efficient transfer of technology, R&D investments influence a company's acquisition of foreign technology. The two elements determine the capacity of absorption as far as a company or country is concerned, that is, the level and utilisation of workforce qualifications influence whether the adoption of external technologies is successful (Keller, 1996). R&D, indeed, allows a company to understand and evaluate new technological trends and innovations. Subject to a certain "productivity gap" as compared with a leader country, the growth of productivity in an industry varies along with spending on R&D (Griffith et al., 2000). This shows that R&D plays a role similar to that of human capital in supplying the skills necessary to the adoption of technology. It is, however, to be noted that, given the dominance of "international inter-firm technology partnerships", there are few opportunities for developing countries to catch up with their developed-country competitors. "Strategic technology partnering" arrangements, indeed, like transfers of advanced technology, are strongly concentrated in the developed countries. Nevertheless, R&D, "patenting, FDI and the localisation of R&D laboratories" are the privilege of these countries. Companies in developing countries are "locked out" of the "inter-firm partnerships" concentrating on joint R&D or on the new "core technologies" of information, new materials and biotechnologies (Freeman and Hagedoorn, 1994). The exception is formed by companies in the Far East and, to a lesser degree, India. For Asia this only concerns Taiwan and Korea, which concentrate most Asian R&D. A weak level of R&D corresponds to a low level of development, which limits the possibilities of joint ventures and of trade based on R&D. In the case of India, collaboration has concerned the bringing up to standard of the high-tech software industry (Petibandla and Petersen, 2004). For Asia, Taiwan constitutes the best example of this exception in which innovation in specific companies or clusters of companies generates strong effects throughout the economy. Beyond the controversy concerning Asian productivity (Krugman, 1996; Lau, 1996), the success of Taiwan in the creation of a POLIS (positive feedback loop innovation system) in three areas – electronics, information and machinery – opens up new perspectives with regard to the debate on productivity by going beyond approaches based on "growth accounting" in terms of production functions. If technology is the "key issue" with regard to improving economic performance, it is important to start with technology systems (Khan, 1997, 2002) and to see how modern technology systems can replace traditional systems in the course of the development process. This transition has been successfully achieved in Taiwan.

As is proven by the debate on the East Asian miracle, the strategic question for a country which has accomplished its technological transition "from traditional to modern" concerns its long-term growth prospects. It is thus the creation of an innovation system which determines the viability of technology-based growth. As Nelson states, the construction of an innovation system is an "evolutionary and path-dependent" process (Nelson, 1994; Nelson and Winter, 1992). The central idea is that the provision of appropriate types of capital, labour and forms of organisation for industries with high added value will lead to rapid increases in productivity. A domestic innovation system should therefore be implemented in order to nourish such growth (Lall, 2001).

"Global technology spillovers" favour the convergence of revenues and "local spillovers" tend towards divergence, whatever the channel may be by which technology is diffused. Concerning the geographic dimension of the international diffusion of technology, it seems that this diffusion is stronger within than between countries (Brandstetter, 2001).

Convergence, monetary and financial management, and exchange rates

Since the work of Shaw and McKinnon, a number of studies have argued that a causal link exists between "financial deepening" and economic growth. The relevant indicator is M2/GDP (i.e. money supply/gross domestic product), or the total volume of credits provided by financial intermediaries to the private sector as a share of GDP. A number of empirical studies have confirmed this (Levine, 1997; Rajan and Zingales, 1998; Hermes and Lensink, 2003).

The degree of "financial deepening" in a developing country is to a large extent endogenous to the state's development strategy. In the CAD strategy, the "carriers" of this strategy are large companies whose financial requirements are significant and can only be satisfied by a "heavily regulated oligopolistic banking system" with repressed interest rates and an underdeveloped financial system. The victims are dynamic companies: the most competitive are discriminated against and have no access to the financial services of the large banks. The priority companies which have access to privileged financing are often not particularly viable and do not repay their loans. Hence – and this is the case in many Arab countries – the accumulation by the banks of considerable volumes of dubious debts has often led to serious financial crises. Thus, in Algeria, the reorganisation of banking system debts amounting to tens of billions of dollars due to oil loans has still not been dealt with: the system continues to produce dubious debts. The precondition for genuine "financial deepening" in a developing country is a change in the state's development orientation and a shift from a CAD to a CAF strategy (Lin, 2003, p. 291). Various recent studies have shown that development of the financial system is an "essential pre-condition" for a positive impact of FDI on economic growth (Herms and Lensink, 2003, p. 158). A developed financial system contributes strongly to the technological diffusion associated with FDI. The vulnerability of emerging countries to banking and monetary crises increases with financial liberalisation, however, particularly when the structural weaknesses of the CAD strategy have not been corrected.

External liberalisation allows an inflow of liquidity into the emerging economy, liquidity which might just as well be invested in productive projects as unproductive ones. Divergence between real and speculative financial activities and their returns grows, thus increasing the probability of a crisis. With the increased risk of failure to pay, capital withdrawals become more and more likely, compounding the financial crisis more rapidly as a consequence of a higher share of short-term loans after liberalisation. Likewise, overvaluation of the currency increases the chances of crisis in both cases. In a less regulated environment, finance does not necessarily go where it is supposed to go, thus increasing the chances of a crisis (Weller, 2001). Investor confidence increasingly leads most often to speculative financing and exuberance and to an excess of credit in the economy. This was the case in South Korea in the 1980s and 1990s (Demetriades and Fattouh, 1999). In Korea this excess liquidity was used to finance speculative investments abroad, such as loans to Russia. The liberalisation of local financial markets and of the capital account should be undertaken on the basis of objective considerations. Financial liberalisation in Korea occurred prematurely as a result of worries about getting into the OECD.

With financial liberalisation appropriate institutions should be established, since vulnerability is of a structural nature. According to Alba et al., the weak institutional environment exacerbated the Asian financial crisis. This is also confirmed by Arestis and Demetriades (1999). Many developing countries – and particularly the majority of Arab states – should establish robust and prudential systems in order to protect their banking systems from systemic crisis; this is even more true for rentier economies with very volatile revenues. The difficulties concerning application of the regulatory model of developed countries are very much a result of a lack of "accurate financial information", highly qualified technicians and an impartial bureaucracy in environments characterised by "weak accounting and legal frameworks", as well as an acute shortage of qualified personnel and "pervasive political interference in public administration".

In order to be efficient in a developing country, prudential reform should be "relatively simple and robust" in the sense of not being highly dependant on other components of the system and also "easy to verify and enforce" (Brownbridge and Kirkpatrick, 2000, p. 20). For example, there should be very strict criteria for granting licences to banks, such as high minimum capital; the integrity of the owners, directors and managers; an increase in the minimum capital ratio above the minimum levels fixed by the "Basle capital accord" which imposes strong restrictions on "insider lending" and makes it possible for regulators to impose limits on increases in credits to high risk sectors, and so on (Brownbridge and Kirkpatrick, 2000, p. 20).

The Asian crisis, preceded by the Mexican crisis of 1994–95 and that of the franc zone in 1994 (which led to strong devaluations), as well as the recent Turkish, Czech and Russian crises, have put the exchange rate policy debate back on the agenda. The policy of "pegging" the exchange rate was established in the 1980s in the form of the theory of exchange-rate-based stabilisation and the nominal anchor approach in place of the flexible exchange rate regime. Fixing of the exchange rate was supposed to increase the credibility of anti-inflationary policies. The "real target approach" asserts that the "currency misalignment" associated with the anchor destroys credibility, making the anchor untenable (Edwards, 1996b). The evidence of the 1990s reveals the reality of the shock which was particularly acute for the developing countries, which moreover were often exposed to perverse movements of their terms of trade and capital volatility. The credibility of the exchange rate results, above all, from the perception that commitments are sustainable. With an overvalued currency and foreign deficits which automatically ensue from it, a pegged exchange rate will not be particularly credible, especially when the exchange reserves are exhausted. Exchange rate policy is not a substitute for fiscal and monetary policy (Edwards, 1996a).

The crises of the 1990s illustrate what happens when exchange rates are not altered in response to currency overvaluation. When developing countries are vulnerable, with weak international reserves, restricted access to capital markets, and costly adjustment policies at the political and economic level, the possibility of altering the nominal exchange rate should not be excluded (Bird, 1998, p. 275).

Another alternative to the exchange rate system is dollarisation and, more recently, euroisation. In recent years, dollarisation has gained new followers: Ecuador, El Salvador and Guatemala (Anil and Dean, 2004, p.461). These countries have adopted the dollar as their official currency. Dollarisation or euroisation may be assimilated to a fixed exchange rate with the advantages of a predictable price for foreign currency and a reduction in transaction costs and currency risks. It can also be a factor favouring investment in developing countries, since investors are more confident of their "rate of return". Dollarisation reduces domestic monetary growth and therefore inflation to the level of the country's trading partners, without which exports would be eliminated from foreign markets and the country would be inundated by imports. A fixed exchange rate also helps local borrowers since loans in foreign currency involve less risk and also because inflation – and thus interest rates – are restricted by foreign currency levels. On the other hand, the state loses the ability to alter the exchange rate, which can affect competitiveness since other countries are still able to devalue. Thus the Brazilian devaluation of 1999 reduced the prices of its exports but increased the cost of Argentinean imports, thus worsening the capital account crisis of the dollarised Argentina. Financial crises (Chilean, Asian, Brazilian, Argentinean, Turkish, and so on) show that a loss of credibility can lead to abandoning a fixed exchange rate and de facto dollarisation or euroisation. If, therefore, a fixed parity is beneficial for the capital account, FDI and portfolio investments due to the reduction of capital outflows, it eliminates the automatic response to shocks which flexible exchange rates provide.

Developing countries, in practice, encounter great difficulties in refusing to allow fixed exchange rates due to their insufficiently developed domestic financial sectors and the flow of volatile international capital; furthermore, devaluation is disastrous at political level and in terms of consumer purchasing power (Kessler, 2000). Fixed exchange rates make it difficult for the "tradables sector" to adapt to changes in economic conditions, such as changing terms of trade. We should, however, take note of the fact that differences exist between dollarisation or euroisation and fixed exchange rates. Dollarisation eliminates the "currency speculation" which affects fixed exchange rates, which makes it possible to reduce interest rates. Transaction costs are eliminated. Countries can make maximum use of the "de facto dollars" which constitute part of the economy and relinquish the role of lender of last resort vis-à-vis its banks in case of crisis by printing money.

The microeconomic and political effects of dollarisation or euroisation are important. In developing countries, dollarisation exacerbates structural disparities by its effects on the different social levels in the same way as "market-friendly reforms", creating winners as well as losers. This is particularly true in countries with strong polarisation of income and wealth, often concentrated on a few primary products with little price flexibility and very dependent on the flux of volatile external capital, and even more so in rentier economies dependent on changing crude oil prices. These countries are particularly vulnerable to the political, economic and social dislocations generated by dollarisation or euroisation, as proven by the Venezuelan, Ecuadorean and Algerian crises, for example.

In Latin America, dollarisation has often been associated with second-generation economic reforms: privatisation, deregulation and free trade agreements following macroeconomic reforms (Anil and Dean, 2004, p. 464). In developing countries, inputs and capital are essentially imported in order to maintain industrial activity, as well as wage goods (i.e. consumer-goods bought by wage earners). With underdeveloped financial markets, the state favours borrowing from abroad. On the "flip side", developing countries do not benefit from developed internal markets and suffer from strong disparities in revenue. In order to borrow they rely on exports and taxes to pay for imports and long-term debt. Since the choice of exchange rate affects the price of both imports and exports, the affect on factor prices can be profound. The affected groups react. Privileged groups, fearing the encroachment of the state, favour dollarisation as a means of protecting their assets (Neiman Anerbach and Flores Quiroga, 2002). (See Table 5)

Emerging countries today often find themselves at significant "crossroads" in terms of dollarisation – and now of euroisation – and of "second-generation reform". The fundamental difficulty is that it is possible to present a balanced budget in some years by means of different austerity measures, culminating in recession, whereas it is "long-term structural changes" on the supply side which are really imperative. Indeed, most macroeconomic stability has come into being despite "shallow financial structures" (Eilat and Zinnes, 2002), a reduced fiscal basis and an inability to control undisciplined fiscal spending, which is what led to the banking crisis of 1988–89 (Edwards, 2001). In the same study, Edwards shows that the countries which are dollarised de facto experience the lowest rates of inflation and growth, the worst fiscal results and more signifi-

Table 5: Expected political effects of dollarisation

Group	**Dollarisation stance and the reasons for it**	**Second-generation reform stance and the reasons for it**
Informal sector	Anti: prefer smaller bills for transactions; inflation and interest rate benefits are less tangible. Tend to vote for anti-US, left-leaning parties. May also appreciate the stability of dollars	Anti: see tax reform as hurting social spending, esp. in the form of increases in consumer taxes, which are more regressive
Agricultural exporters	Anti: current account effects which outweigh reductions in transaction costs and elimination of exchange rate volatility	Anti: because of putative reforms of agrarian sector, esp. in land tenure
Consumers	Anti: increases the costs of coveted foreign goods	Mixed: anti fiscal reforms, but may welcome regulatory reform
Small and medium-sized enterprises; informal economy	Anti: dealings with smaller levels of currency; see it as an imposition on their way of doing business; do not have access to international lending	Anti/neutral: do not see any direct benefits from fiscal and legal reform; if anything, want to avoid paying taxes
Organised labour	Pro: if part of large domestic enterprises with heavy international debt Anti: if appreciation makes consumption of imports more expensive and leads to a recession, including increased unemployment On balance, strongly "anti"	Anti: generally oppose further institutional reforms which often include a weakening of labour protection in order to make labour "more flexible"
Mining exporters	Pro: heavily dependent on outside investment and technology; reduction of transaction costs; stability of exchange rate Anti: appreciation of export prices On balance, probably pro	Anti: historically dependent on state protection and subsidies
Large domestic industry	Mixed: those with large dollar-denominated debt, or need to borrow and to benefit from stability of rates and reduced transaction costs are pro; those who are export-orientated are anti	Anti: often benefit from existing regulations and relationships that act as well established barriers to entry
State (esp. central government)a	Mixed-anti: central banks and executive branch because of putative loss of control; pro: Ministry of Finance for balance-of-payments reasons, stability; populist leaders who sell it as a panacea	Mixed-anti: requires major restructuring and downsizing, large public unions in many Latin American countries; pro: seen as an opportunity by technocrats for the state to reinvent its role
New service industries, e.g. financial, IT services	Pro: export- and internationally orientated	Pro: new generation wants clear rules and streamlined regulations
International investors	Pro: investment stability	Pro: investment, domestic business climate
Drug traffickers	Pro: easier to conduct transactions, launder dollar proceeds	Pro: easier to use proceeds to launder money, purchase non-currency assets

Note: Provincial and state governments are generally opposed to both dollarisation and second-generation reforms as they have locked in benefits from fiscal transfers.

Source: Anil, H. and Dean, J. W., 2004, p. 466.

cant "current account reversals" than other emerging countries.

Macroeconomic reforms, including financial deregulation, have not increased savings or improved access to credit (Plies and Reinhart, 1999). Investors prefer to transfer their capital abroad (capital flight) or to invest in securities rather than investing in private sector projects that generate real returns. Financial systems remain fairly underdeveloped and very inefficient in the area of domestic credit. This characterises Arab countries in particular, with the exception of the Gulf States.

Dollarisation or euroisation in themselves, therefore, are incapable of resolving the deeper problems. Reforms thus remain the only possible way: fiscal reforms and development of the financial sector and of a "well functioning judicial and regulatory system" (new institutions). For agricultural countries, this also assumes an overhaul of the agricultural sector in order to improve productivity incentives. The difficulty of implementing fiscal reforms due to vested interests is doubled by significant technical problems concerning their implementation by bureaucrats and the regulatory authorities, problems which are more complex than those of macroeconomic reform and "trade reform". Although the theory concerning the two latter points is well established, that of the configuration of the "optimal modes of regulation and fiscal policy" is more ambiguous (Krueger, 2000). In view of the difficulties of implementation of second-generation reforms in developing countries, dollarisation and euroisation appear rather as substitutes for reform since their implementation has not been accompanied by reforms, whether fiscal, financial, regulatory or institutional. Structural imbalances and fundamental bottlenecks remain more evident than ever. The debates in the Euro-Med periphery concerning the benefits of euroisation and its inevitability are significant. However, without second-generation reforms, the benefits of "the improved macroeconomic investment climate" remain limited and confined to segments of the economy which are important enough to be able to benefit from credit lines and domestic or international trade (Hira and Dean, 2003, p. 479).

These results indicate to some authors that the choice of exchange rate is ultimately of secondary importance in comparison with the development of monetary, fiscal and financial institutions in the macroeconomic success of developing countries. Improvements in the regulation of the financial and banking sector, fiscal discipline, consensus on a predictable and durable monetary policy, and trade liberalisation, on the other hand, are priorities (Calvo and Mishkin, 2003, p. 115).

By way of conclusion it may be noted that in the case of rentier economies the experience of Saudi Arabia, which combines extreme dependence with financial openness under a "rigid peg", shows that (Taher, Salim and Snowden, 2003) the key factor for countries exporting "primary commodities" and wishing to maintain a "pegged exchange rate" is that the "fiscal position" should be completely "consistent". In order to do this, providing the "structural budgetary deficits are separate, it is essential that public borrowing be limited to foreign currency denominated loans", which prevents any default which would lead to abandonment of the peg. This would allow the banks to concentrate their loans on the private sector. This assumes that external resources have been accumulated in the course of the boom period of the business cycle.

From the "developmental state" to the regulatory state

The "Asian miracle" has underlined the role of the state in industrialisation and development. The concept of the "developmental state" has been proposed (see Leftwich, 1999; Amsden, 1997; Lall, 1996 and Wade in this volume). At the same time, Evans was asking about the "institutional conditions" of effective state action in promoting industrial development. Based on three cases (Brazil, Korea and India) in the same industry – computers – Evans proposed the concept of "embedded autonomy" to explain the effectiveness of industrial policies across sectors and countries. Evans' conclusion is that:

> *Autonomy is fundamental to the definition of the developmental state but not sufficient. The ability to effect transformation depends on state-society relations as well. Autonomous states completely insulated from society could be very effective predators. Developmental states must be immersed in a dense network of ties that bind them to societal allies with transformational goals. Embedded autonomy, not just autonomy, gives the developmental state its efficacy.*
>
> *The power of embedded autonomy arises from the fusion of what seem at first to be contradictory characteristics. Embeddedness provides sources of intelligence and channels of implementation that enhance the competence of the state. Autonomy complements embeddedness, protecting the state from piecemeal capture, which would destroy the cohesiveness of the state itself and eventually undermine the coherence of its social interlocutors … Just as predatory states deliberately disorganize society, developmental states help organize it. (Evans, 1995, p. 248)*

Empirical studies conducted in different countries confirm – with qualifications – this role of embeddedness in Korea's very strong development, while it was mitigated in Brazil where a competent administration exists which implements policies without "embeddedness" and in Bangladesh where administrative capacities are weak, but whose "successful industries" are those in which the state intervenes least. In Egypt, on the other hand, where administrative capacities are more modest, embeddedness makes it possible to improve the quality of economic policy quite substantially (Baer, Sfahani and Rachid, 1999, p. 402). A missing variable in most versions of the theory of modernisation is the role of the *developmental state* entrenched in society. This theory predicts a chain reaction of social change (education, urbanisation, professionalisation, and so on) following industrialisation and, in turn, leading to "participatory politics". A strong state is often a characteristic of developing countries on the way to industrialisation. This "developmental state" can in turn shape social mobilisation and the political consequences which accompany economic growth (Thompson, 1996, p. 627). Developmental states were crucial in post-war industrialisation in developing countries. While neo-classical economics largely explains how markets "flourish", states Amsden, nothing is said about how flourishing markets come into being in the first place. She suggested that developing countries face the same insoluble dilemmas as existed at the time of early industrialisation. She elaborates the point as follows:

> *Countries with low productivity require low interest rates to stimulate investment, and high interest rates to induce people to save … they need undervalued exchange rates to boost exports, and overvalued exchange rates to minimise the cost of foreign repayments and imports – not just imports of raw materials, which rich and poor countries alike require, but also of intermediate and capital goods, which poor countries are unable to produce alone. They must protect their new industries from foreign competition, but they require free trade to meet their import needs. They crave stability to grow, to keep their capital at home, and to direct their investment toward long-term ventures. Yet the prerequisite of stability is growth. (Amsden, 1989, p. 13)*

The developmental state tries to "bend" these contradictory forces to its will on pain of seeing industrialisation "founder" because of economic penetration: too many imports, too many debts, too much consumption of foreign goods, too low a level of saving and investment. Contrary to the advice of international financial institutions, relative prices have been distorted in order to promote industrial take-off. Interest rates are increased with the aim of raising savings levels and investment is encouraged by means of improved loans. Exchange rates are "juggled" in order to favour the cheapest imports (capital goods) within the framework of import-substitution industrialisation. In sum, the "developmental state" has the aim of subsidising industrialisation. This is what was done in Brazil, Mexico, Turkey and East Asia. The "tiger" economies of Singapore, South Korea and Taiwan "learned faster, educated better, subsidised more efficiently" and exported more than the other developmental states. The "tigers" succeeded in linking financial subsidies to performance better than any of the other developmental states in the world (Thompson, 1996, p. 630). Whilst also encouraging oligopolies, the "tigers" prevented the emergence of inefficient monopolies. State intervention permitted the large companies to achieve economies of scale rather than becoming "white elephants". The great discipline of these states is explained by the type of industrialisation pursued, in other words an "export oriented strategy", based on market discipline. Apart from the enigma of growth inherent in this strategy, the latter helped keep domestic industry "finely tuned". The strong repression of trade unions in Malaysia, Singapore, South Korea and Taiwan also facilitated "export oriented industrialisation" and greater involvement of labour into the state's developmental plans (Rueschemeyer et al., pp. 210–311). Democratisation in Pacific Asia did not come about until after irreversible progress had been made in terms of development (Thompson, 1996, p. 637). In Korea, Taiwan and Thailand governments managed to achieve a significant increase in living standards before a democratic transition was initiated (Haggard and Kaufman, 1991, Chapter 2) at the behest of the emerging middle class. Indeed, in the "tiger" economies three decades of sustained development produced a significant middle class, a condition of a real democratic transition, whilst the state was increasingly "undermined" by successful development. Reduction of the state's autonomy led to a relaxation of state discipline in relation to the large industrial groups which henceforth increased their foreign borrowing. In 1997, Korea had the highest proportion of short-term debt in Asia, Latin America or Eastern Europe (Smith, 1998, p. 75). The external catalysts of the 1997 crisis were the change in export conditions for Korean companies and a loss of international confidence in the "new Asian economies". This, coupled with the fall in the yen, which meant that the Japanese were unable to revive growth, and the heavy indebtedness of the "chaebols" accelerated the crisis and put an end to the "Korean miracle". Acceptance of IMF conditions (Minns, 2001, p. 1038) consecrated the end of the "developmental state" stage and, more generally, of neo-mercantilist states in the region (Cumings, 1998, p. 51).

The Korean example shows that state autonomy depends on a particular configuration of social groups at a given time, their relationship with the state being historically specific. The particular form of autonomy which characterised the Korean state in its developmental heyday was a "mix of public policy" and a "pattern of ownership" and control of capital different from other emerging economies, such as Taiwan and Mexico (Minns, 2001, p. 1038).

The Asian economic crisis had significant economic consequences throughout the world, especially in Europe. It created a deep ideological fracture at the heart of the multilateral policy paradigm of the Washington Consensus. Indeed, prior to the collapse, there was broad agreement amongst orthodox economists that developing countries should pursue a particular set of economic policies, including economic and financial liberalisation, privatisation of public enterprises, fiscal and commercial discipline, deregulation of exchange rates and FDI. This agreement was ruptured after the crisis. Indeed, doubts appeared concerning the presumed benefits of one of the key elements – financial liberalisation – and thus weakened orthodox analysis of the origins of the Asian miracle (Jayasuriya and Rosser, 2001, p. 381). In the same context a new variation emerged, namely the so-called "post-Washington consensus". The new policy paradigm underlying this new consensus includes civil society, social safety nets and, above all, governance and social capital, elements which were to be added to markets opened up to deregulation, liberalisation and structural adjustment. This new version is an attempt to put more emphasis on the political and institutional foundations of structural reform programmes. By means of governance one targets the organisation and management of development processes. This goes further than the "policy framework, rules and institutions" which regulate the steering of public and private activity: an adequate legal system, systems of financial and corporate accountability, judicial independence and transparent regulatory structures. This leads to greater emphasis on "institution building", whereas the Consensus privileges the "shrinking state". Today it is a question of prioritising the "right institutional mix" for good market functioning (Jayasuriya and Rosser, 2001, p. 389).

Associated with this "new market governance" is the emergence of the "regulatory state". With the end of the "developmentalist regime" and the economic strategies associated with it, new forms of state organisation and political rule emerged (Jayasuriya, 2003, p. 205) on the basis of globalisation, transforming both regional and domestic governance. This new form of state organisation, the regulatory state, has the task of promoting – as desired by the multinationals – "good" governance. This state is very different from the interventionist model associated with the Asian economic miracle.

The principal features of the regulatory state are:

- A separation of policy-making from implementation (through contracting services out, for example).
- Creation of autonomous regulatory institutions, such as independent central banks.
- An increase in the role of the state as a meta-regulator: it does not regulate directly but rather "shapes" the institutional context of the regulatory institutions.
- A shift from a discretionary to a rules-based mode of governance in a number of economic and social policy areas. There is a transition from direct state intervention to governance ("facilitating intervention").

These new orientations are already present in the programmes of the World Bank (Jayasuriya, 2000). The process of depoliticisation may be described in terms of three aspects in particular: (1) autonomy of economic institutions, including the central bank and other regulatory institutions, vis-à-vis the elected authorities, (2) a "shift in economic policy making" from "discretion to rule-based forms" of fiscal and monetary governance, for example, and (3) "decontextualisation" of the administration and its agencies from economic and social power relations and its consequent embedding in the frameworks of responsibility and community. In short, depoliticisation, or rather strategies of "anti-politics" today supply the underlying rationale of many governance projects. This should be appreciated in light of the collapse of state development projects and the governance paradigms and strategies associated with them (Jayasuria, 2003, p. 206).

"Reproduction" of the global economy indeed requires increasing harmonisation of standards and codes such as "corporate governance, transparency standards and other macroeconomic and microeconomic policies", the parameters of which are broadly defined by supranational organisations. The structures of regional governance increasingly constitute the privileged forum for "fleshing out standards" (Jayasuria, 2003, p. 207). This goes well beyond trade liberalisation and constitutes the raison d'être of the new regionalism. By way of summary, the expansion of the global market economy and the increasing vulnerability of economies to financial crisis require the expansion of a type of "regulatory regionalism" in order to help "regional policy harmonisation". This goes beyond the new regionalism of the 1990s. Thus the idea – asserted increasingly often – that regional integration projects consecutive to trade liberalisation only have "limited viability" for the NICs (newly industrialising countries) of East Asia or Latin America. According to some, it is necessary to go further: for example, towards a "monetary regionalism" which would offer some protection to increasingly vulnerable national economies. Dieter writes:

> *[countries] participating in a conventional integration project do not enjoy additional protection against*

> *financial crises. Neither with regard to the stabilisation of the exchange rate of their currencies nor with regard to the stabilisation of capital flows do conventional integration schemes strengthen the economies of their member countries. (Dieter, 2000: p. 2)*

After the Asian crisis, it appeared to the Asian states that globalisation of markets would require a minimum degree of regional monetary cooperation in order to avoid future crises. The difference between the regionalism of the 1990s and the new regulatory regionalism is that now the emphasis is on integration by means of regulation rather than liberalisation. This new reality underlines the extent to which the Barcelona agreements and the new regionalism underlying them have been outdated at the macroeconomic level.

3. Conclusion

This study seeks to illuminate the initial differences and those relating to the situation of the Arab region in comparison with other regions of the world, and the exception constituted by Arab growth without development, nourished solely by the favourable terms of trade pertaining to oil. The reversal of these terms of trade from 1984 plunged the region into stagnation and political and social instability. This crisis in the economy lasted until the end of the 1990s, bringing about, within the framework of the structural adjustment programmes intended to reestablish the major macroeconomic equilibria, the abandonment of the interventionist and post-independence redistributive model. The implementation of economic and financial reforms clashed with the rentier features of the political regime with which these economic policies were associated. Economic liberalisation and the necessary democratisation could not be brought to completion. Arab strategies of economic liberalisation appear to be simply means of survival for the ruling regimes (or prebendary and corporatist states). At the same time, the social groups linked to the new commercial lobbies in alliance with the state bureaucracy have consolidated their position. Hence the region's exclusion from the great world movement of democratisation and the denial to the people of the region of the fruits of liberalisation. In parallel with this, problems are accumulating: jobs, poverty, unofficial migration, absence of convergence with the countries of the European Union in terms of revenues, as postulated by the Barcelona Declaration of 1995, and so on. The challenge of transforming the rentier economies remains. The abundance of capital, though far from being fairly distributed, paralyses reforms, particularly those related to sustainable medium- and long-term development. For this reason, the Arab experience constitutes an exception by comparison with the significant development achieved by East Asia and Central and Latin America.

Real economic convergence is thus more topical than ever because an expanded Europe is proposing a new complementary strategy in the wake of Barcelona, namely a neighbourhood strategy on the basis of shared "common values". What can the European Union do within the scope of its partnership with the region in order to implement all the reforms required for real convergence in terms of financial and monetary stability and a fair redistribution of the fruits of development?

As industrialisation is the motor of development by means of structural change, as is underlined by the experiences of the NICs, we propose a dynamic model of converging development inspired by that of Lin. We have analysed the role of a number of crucial and strategic parameters in this development, particularly human capital. Technological and economic catch up assumes the construction of a public system of research and advanced training linked to the industrial, agricultural and medical sectors in order to sustain technical progress. This influences the acquisition and command of the necessary physical technologies, which is easier than in the past, due to the close connections between physical technologies and the engineering sciences, which are more globalised than national nowadays. The development of appropriate social technologies is necessary in order to implement these technologies efficiently, as Nelson points out: "it is far easier to advocate institutional factors, or to mount programmes aimed at reform, than actually to achieve a system that encourages economic catch up" (Nelson, 2004, p. 372). Unfortunately, there are few direct lessons in terms of a development model to be drawn from the experiences of East and Southeast Asia, whether in relation to electronics, motor vehicles or broader economic strategy.

Export-led growth cannot be an option for all and electronics is now far too saturated a market, particularly since China and Mexico came on the scene as major exporters. Other development paths and alternative leader sectors need to be identified. Let us remember that, despite its pretensions, the Arab region has not been in a position to do what was intended when the petrochemical industry got off the ground. This was the expected leader sector as the chemical industry was in Germany. (For the reasons for this failure, also in relation to countries such as Iran, Venezuela Indonesia and Nigeria, see Sid Ahmed, 1986). In any case, with any development strategy, innovation and trial and error emerge as important elements, with little being predict-

Table 6: Substitutes for missing prerequisites in Asian NICs

Prerequisite for growth-evident in the USA or Japan	**Asian substitution for missing prerequisite**
Strong entrepreneurial and managerial capacity	Korea – state sponsorship of the *chaebol* Singapore – subsidies for TNC subsidiaries
Large internal markets/access to export markets via FDI/trade	Korea, Taiwan, Hong Kong – OEM subcontracting system – export-led growth Southeast Asia – exports via TNC subsidiaries
Access to advanced technology/R&D clusters	Singapore/Malaysia/Thailand – foreign direct investment – TNC subsidiaries Korea, Taiwan, Hong Kong, OEM, joint ventures

Source: Hobday, 2003, p. 309.

able at the outset and little guarantee of success (Hobday, 2003, p. 310). The experience of the NICs suggests that the latecomers of today should first of all make the most of their different resources which, at least partially, are shaped by their state of "backwardness". The OEM (original equipment manufactured) system made the fortunes of Korea, Taiwan and Hong Kong at the outset, enabling them to launch their exports and acquire foreign technologies. If Hong Kong and Singapore pursued export-led policies, South Korea and Taiwan combined these policies with import-substitution industrialisation, controlling and prohibiting imports in order to protect local companies and involving the state in boosting the latter. Taiwan negotiated the entry of FDI, laying down certain standards concerning "local content".

The objectives of export and competition policy were also different. Taiwan put greater emphasis on the "small size local firms relying on speed and flexibility", whilst the big firms benefited from high volume and the process-intensive electronic sectors. Taiwan and Hong Kong specialised in "fast changing market niches", whilst Korea favoured vertical and horizontal integration along the lines of the Japanese "keiretsu" model. Concerning ownership, Korea and Taiwan "relied mostly on locally-owned firms", while Singapore relied completely on foreign firms. Hong Kong relied on a mixture of local and foreign companies, while the economies of the Asian Southeast established a very different model based on FDI and relying mostly on multinational subsidiaries. The emergence of exporting subsidiaries "from small beginnings to large export zones of production" supported by the state constituted a real innovation, like OEM of the "gerschenkronian" type (Hobday, 2003, p. 304). Without the expansion of multinationals' investments, the export of electronics and the assimilation of technology would perhaps never have taken place. The multinationals represented a new organisational approach permitting the transfer of technology, systematic local technological learning and the export of products to the international market. Initiated in Singapore, this institutional innovation was taken up again by neighbouring countries for their exports to the United States and Europe. Even if FDI had already begun, the electronics industry constituted an extraordinary expansion of FDI in the region, better known for its export orientation than supply to local markets. This was in close association, as we have seen, with clusters of industrial development in different locations outside the multinational's home country. Today, the disk drive cluster in Thailand is the most important in the world, alongside Malaysia. Penang has become the greatest international concentration of the semi-conductor packaging and testing industry. The question is whether these countries would have performed even better if, instead of favouring multinationals, they had supported local companies. China today seems to have adopted a strategy which combines the two models (Hobday, 2003, p. 305).

Concerning the "missing prerequisites", the question is how the "latecomers" substituted them. Table 6 sums up the substitution mechanisms which were implemented.

It has been observed that in Korea the embryonic chaebol was promoted in the first stages of industrialisation as a substitute for the missing entrepreneurial business and managerial capacities of the USA and Japan. In Singapore and Malaysia, multinational subsidiaries were substituted for lack of export experience and technological capabilities, on the basis of subsidies, export promotion schemes, tax holidays and infrastructural support. For Hong Kong, Korea and Taiwan, the OEM system substituted for direct access to advanced markets and the lack of technological capability and worked as a kind of "technological training school". Later on, China has followed with a range of strategies and broader paths which both imitate and build upon East and Southeast Asian growth models.

Another lesson learned from the Asian NICs – the imitation and simple transfer of technology and minimum knowledge without local bases – is not sufficient to ensure "catch up".

In light of the Asian models, it is clear that other developing countries should identify substitution routes in relation to the "missing prerequisites" of industrialisation. This applies to the Euro-Arab periphery. Every country can choose its own development path according to its own distinctive resources, which leads to the development of the necessary strategic innovations to exploit market and technological opportunities. An excellent education system is necessary in all cases (Ito, 1997, p. 192).

Neighbourhood effects are also crucial – as formations of flying geese suggest, for example – particularly in relation to demand spillovers and technological transfer linked to technological and research capacities and an appropriately qualified workforce. A government-led industrial policy is inefficient because the bureaucracy is weak and subject to political pressures: a strong meritocracy with an incentive system outside the sphere of influence of these pressures influences the effectiveness of state intervention. Intermediation – as in the case of Korea – particularly by means of the banking system is more effective in the first stages if the available financial expertise is limited. Resource allocation via the stock market is inefficient at these stages, requiring a broad base of heterogeneous participation in order to function without excessive volatility. A significant case is the Algiers Stock Exchange where, after almost a decade, only three securities are quoted.

As far as industrial policy is concerned, although it has played an important role in some Asian countries (Singh, 1994) – notably in relation to the targeted and promoted industries which benefit particularly from subsidies – it is in decline today with the reduction, indeed abolition of customs barriers, and the lifting of restrictions concerning exchange rates and foreign currency access. The granting of subsidies only to industries and not to individual firms or to some vested interest makes it possible to maintain competitive pressures (Ito, 1997, p. 193), while rapid success in exports made it possible to lift protectionism.

A successful industrial policy requires several prerequisites, for example, infrastructure, including electricity, highways, airports, schools and health care facilities. An incentive system to reward economic agents for hard work is also needed, as is a "monitoring device" which guarantees that the reward system is not corrupt and a "political economic structure to correct faults (checks and balances). It also requires a competition mechanism (not necessarily markets) and, above all, competent technocrats, properly paid and protected against political pressures. Bureaucratic decisions should be monitored by others, otherwise the bureaucracy is transformed into an inefficient planning machine, propelled by inertia. With improvements in the education of business people and of the general population, the role of industrial policy tends to diminish over time. The handicap which significant natural resources can represent is not fatal. The "Dutch disease" can indeed be neutralised, as Corden (1981) showed on the basis of the Indonesian case, with a policy of compensation for losses registered by the tradables sector – which is what Algeria did in the 1970s. This, however, necessitates a relatively well-developed and efficient administration, as has been proved by Norway, for example, with the setting up of a whole set of policies aiming to neutralise rentier effects, particularly in sectors such as the fishing or agriculture of Finmark (Norwegian county). The successes of countries such as Thailand and Malaysia, which are rich in natural resources, are in this direction, tradables increasing faster than non-tradable goods.

The competence of the bureaucracy depends very much on the quality of education and thus of human resources; however, quality is not improved solely by government spending and number of students, as the Arab region bears witness, being first among developing countries in terms of the volume of resources allocated to the sector since 1960.

Another important lesson for neighbourhood policies is that rapid growth is contagious in relation to neighbours in the sense that it induces more rapid economic growth in them. This concerns the spillover of global demand. It also appears in view of the experiences presented that development of the financial sector constitutes an equally essential precondition for a positive FDI impact on growth. It contributes strongly to technological diffusion and the expansion of industrial areas.

Another lesson is that financial liberalisation increases the vulnerability of emerging countries to banking, monetary and financial crises, as shown by the Asian crisis of 1997, as well as previous and subsequent crises elsewhere. In an unregulated environment, as already mentioned, finance does not necessarily go where it should. Financial liberalisation should not intervene until after the establishment of the appropriate institutions and a robust, prudential system. Today, developing countries are at a crossroads as much in terms of dollarisation – and, for the Euro-Med region, of euroisation – as second-generation reforms. The bulk of economic stability has been managed despite shallow financial structures. In the transition countries of the European periphery, the "shadow economy" has spread (Schneider and Ernst, 2000). As János Kornai has shown, transition entails a systemic transformation, making shadow activities unavoidable (Kornai, 1996).

The presence of a significant shadow economy – 53 % of GDP in the former communist countries in transition, but also in the Arab region – has the result of making macro-policy and, consequently, maintaining macroeconomic stability less efficient. Monetary policy is weakened: since the shadow companies use the banking system less (reducing intermediation) they are less connected to financial markets and bias the indicators linked to macro-policy decisions (an increase in official unemployment does not necessarily imply a need for Keynesian fiscal stimulants if it is caused by a shift of labour towards a "shadow economy" (Eilat and Zinnes, 2002, p. 1236). To this one might add a number of microeconomic distortions, such as distortions in resource allocation which can affect the composition of GNP (resources can be allocated to sectors most favourable to the shadow economy, such as trade, services and construction). The economy's international competitiveness is equally negatively affected by the shadow economy, according to the indicators cited by Eilat et al. (2002, p. 1246), reducing the export capacity of the country by the same extent and thus its attractiveness. Policymakers have so far shown little interest in this problem which, by means of its various impacts, negatively affects – beyond macroeconomic stability – medium- and long-term performance with regard to growth. Concerning the financial deregulation carried out in the Arab region, macroeconomic reforms have generally not increased savings, nor prevented the continuing capital flight, nor improved access to credit. State securities are still preferred to private-sector ones, and financial systems remain underdeveloped. Under these conditions, calls for euroisation seem more like strategies aimed at preventing second-generation reforms, and so like substitutes for the latter. Euroisation beyond its proper limits – which are also those of dollarisation – is only possible with the parallel implementation of fiscal, financial-regulatory and institutional reform. Without these reforms, the benefits of macroeconomic progress remain limited and confined to the segments which are sufficiently important to benefit from local and international trade and credit lines.

The Asian economic crisis has had significant consequences throughout the world. It led to a profound ideological split concerning the multilateral policy paradigm which is the Washington Consensus to the detriment of the orthodox wing, following doubts which appeared concerning the benefits of one of the key elements, financial liberalisation. Thus a new variation emerged, the so-called post-Washington Consensus, with its additions of civil society, social safety nets, governance and social capital. The emphasis today is increasingly being put on the political and institutional foundations of structural reform programmes. Governance aims at the organisation and also the management of development. Thus building up institutional capacity is stressed, whereas the Consensus favoured the "shrinking state". Priority is given to the "right institutional mix" for the functioning of markets. The developmental state which assured "market governance" in Asia prior to the crisis has been transformed into the regulatory state, ending the developmental regime and its economic strategies. This corresponds to the new forms of state organisation and of "emerging political rule" on the basis of globalisation, transforming national as well as regional governance. These new regulatory states that World Bank programmes are trying to promote are aimed at promoting good governance. Depoliticisation supplies the underlying rationale of many governance projects. This has closed the gap opened up by abandoning state development projects and the governance paradigms and strategies associated with them. Also emerging from the regulatory regionalisms substituting for the open regionalisms of the 1990s is that of Barcelona. This shows that the regulatory state is not confined within national borders but is part of a governance system at different levels, connected as it is with multinational organisations and national and local agencies. A good example of this is the ASP (ASEAN Regional Surveillance process). These region-wide regulatory frameworks are accompanied by a world dynamic leading to a growing harmonisation of standards and codes such as corporate governance, transparency standards and other standard macro- and microeconomic policies the parameters of which have been broadly defined by supranational organisations. This goes well beyond simple trade liberalisation. The growing vulnerability of economies to financial crisis represents a strong argument in favour of monetary regionalisms which would offer protection to national economies. Globalisation of markets requires – as the Asian crisis shows – a minimum degree of regional monetary cooperation. Whereas the regionalism of the 1990s emphasised integration by means of the liberalisation of commerce (Barcelona, for example, with the project of a Euro-Med free trade zone), the new regionalism suggests integration by means of regulation.

The neighbourhood policy project through the strategic partnership adopted at Dublin in May 2004, following the conference of foreign ministers of the Euro-Med zone, is fully in line with the new concept of regulatory regionalism. The Treaty of Agadir in March 2004 opens the way for "a major step forward in South–South regional integration" after the reassertion by ministers of their support for the trade and economic integration initiative undertaken in the Mediterranean. The countries which are not signatories of the Barcelona Declaration are encouraged to join these initiatives. The ministers also cite the failure to realise the free trade zone by 2010, in respect of which they encourage the Mediterranean partners to conclude free trade agreements among themselves in the meantime.

We have recalled the importance of technical regulations, standardisation, "conformity assessment" and European legislation. The national action programmes to be elaborated within the framework of neighbourhood policy will repeat all these propositions: those linked to regional integration but also those linked to the liberalisation of services, accompanied by "regulatory approximation". Support has been given to the project "Charter for Entrepreneurship", and to the programme aiming to promote "best practice in enterprise policy" (MED BEST) with the aim of reinforcing cooperation with a view to regulatory and administrative reforms, as well as extending the European Research Area to the Mediterranean partners.

The difficulty is that nowhere is it mentioned, beyond the problems of stability and necessary regulation, what should be done to ensure economic development beforehand or in concomitance. In short, how can rentier economies be transformed and made to converge? In contrast to Asia, the Arab region has not followed – as we have seen – the strategy of industrial deepening arrived at through a policy of both solidifying the developmental state and encouraging the native private sector. Indeed, it did the opposite, choosing a system relying heavily on financial rents, "overbanking" and the encouragement of joint ventures between the public sector and international capital, rather than with the domestic private sector (Aert, 1999, p. 913). Thus a new stratum of comparatively big business, particularly in commerce, and rather less in industry and construction has been created or at least supported by the state. This leads to what Aert describes as a Catch-22 situation: a degree of liberalisation is essential for real regional economic integration, but this is obstructed by the equivocal agenda of the private sector. The industrial bourgeoisie which is in favour of democratisation is hostile to the opening of borders which is desired by the commercial bourgeoisie, which is more linked to the authoritarian power structures (Aert), 1999, p. 919).

If the states are aware of the necessity of economic reforms of a structural kind, their content and timing remain vague. Most countries have not even passed the ISI phase which makes "local business" incapable of meeting foreign competition or creating joint ventures. In addition, the results of structural adjustment programmes have been very mixed in terms of restoring macroeconomic stability and extremely negative in terms of creating new opportunities for investment and growth. If the least doubt exists on this point, let us remember that the Arab region has the highest percentage in the world of capital flight as a percentage of GDP. The "domestic push factors" and the "international pull factors" have been combined to induce capital outflows, principally in the form of deposits and savings in Western countries. As long as the governments remain as they are, "regionalism" risks remaining a delusion and bilateralism the rule, as is the case today in Asia (Ravenhill, 2003, p. 299). Liberalism indeed offers greater advantages to the "more domestically inclined protectionist interests" with the possible inclusion of clauses for the exclusion of other competitors under the heading of liberalisation.

We can only imagine a framework and appropriate development policies taking into account both the models of East and Southeast Asia, and the Chinese synthesis of the two, and this against the background of cyclical movements of gross terms of trade of a magnitude unknown elsewhere. We should remember that by the end of 2004, the OPEC countries will have accumulated more than USD 400 billion (on the basis of an demand for OPEC oil of 30 million b/d at an average price of \$35 per barrel) compared with USD 140 billion in 1986 (on the basis of an average price of \$13). These figures illustrate the challenge facing neighbourhood policy.

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Stephen Kosack

Aid and foreign direct investment

Europe – like the whole Western World – today faces a simple challenge: to keep ourselves safe, we must help the rest of the world share in our prosperity. The challenge is hardly new – it was part of the Cold War too – but despite more than five decades of experience with it, we still are far from knowing its solution. Aid and foreign direct investment (FDI) both were once promising possibilities, but both have proven largely ineffective. The success of the Marshall Plan proved to be beginners' luck, and the aid programmes that followed it on the whole encouraged more dependency and graft than prosperity and development. In recent years foreign direct investment seemed to work better, but it's clear today that it fails just as often, and even its seeming successes can be ephemeral.

Yet this gloomy aggregate performance hides the fact that both aid and FDI sometimes *can* spur development, and as Europe wrestles with how to promote prosperity in its backyard, it must abandon neither. Instead, we must look back on, and learn from, our experience with aid and FDI, and try to make both more effective.

To that end, I want to pose two questions, and then frame an answer to each. First, how do aid and FDI affect development? And second, how can Europe best use each to stimulate development in its neighborhood? So as to maximize my comparative contribution to this conference, I focus more on the first question and only frame the second.

1. How does aid affect development?

The last half century provides us with a good deal of evidence of the effect of both aid and FDI on development. The most important lesson about aid, hands down, is that it is fungible. Mostly, if not entirely, it simply substitutes for what a government would have spent its money on anyway; therefore its marginal effect is to add to government spending generally. If you know how a government tends to spend its money, you can predict basically what the marginal effect of any aid to that country will be.

To ask "How does aid affect development?" is, then, akin to asking "How does government spending affect development?" This is a much larger question, of course, but thanks to the work by Gus Ranis, Frances Stewart, and Alejandro Ramirez, we can get closer to an answer (Ranis, Stewart, and Ramirez 2000). Figure 1 identifies a series of pathways between economic growth and human development.[1]

The figure shows that growth and human development can feed off each other – this Ranis et al. call a "virtuous cycle" of sustainable development. It is also possible, however, for growth to add to growth directly, without adding to human development. Empirical work demonstrates clearly that over the long term this sort of growth is unsustainable, and leads instead to a "vicious cycle" of poor growth and poorer human development.

Aid, working through government spending, may spur human development, or it may not. A government that is committed to human development will spend the extra resources that aid provides on things that improve the quality of life of the population, and add to their human capital, making them more productive and setting the stage for further growth. But if given to a country whose government is not committed to human development, aid may fail entirely to enhance quality of life or human capital. (And in the extreme, if a government prefers to use its resources to solidify its hold on power through repression, aid to that government may even reduce quality of life and human capital.) Aid works through – and aid's effect is determined by – government spending preferences (see figure 2).

Since FDI is by nature private, its role in development is more complex. FDI's most obvious effect is to add to capital. In addition, FDI can add to household income through wages; government revenue though taxes; and can increase economic efficiency through technological spillovers (see figure 3).

But none of these paths are as clear as the one from aid to government revenue – hence the dotted lines.

1 Human development is a broader concept of development than simply economic growth; it includes not only income, but also health and education (human capital).

Figure 1

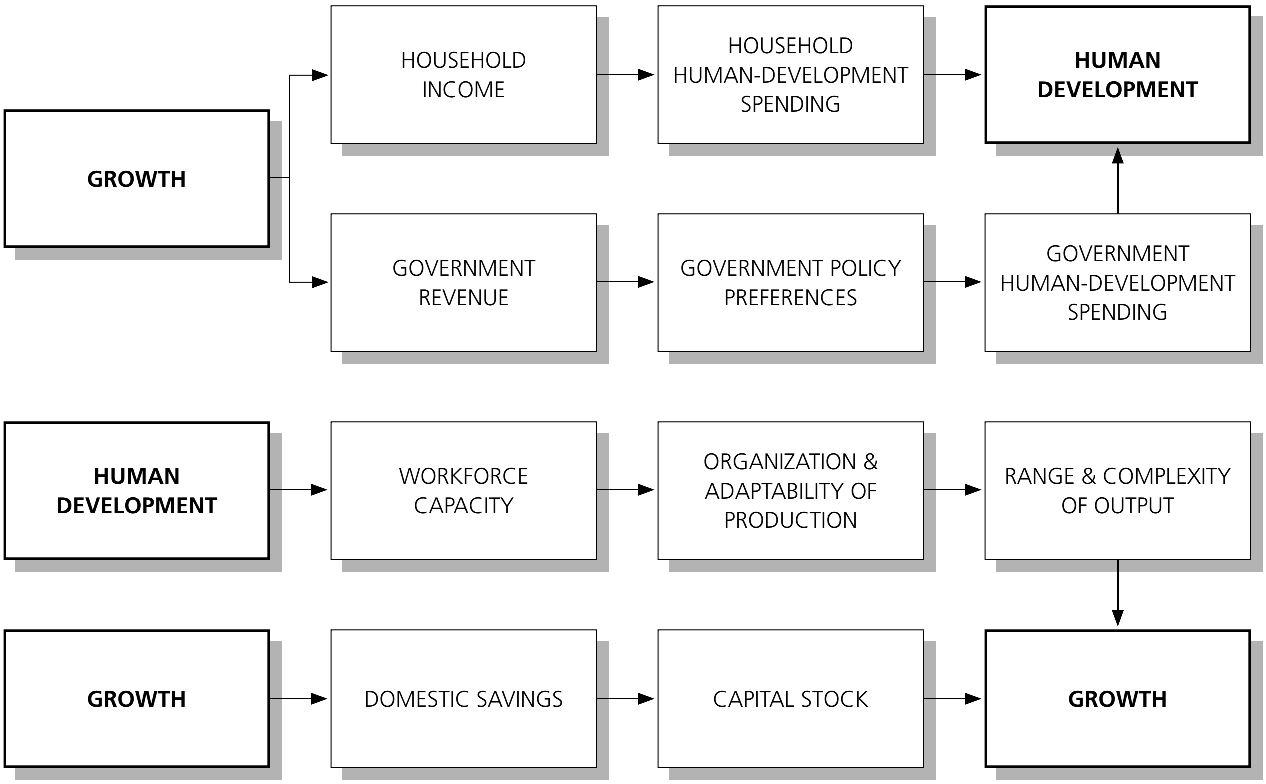


Figure 2

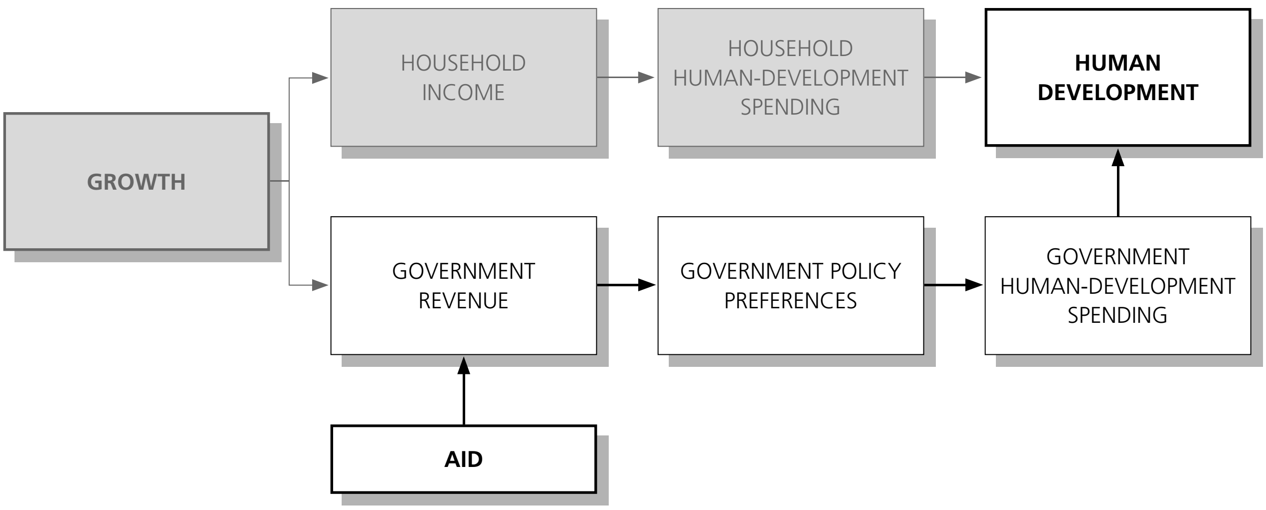
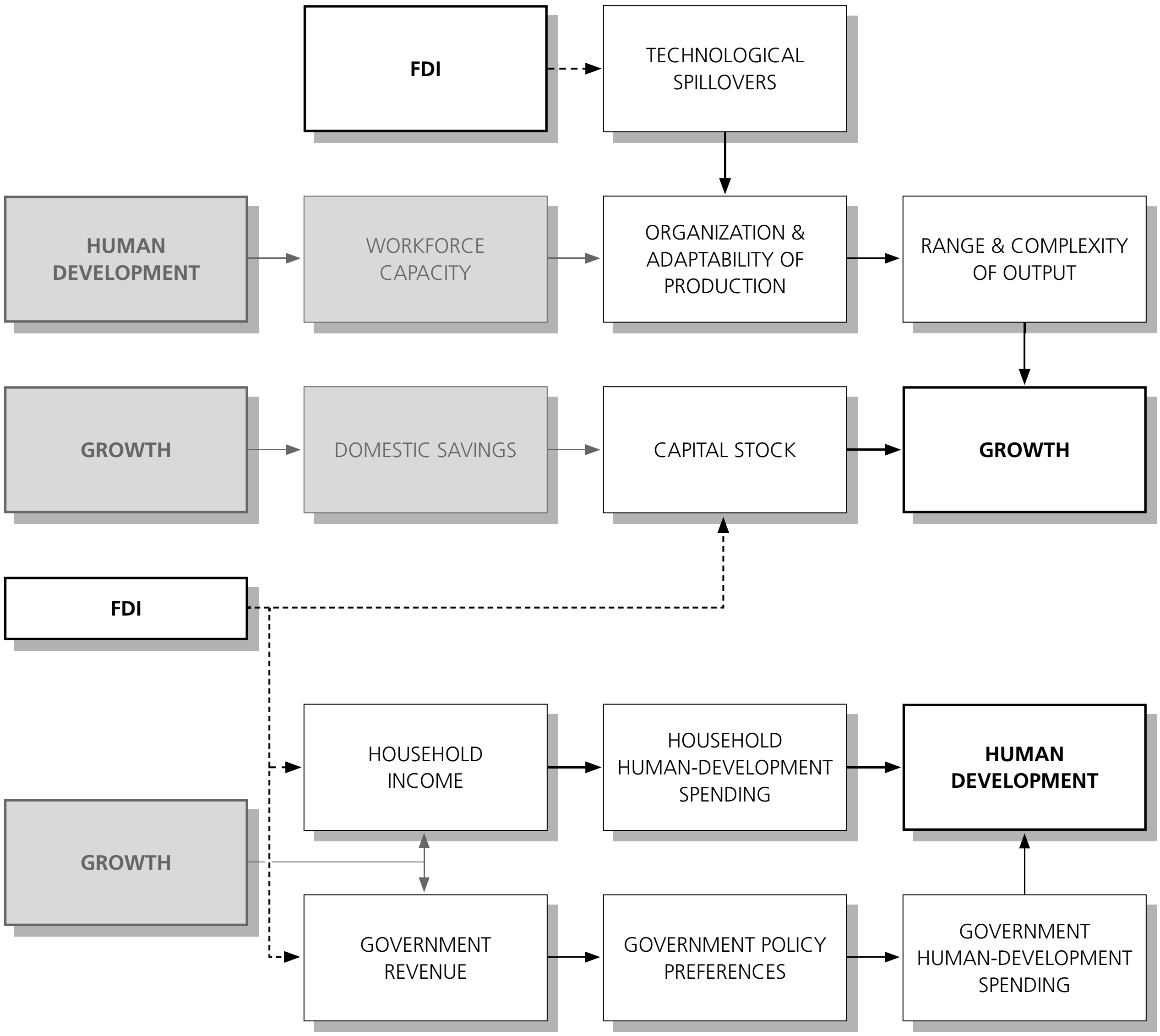


Figure 3



FDI *may* add to the capital stock, but not if it crowds out domestic investment. It *may* increase household income, but not if it lowers the wage rate. It *may* increase government revenue, but not if it is only attracted with huge tax breaks. It *may* provide technological spillovers, but not if the economy is not developed enough to take advantage of them.

Thus just as aid's effect is contingent on government preferences, FDI's is contingent on the state of the economy.

These dynamics need more attention before we fully understand them. In initial empirical work I've done with my colleague Jennifer Tobin (Kosack and Tobin 2004), we find that the effect of both aid and FDI on development depend upon the existing level of human capital: given a relatively low existing level of human capital, aid will hasten development, but at very low levels of development, aid will slow development. This evidence fits well, though not perfectly, with the story I'm telling here. Clearly countries with extensive human capital have governments that are committed to human development, and hence aid to them contributes to human development; but these countries are not the *only* ones with governments committed to human development. To complete our understanding of how aid will be spent, we need a way to measure a government's spending on human development that is independent of human development itself. (Democracy, a promising candidate – see Kosack 2003 – turns out to be only part of the answer; indeed, some of the governments most committed to human development have been communist.)

The evidence of the effect of foreign direct investment on development is more ambiguous. One thing is for certain: FDI that can slow the development of countries with very limited human capital (our research shows FDI slows development in a country with a level of human capital at or less than that of Senegal or the Côte d'Ivoire). But once a country acquires a relatively low threshold level of human capital, FDI can sometimes have a positive effect, and sometimes a negative effect.

The difference is likely due to how well-suited the foreign investment is to the domestic economy. At a minimum, beneficial foreign investment will pass two tests:

1. It will be impossible for the domestic economy to provide the same or similar investment; and
2. The foreign investment will contribute to human development via one or more of the paths in the above figure: by
   a) adding to the capital stock,
   b) increasing household income,
   c) increasing government revenues, or
   d) providing technological spillovers.

2. When do countries benefit fom aid?

Given what we know of the way aid and FDI affect development, how can Europe use both – how can it allot aid and encourage FDI – to spur development in its neighbors?

Consider some of the countries in question:

The most striking thing in the table below is that many of Europe's neighbors, particularly those to its immediate east, are impoverished but relatively rich in human capital. According to our analysis above, this makes them prime candidates for aid, and perhaps for certain types of FDI too. Because these countries have demonstrated commitments to human-development spending, we can expect them to spend some portion of aid money on human development. Because these countries will probably lack the domestic investment capacity in at least some sectors to make full use of their human capital, there's a good chance that the right kind of FDI could add to their growth and human development.

We can be a bit more specific. The empirical work I mentioned above suggests that once a country reaches a level of human capital of 0.55 or higher, aid to it starts to have a positive effect. Yemen is the only country below that level. This research relies on regression analysis, so its specific coefficients must not be taken

Country	Human Capital (2000)	Average 2000–2003 FDI/GDP	Aid/GDP	GDP per capita (constant 1995 US$)	GDP per capita growth (annual %)
Bulgaria	0.92	6.03	2.54	1691.36	5.9
Romania	0.89	2.76	1.45	1599.85	4.7
Turkey	0.82	1.39	0.21	2959.40	1.7
Armenia	0.90	4.48	10.68	741.47	10.2
Belarus	0.91	1.63	0.30	2066.72	5.9
Georgia	–	4.25	8.00	845.23	5.9
Iran	0.79	0.04	0.11	1774.62	4.6
Israel	0.95	5.02	0.55	17016.39	–0.5
Kazakhstan	0.82	11.16	0.87	1835.62	10.6
Kuwait	0.88	0.97	0.01	12058.86	–2.7
Moldova	0.86	9.14	8.21	470.73	5.8
Russian Federation	0.89	1.92	0.46	3214.11	7.3
Saudi Arabia	0.79	0.52	0.02	7687.77	–0.3
Turkmenistan	–	–	1.39	846.57	17.1
Ukraine	0.89	1.91	1.44	1003.06	8.3
Uzbekistan	–	–	1.58	683.62	2.9
Yemen	0.54	0.95	4.87	328.04	1.6

Human capital is a measure of the health and education of the population, scaled from 0 to 1. It is basically the UN's Human Development Index without its income component.

too seriously; nonetheless, they are of some value. The research shows that, when given to a country with a level of human capital of almost 0.80 – Saudi Arabia – aid worth one per cent of GDP would increase the country's expected annual economic growth by 0.5 per cent, and would increase the country's expected score on the UN's Human Development Index (HDI, which is measured on a scale of 0 to 1) by 0.0043 points over five years. When given to a country with a level of human capital of approximately 0.90 – Romania, Russia, or Armenia – aid worth one percent of GDP would increase expected growth by 0.62 percent, and would increase the countries expected HDI by 0.0055 in five years. Naturally these predictions suffer from a simplistic and homogeneous depiction of the governments in question, and of how those governments choose to spend their money; but they do show that most of the countries in Europe's backyard would probably get some benefit from aid.

The myriad types of FDI make it difficult to make similar predictions for it. In our research, FDI in general appears to slow human development, and aggregate FDI has no discernable effect on growth at any level of human capital. The key to good FDI is that it adds to the economy, something that is impossible to discern without knowing a great deal about the economy and the specific investment in question. Therefore, in general FDI should be approached cautiously. In recent years, Western governments and international organizations have encouraged developing countries to open themselves completely up to foreign investors, and to do all they can to attract FDI. This advice is almost certainly harmful, and the EU will not help to foster development in its neighborhood if it pushes for them to aggressively court any and all FDI. The better course is to encourage these neighbors to proceed case-by-case. In particular, tax breaks to encourage foreign investors – which frequently come at the expense of human-development spending – should be used rarely, only when the investment will clearly benefit the economy.

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Hansjörg Herr

Deregulation, currency competition and deflation in the global economy

Introduction

Both economic policy and the general public still put the problem of inflation at the centre of their concerns. At the end of the 1960s an inflationary wave developed in the industrialized and developing countries which gathered momentum during the 1970s and reached its peak at the beginning of the 1980s, before falling back.

Deflation has again become a serious problem. In this article I shall show that since the 1990s the world economy has developed into a constellation which contains latent deflationary risks. These dangers are thus not a short-term phenomenon, but endanger the world economy in both the medium and the long term.

Deflation is not only a topic of concern in relation to trade. Asset price deflation – a fall in the prices of shares or real estate – leads to similar problems. Devaluation has a similar effect when borrowers in the devaluing country have debts in a foreign currency. Deflation on tradable goods markets, asset price deflation and devaluations must be seen in close connection and should all form part of an analysis of a deflationary economic constellation.

In section 1, I discuss the end of inflation. Section 2 deals with the instability of asset markets, especially stock markets. Section 3 looks at international currency markets, while in section 4 labor market developments are considered in detail because in many countries the nominal wage level represents the last anchor against deflation. The final section summarises the main arguments.

1. The end of inflation

The inflationary dynamic which still dominated the world economy in the 1980s and early 1990s has flattened out. In 2003 the inflation rate in the industrialised countries sank below 2 per cent, and in the developing countries below 6 per cent (see Table 1). However, it is important to keep in mind that due to quality improvements and new products the real inflation rate is another 1–2 per cent below the official one. Thus, the inflation rate in the Western world was more or less zero in 2003 (see Rogoff 2003).

Among the developed countries, deflation hit Japan, which since the mid 1990s has been fighting against a falling price level. However, since the beginning of the 2000s and under pressure of the economic downswing, deflationary dangers have also been perceived in other developed countries. Thus, the International Monetary Fund (IMF) in spring 2003 considered Germany, Japan, Taiwan and Hong Kong as countries at a high risk of deflation (IMF 2003). The US Federal Reserve Bank was

Table 1: Inflation rates (consumer price index)
(Annual changes in %)

	1980–84	1985–89	1990–94	1995–99	2000–03	2000–04	2003
World	14.1	15.5	30.4	8.4	4.1	3.9	3.9
Industrialized countries	8.7	3.9	3.8	2.0	2.0	1.8	1.9
Developing countries	31.4	48.0	53.2	13.1	5.7	5.6	6.0
Africa	16.8	17.9	39.8	20.6	11.8	11.0	10.7
Asia	9.0	11.5	10.5	7.3	2.3	2.4	2.6
Latin America	82.4	185.9	232.6	17.2	8.2	7.9	10.9
Middle East	18.6	22.5	30.4	29.6	16.4	15.3	13.4
Transforming countries	6.2	7.7	363.2	53.9	14.5	13.4	10.0

Source: Rogoff (2003).

also concerned about possible deflation and reacted extremely quickly with a decisive cut in interest rates after the long upswing of the 1990s. Some developing countries were also threatened by deflation: China in particular has fought against a falling price level since the end of the 1990s.

Goods market deflation has several harmful effects:

1. Deflations have a negative effect on the debt situation of enterprises, banks and insurance companies, as well as private and public debtor households. The classic analysis of the negative debt effects of deflation was written by Irving Fisher (1933), who analysed the deflationary world economic crisis at the beginning of the 1930s. He found that a declining price level in the goods market will lead automatically after a certain point to an increase in the real debt burden and thus force debtors into liquidity problems or even total ruin. Let us look at a firm which (in fact, like all real-world firms) finances part of its productive capital by borrowing. With falling prices turnover will decrease even under the optimistic expectation of selling the same quantity of goods as before. The financial obligations of the firm do not decrease with deflation, however, because debts are fixed nominally. The interest rate may be lowered under deflation or fall almost to zero, but the nominal interest rate cannot fall below zero because no economic actor would lend money at negative nominal interest rates, instead preferring to hold on to their money. At an interest rate of zero there is a liquidity trap as described by Keynes (1936). Similar effects are to be expected for indebted private and public households. If debtors in such a situation try to sell their goods or assets, prices will fall even more rapidly and real debts increase further. The lack of liquidity and the insolvency of firms and households sooner or later affect also the banking system, which during deflation builds up non-performing loans. Credit chains will be broken and financial system distortions will destroy the coherence of a monetary production economy and the credit-investment-income-building mechanism which is typical of prosperous economies (Minsky 1980). The result is what Fisher (1933, p. 344) described as follows: "The more the debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but is capsizing." The general uncertainty which results from a massive increase in debtor insolvency, together with the problems of the whole financial system, contributes to the destruction of the economy.
2. Deflations have a negative influence on the demand for goods. If consumers expect falling prices they will postpone the purchase of durable consumer goods (including real estate). A similar effect influences investment demand. What manager would buy a machine today which his competitor can buy more cheaply in six months' time and so obtain a competitive advantage? The decline in the quantity of demand during deflation reinforces the abovementioned nominal decline in sales. If redundancies and losses ensue, goods demand will fall further and exacerbate the deflationary process.[1]
3. Asset price deflation can make consumption and investment fall further.

Clearly, the balance sheet effects of inflation are the most destructive. This means that deflation increases the debt burden and destroys the equity of debtors.[2] Such destructive effects can also be found in other markets. We shall start with the stock market.

2. Stock markets and deflation

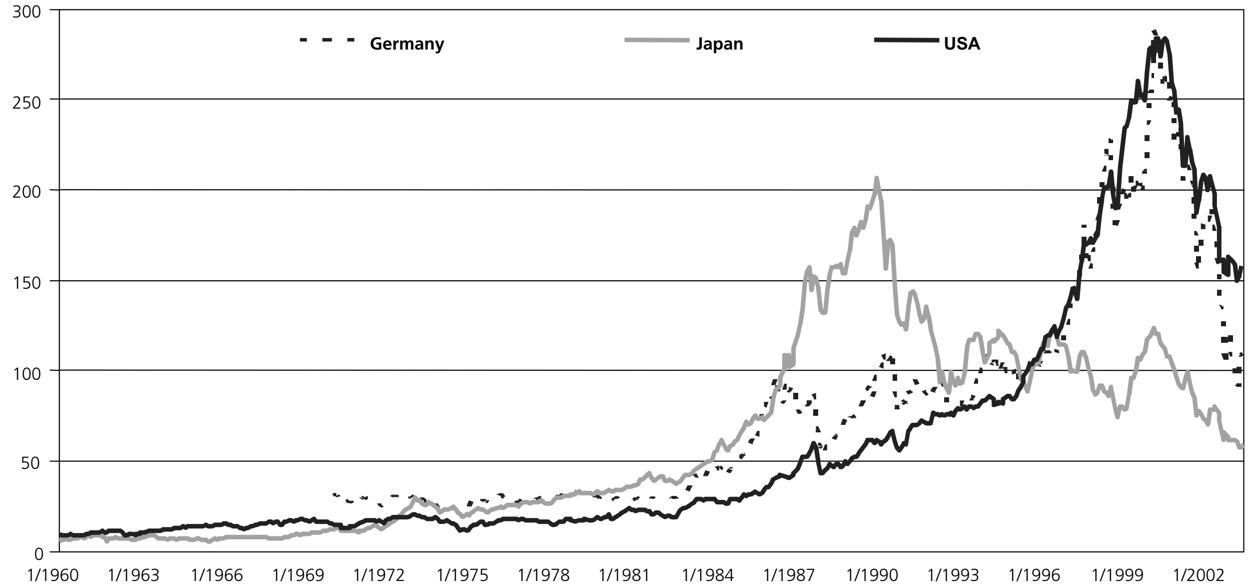
Stock markets can be seen as ideal asset markets. Actors on stock markets have to build their expectations concerning the performance of the firms behind the shares, for example, what profits they are likely to make, what dividends they may issue, what stock price changes are to be expected. The type of shareholder that we have just described has a long-term time horizon. However, there are other actors on share markets, so-called speculators, who have a short-term time horizon. They are not interested in the underlying performance of firms, but in the development of stock prices over the next three months, two days or four hours, according to preference. These actors try to find out what stock price developments other actors expect. It is like a "beauty contest" in which the winner is the person whose expectation is closest to the average resulting from the choices of all participants (Keynes 1936, p. 156). This logic of expectation-building reinforces exaggerations and cumulative processes.

However, even in the absence of speculation the basic problem of stock markets is that there is no an-

1 If there is net monetary wealth in an economy then real net monetary wealth may increase during deflation and thus increase consumer demand. This phenomenon is quantitatively low and exists only under extremely uncertain conditions (Heine and Herr 2003).

2 In contrast to mainstream economists, Minsky (1975) and Stiglitz and Greenwald (2003) focus their analysis on these points.

Figure 1: The development of stock price indices



Source: IMF International Statistical Yearbook 2000/2003.

chor for stock prices. The prices of, say, gherkins and camping chairs have a gravitational centre in the market price which is derived from their production costs. In the case of stock prices, however, there is no such gravitational centre because no one knows the "correct" price of stocks. In view of future uncertainty, expectations can only be subjective and are based on flimsy reasoning, potentially giving rise to dramatic changes. Overoptimistic periods will lead to stock market exuberance, while pessimism might leave stock prices in the doldrums for a long time.[3]

Figure 1 shows how the development of stock prices in the Western world has become rather wayward since the 1980s. From the mid 1980s, Japan faced gigantic asset price inflation which, after the bubble burst, gave way to enormous asset price deflation. A comparable asset price inflation with a succeeding asset price deflation took place in relation to the New Economy in the US and Europe during the second half of the 1990s. Alan Greenspan, President of the US Federal Reserve Bank, had warned as early as 1996 against irrational exuberance on the stock markets, but that was only the beginning. There had been no year between 1881 and 1998 with a comparable p/e ratio in the US, while in Europe the distortion was much the same (Shiller 2000, pp. 6ff).

Real estate markets are subject to the same price developments as stock markets. Thus, a bubble in the real estate sector accompanied the stock bubble in Japan. With the crash of the real estate market in Japan prices fell precipitately: in Tokyo, for example, by up to 80 per cent. To give another example, the countries involved in the Asian crisis of 1997 experienced speculative stock and real estate market bubbles before the crisis got under way.

Asset price deflations may have disastrous effects, first of all on the balance sheets of banks and enterprises. Enterprises will have to adjust the prices of their assets. Debtor collateral (from shares to real estate) is destroyed. Firms may therefore become insolvent and fail to redeem their pledges. Bankruptcies and non-performing loans will lead to problems in the banking system. In the case of banks which themselves hold real estate and stocks, the situation will be further strained. An asset price deflation can thus change a healthy banking system into one with unsustainably high non-performing loans. Because of the lack of equity such a banking system will thus have to refuse new credits, leading to very restrictive credit rationing. Interest rates in such a situation may be low and credit demand high, but the banking system will not supply credits (Stiglitz and Greenwald 2003; Minsky 1980). Such credit rationing will lead to a deep crisis of the whole economy because without credit expansion economic activity will stagnate. A good example of very restrictive credit rationing as a result of asset price deflation is Japan at the beginning of the 1990s. Indeed, Japan has still not been able to emerge from its banking crisis. Another

3 There is a broad debate concerning whether stock prices are determined by fundamentals or not (Shleifer 2000).

major fall in stock and real estate prices would lead to similar problems for the US and Europe.

The chances of companies obtaining credit worsen at the same time as the assets used as collateral lose value. To the extent that private households are indebted, similar processes affect them too. One needs only recall the banking crisis in the US during the 1980s which was mainly caused by the indebtedness of private households, especially buyers of real estate.

Demand for consumer goods is dependent not only on current income, but also on household wealth. While in the case of a developing stock market bubble consumption is encouraged (see the US in the 1990s), it will be negatively influenced during asset price deflation. Especially in the case of capital based pension systems or old age pensions with a strong element of private savings, the negative effects of asset price deflation can be expected to be very strong.

In all Western countries the importance of the stock market has increased in recent decades and a "stock market culture" has emerged. On the one hand, even actors with small or middle incomes speculate on the stock market, while on the other, the development of stock prices has become an indicator to evaluate management quality (principle of shareholder value). Overall, stock markets have become more important for economic development.

The volatility of stock prices is increased by the fact that the stock markets of different countries have become interlinked as a result of liberalized international capital markets. Thus, an important part of capital inflows in the US during the 1990s was a result of stock buying in the US by foreigners. Without these inflows the exaggeration of the market would probably not have been so strong. Similar reinforcements can be observed in developing countries in phases of high capital inflows, which in case of withdrawal of capital turn into a threefold crisis in which stock prices fall, the currency devalues and the domestic financial system breaks down. The crises in Asia are among many examples of such a development.

3. International currency markets and debts

Currency market as asset market

The monetary system after the Second World War provided the Western world with a stable national as well as international framework, which was an important element in the "economic miracle" of the 1950s and 1960s. At the time of the end of the Bretton Woods system in 1973, a wave of deregulation of international capital flows started, first among the industrialized countries, then in the less developed countries (Cooper 1999).

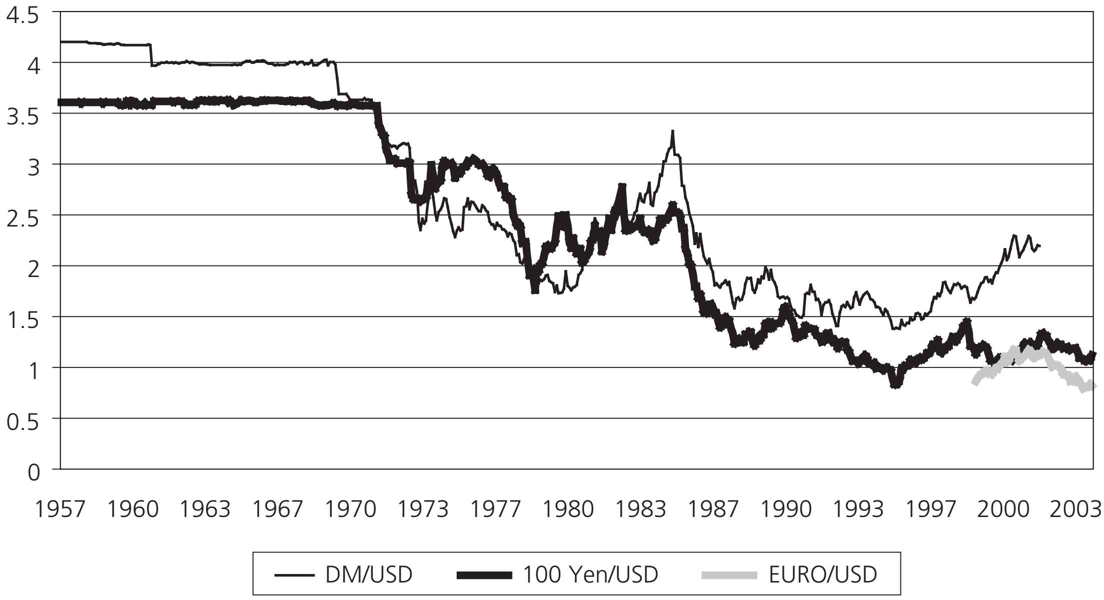
In the wake of the Bretton Woods system the world economy comprises a mixture of different monetary regimes. Exchange rates between the biggest currency blocs – US dollar, euro (Deutschmark) and yen – are completely flexible. In 2001, almost 30 per cent of world currencies followed a regime of flexible exchange rates; slightly more than 20 per cent were characterised by fixed exchange rates; while the rest followed a middle way (from bound exchange rates with discretionary changes to systems with formally flexible rates, but with massive central bank interventions) (Bubula and Ötker-Robe 2002). The majority of currencies in the developing world are more or less bound to the US dollar or the euro. The yen has so far not become a currency to which other currencies are pegged. The existing monetary system is thus, in respect of most of its elements, a system of currency blocs interlinked by flexible exchange rates, but which internally has rather fixed exchange rates.

Since the 1970s, there have been extreme medium-term exchange rate shifts between the three most important world currencies (see Figure 2). The monetary system has transformed itself virtually into a shock-creating machine, a permanent source of uncertainty in the world economy and so a disturbing factor for global economic development (see also Davidson 1982; Mundell 2000).

Currency markets with flexible exchange rates function in a similar fashion to stock markets. Supply and demand for currencies is immediately balanced by exchange rate adjustments. Besides interest rates, exchange rates are mainly driven by subjective expectations regarding the quality of a currency and by expectations concerning future development of exchange rates. And here lies the problem: no economic model can explain the development of exchange rates in terms of fundamentals. Differences in inflation rates, interest rates, productivity developments or growth rates, for example, are not sufficient to explain the exchange rate movements of the US dollar against the D-Mark or the euro. As capital flows create deficits or surpluses in the current account, there are also no fundamentals which could explain the worldwide development of surging current account imbalances over recent decades. We simply do not know which factors influence expectations.

We do not know, therefore, how the US dollar will develop over the next year or even the next six months. Currency markets with flexible exchange rates thus en-

Figure 2: Development of exchange rates between US dollar, yen and Deutschmark (euro)



Source: IMF, Bureau of Labor Statistics, Deutsche Bundesbank, Bank of Japan.

counter the same problem as stock markets: there is no anchor for expectations and so no anchor for exchange rate levels. In addition, currency markets may participate as enthusiastically in the logic of the "beauty contest" (see above) as stock markets. In the most recent debate it has been argued that the non-existence of an anchor for exchange rates is characterized by multiple equilibriums (Obstfeld 1994): for example, changes in expectations can transform the exchange rate from a "good" equilibrium with a high level of employment and a tendency for a balanced current account into a "bad" one with low employment and current account deficits which are not sustainable.

Economic development follows a sequential logic. A particular state of expectations and other factors, such as monetary policy, will thus lead to a specific short-term equilibrium. When expectations change, the economy will jump into the next phase, and so on. A relevant part of the dynamics will then lie in changes in expectations which are outside strict economic explanations (Hahn 1981). This sequential logic destroys the belief that there is a long-term trend derived from fundamentals. Empirical trends are only the outcome of a sequence of short-term developments.

World currency systems can be divided into hegemonic systems and multi-currency standards. In a hegemonic currency system there is an unchallenged currency which stands at the top of the currency hierarchy. Historically, the leading currency has been provided by countries playing an important role in the world economy and being also politically and militarily dominant. Central to a hegemonic currency system is the absence of competition among different currencies. Within a stable hegemonic currency system the barriers to international monetary functions shifting from one currency to another are extremely high and this will occur only when strong inflationary tendencies affect the leading currency. In a multi-currency standard more than one currency takes on international functions, and economic actors become aware that the countries which issue internationally important currencies are particularly important. Within a framework of changing expectations these actors will shift international monetary functions from one currency to another. Periodic shifts will therefore occur in international monetary functions according to changes in ranking in the currency hierarchy. The probability of destabilizing regroupings of international portfolios, and so on, will thus increase dramatically compared to a system with an unchallenged leading currency (Kindleberger 1981; Herr 1997).

Over the past few decades the world economy has developed from a stable hegemonic currency system into a strongly competitive system, particularly between the US dollar and the euro, with the yen also playing a role. Other currencies play a minor role. Table 2 shows that the euro and the US dollar have nearly the same importance in cross-border bank credits and in gross issuance in the international bond and note markets. The position of the yen and other currencies in these areas is comparatively low. Clearly, there is no longer a hegemonic currency system with one national currency performing all international monetary functions.

Table 2: Cross-border claims of BIS reporting banks, stocks at end Sept. 2003 (USD billion)

Total claims (by currency)	
US Dollar	6008.7
Euro	5408.6
Yen	751.6
Other [a)]	2761.0
Gross issuance in international bond and note markets, 2003 (by currency)	
US Dollar	1167.0
Euro	1289.9
Yen	102.9
Other [a)]	234.0

a) Including unallocated currencies

Source: BIS (2004, p. 17 and 32).

Currency competition is characterized by a number of different mechanisms. Governments or central banks can actively fight for a dominant position for their national currency within the currency hierarchy. The most decisive economic instruments, besides such dimensions as political stability and political and military dominance, are: a high degree of price stability, the absence of devaluations (in the best case, constant small revaluations), current account surpluses or establishing a position as an international net-creditor, as well as high growth rates and rising productivity. Japan (currently with the highest net-creditor position) and Germany (currently with the second highest net-creditor position) are good examples because since the Second World War both countries have managed to develop their currencies almost out of nothing into ones of international importance. It is questionable, however, whether Japan or the Federal Republic of Germany had a strategy for establishing the national currency as internationally important.[4] For the purposes of currency competition this is unimportant. The competition between currencies is caused by international owners of wealth, banks, investment and pension funds, or companies. If a country with a reserve currency does not meet the expected standards concerning price level stability or an economic policy which strongly promotes currency stability, then capital will be withdrawn and relocated in a competing currency. Expectations regarding economic policies or political developments may initiate capital relocations which under a hegemonic system would not have occurred. It must be kept in mind that only the first investors will escape without losses. This logic of asset markets causes sudden and cumulative portfolio shifts during periods of changing expectations. The result of these activities is the excessive currency fluctuations which the world economy has experienced since the 1970s. The current global exchange rate system suffers from an explosive mixture, including flexible exchange rates with no centre of gravity able to limit violent exchange rate movements. At the same time, the intensive currency competition in the existing multi-currency system leads to a constellation which periodically causes massive portfolio shifts and thus exchange rate and current account instabilities.

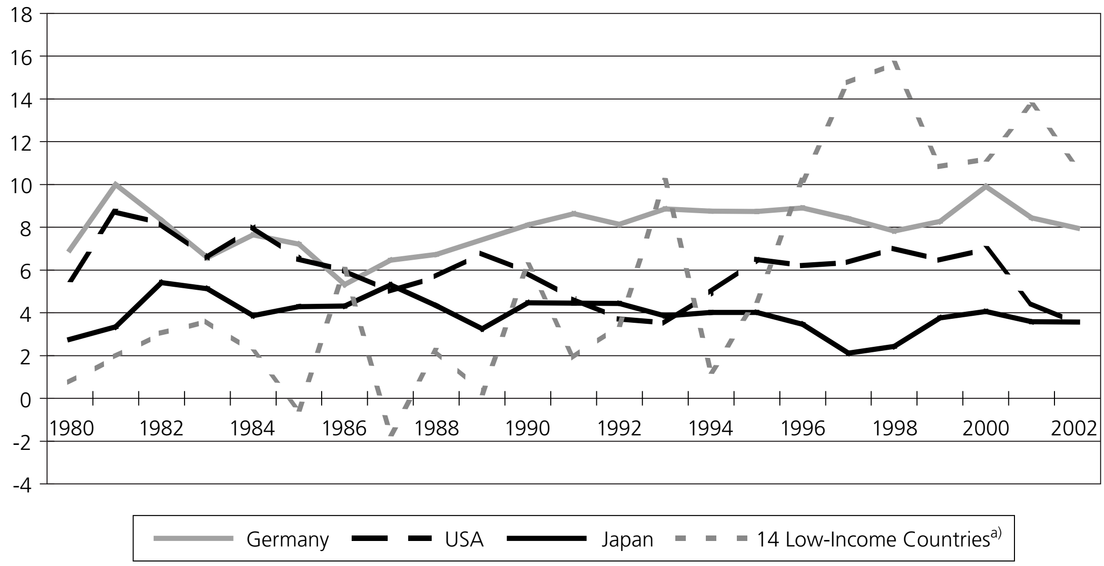
Deregulated international capital markets force all world currencies to compete with each other because economic actors can keep their wealth in both the domestic and foreign currencies. Whereas in the middle rank of the currency hierarchy we find currencies which fulfil almost all monetary functions for the domestic economy but play no international role, at the bottom of the currency hierarchy we find currencies which only partially fulfil domestic monetary functions. These national monetary systems are undermined by foreign currencies. Table 3 shows the extent of dollarization (or euroization). If we add the deposits kept in foreign currencies abroad and the cash held in foreign currencies – both statistically difficult to register – we get some idea of the degree to which the currencies of peripheral countries have lost out in the competition with the US dollar or the euro. Dollarization has a long series of negative effects.[5] If national currencies are threatened by dollarization in the above-mentioned way by competition with the leading international currencies, the constraints on domestic monetary policy become extremely strong. A precipitate fall in inflation rates, especially in developing countries (see Table 1), is one result of this.

Countries facing deregulated international capital flows and issuing weak currencies at the bottom of the currency hierarchy have to compensate for the low quality of their currency by high interest rates to mo-

4 The German Central Bank was for a long time unhappy with the increasing international role of the D-Mark because this ran counter to its mercantile ambitions for Germany (Emminger 1986).

5 Dollarization leads to a currency mismatch when banks lend foreign currency deposits to domestic borrowers which earn their revenues in domestic currency. It stimulates capital exports if domestic banks are afraid of the currency mismatch of debtors and prefer to invest abroad. In addition, dollarization hollows out the function of the central bank as lender of last resort and reduces monetary policy options to a minimum. On the dollarization debate, see Haiduk et al (2004).

Figure 3: Real interest rates in selected countries



a) *Selected according to complete availability of data: Bangladesh, Cameroon, Central African Republic, Chad, Congo Republic, Gambia, India, Kenya, Lesotho, Malawi, Nigeria, Sierra Leone, Zambia, Zimbabwe.*

Source: World Bank, *World Development Indicators 2004*.

Table 3: Evolution of share of average foreign currency deposits in total deposits (%)

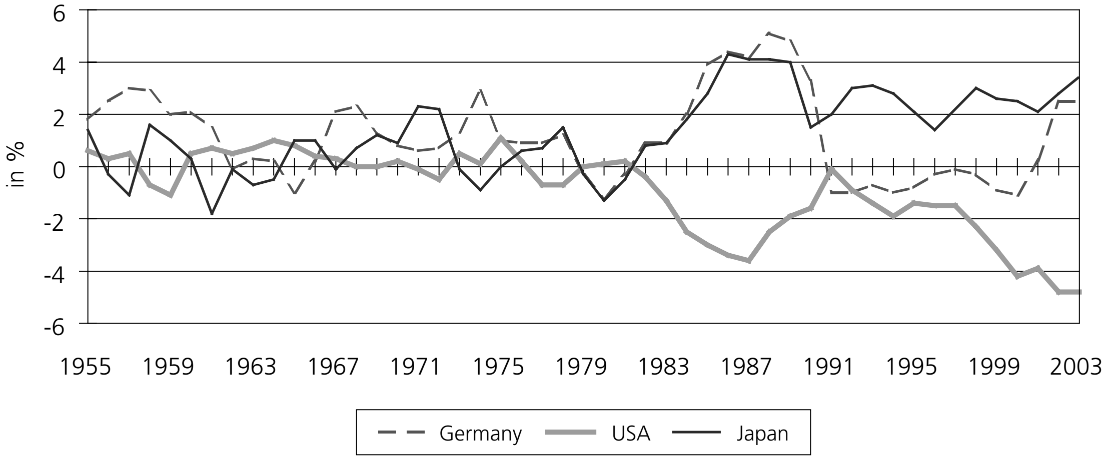
Regions	**Number of countries**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
South America	8	45.8	46.1	49.4	53.2	54.0	55.9
Transition economies	26	37.3	38.9	43.5	44.3	46.9	47.7
Middle East	7	36.5	37.2	37.7	37.5	38.2	41.9
Africa	14	27.9	27.3	27.8	28.9	32.7	33.2
Asia	13	24.9	28.0	26.8	28.8	28.7	28.2
Central America and Mexico	7	20.6	20.8	22.0	22.1	22.5	24.7
	10	6.3	7.6	6.8	6.7	6.1	6.2
Developed countries	14	7.4	7.5	7.5	6.7	7.0	6.6

Source: De Nicoló, Honohan and Ize (2003, p. 6).

tivate economic actors to keep wealth in the national currency. Figure 3 shows that peripheral countries have been forced to maintain higher real interest rates to survive currency competition over the past two decades. With high real interest rates dynamic economic activity is almost impossible because few investment projects can earn such a high rate of return. In addition, such high interest rates lead to negative distributional effects and an adverse selection of debtors (Stiglitz and Greenwald 2003).

The increase in currency competition from the top of the currency hierarchy to the bottom has led to a world economic regime that focuses on price level stability and, in general, on economic policies favouring monetary wealth holders. If a national currency does not meet the expectations of wealth holders capital will be exported to countries whose currency is at the top of the hierarchy. No central bank in the world can ignore the non-acceptance of its currency and therefore must seek to defend it with a restrictive monetary policy. Thus, the US dollar and the euro defend their position as leading currencies; middle currencies defend the domestic economic functions of their currency; and many peripheral countries fight simply for the economic survival of their currency. The competition between the countries at the top of the currency hierarchy in a multi-currency system can lead to an internationally restrictive standard of price level stability. This high standard increases the pressure on world currencies to maintain high price level stability, the outcome is a world eco-

Figure 4: Current account balances of the United States, Germany and Japan (% of GDP)



Source: Bureau of Labor Statistics, Deutsche Bundesbank, Bank of Japan

nomic constellation with a strong deflationary tendency or one which is characterized by such a high standard set for price level stability that small shocks can lead economies into a deflationary situation. Globalization and deregulation have therefore promoted a political economy with extremely low inflation rates. There is little likelihood that this will change over the next few decades.[6]

Reinforcement of the power of financial wealth holders and the orientation of economic policy in line with their interests imply high costs for the world economy in respect of growth and employment. However, there is also the danger of increased deflationary tendencies which can lead to deep depression and stagnation worldwide. It would be wrong to attribute these developments to the skilful lobbying of financial wealth holders: in a monetary production economy almost everyone is a financial wealth holder, although to different degrees. It is the individual economic calculus of securing one's wealth (Riese 2001) and the logic of markets which produce these results within the current deregulated framework of the world economy.

Foreign debts and exchange rates

International capital streams, which themselves are influenced primarily by expectations, created huge current account imbalances in the 1980s and 1990s compared to earlier decades. Figures 2 and 4 show that during the 1980s and 1990s the United States experienced both periodic revaluation of the dollar and unprecedented current account imbalances which corresponded to high net-capital imports. During the 1980s, US deficits corresponded to the high current account surpluses of Japan and Germany. In the 1990s, Japan in particular had high surpluses, while Germany, after a few deficit years in the wake of reunification, returned to record surpluses from the end of the 1990s. The post Bretton Woods era is therefore also the era of building up creditor-debtor relationships between countries, which was previously almost unknown. Meanwhile, the United States is the biggest debtor country in the world.

The instability of international capital streams, current account balances and exchange rates is not limited to the industrialized countries, but also characterises the relationship between industrialized and developing countries. This is most obvious in the case of emerging markets affected by instable capital flows, violent exchange rate movements and high foreign debt. The less developed countries are not in a position to attract private capital and depend almost solely on support from public donors. Table 4 shows that peripheral countries have a high degree of foreign debt. Some of it is caused by current account deficits, another part by the fact that companies, banks and public households in peripheral countries usually become indebted abroad, whereas private households export capital and build up a foreign net-debtor position.

Here, we face a central problem of the world economy: international credits are more or less only denomi-

6 Without hesitation we agree with Rogoff (2003, p. 21) when he writes: "I have argued that globalisation and de-regulation have been powerful forces supporting the political economy of low inflation. Indeed, the most likely scenario is that these engines of higher competition and productivity will only continue to strengthen in coming decades."

Table 4: External debt as a percentage of GD

	1981	1986	1991	1996	1998	2000
Developing countries (excl. transition countries)	27.8	38.4	38.6	33.8	38.1	36.0
Africa	31.4	55.9	62.6	57.4	70.2	67.7
Asia	18.6	27.1	32.9	27.8	31.6	27.9
Latin America	39.8	51.6	39.3	35.8	37.5	38.6
Middle East and Europe	–	33.2	32.0	30.2	39.2	36.7

Source: IMF, World Economic Outlook (diff. Editions).

nated in US dollars, euros or yen. This means that only borrowers in the United States, the EU (those countries which have signed up to Economic and Monetary Union) and Japan can denominate foreign debt in their own currency. This state of affairs, which is without remedy and which is economically extremely negative, has become known in the economic debate as "original sin" (Eichengreen, Hausmann and Panizza 2002).

Debts in foreign currencies as a result of dollarization add to the high foreign indebtedness of many of these countries.

As soon as creditors and debtors operate in different currencies – whether these are cross-border credits or domestic credit in foreign currency – a new risk emerges: the possibility of a change in the exchange rate, which affects both creditors and debtors. If it comes to a devaluation of the debtor's currency they may incur massive liquidity and solvency problems as the debt increases expressed in domestic currency. The higher the ratio of foreign (gross) debt to GDP and the stronger the devaluation, the more the real debt burden increases in the devaluing country. We can describe this process as the deflationary effect of devaluation.

Devaluations in economies characterized by high debts in foreign currencies are much more destructive than deflations in goods markets because the central banks of devaluing countries have limited resources to fight a spreading liquidity crisis. If many of the banks and enterprises which are indebted in a foreign currency become insolvent, the central bank cannot take over the function of the lender of last resort because it cannot create the necessary means. After the central bank has exhausted its reserves it can only passively watch the spreading of a liquidity and insolvency crisis among the banks and enterprises indebted in a foreign currency.

In cases of high indebtedness in a foreign currency devaluations lead to twofold crises as devaluations lead to a banking crisis in the devaluing country. A banking crisis will destroy trust in the currency and thus lead to panic and capital flight. This leads to an increase in real debts and thus to an intensification of the banking crisis. As Fisher puts it, the more the economic boat tips the more it tends to tip (Kaminsky and Reinhart 1999).

In many cases there is a threefold crisis, where currency and banking crises are correlated with a stock market and often a real estate market crash. Domestic and foreign investors withdraw their money from stocks and real estate to put it in foreign currency. A restrictive monetary policy with increasing interest rates, which usually accompanies a currency crisis, intensifies asset price deflation. Typically, before a crisis the foreign indebtedness of crisis-driven countries increases. This is caused either by an increase in the debts of public households (for example, in Latin America during the 1970s or in Russia before the crisis in 1998) or by a boom in domestic investment (as in Asia before the Asian crisis in 1997). Domestic credit expansion is correlated with increased borrowing in foreign currency. The credit supply then comes to a great extent from abroad. At the same time, a stock and real estate boom occurs in many cases prior to a currency crisis, which exposes the domestic banking system to additional risks. This holds particularly when the domestic banking system itself holds real estate and stocks, or finances speculation in real estate and stocks, or when they are heavily used as collateral for credits. Only countries at the top of the currency hierarchy are not affected by "original sin" and can build up foreign debt without the danger of these twofold or threefold crises.

4. The erosion of the wage anchor

In equilibrium and in the long term, the price level of an economy will be determined by costs of production. These costs are the anchor of the price level. In the short term, disequilibria on the goods market can influence the price level. Excess demand increases the price level, whereas excess supply pushes companies to lower prices. We will focus here on production costs because in the long run enterprises adjust their prices to costs. In a closed economy production costs are ultimately wage costs and profit rate multiplied by capital stock. Profit can – to simplify – be assumed to equal interest costs, which are calculated by multiplying the capital stock by the interest rate (Heine and Herr 2003 and 2004).

Although changes in the profit rate may influence the price level nominal wages continue to provide the economy with a nominal anchor. If unit labor costs increase, this will lead to a wage-price spiral ushering in inflation. If unit labor costs decline, costs and price level will fall. The result of a reduction in unit labor costs is deflation (Keynes 1930). Unit labor costs themselves are dependent upon changes in the nominal wage rate and changes in labor productivity. If hourly wages increase more than productivity unit labor costs increase, which results in wage inflation and an increasing price level. If wage rates rise less than productivity or become negative, the price level will fall and the economy will sink into wage deflation because of the falling unit labor costs. In a more detailed analysis other costs could be included, particularly those imposed by the state in the form of taxes and duties. A VAT or petrol tax increase may help to explain the logic of cost inflation. It is well known that such tax increases lead directly to price level increases. All companies will be affected in the same way, which is why a cost shift is easily applied. If one considers the effects of foreign trade, a currency appreciation has deflationary effects because the prices of imported goods fall, while in the opposite case the prices of imported goods increase along with the price level.

Productivity-oriented wage development, which serves as a nominal anchor in the economy, thus implies wage increases equalling the inflation target plus the increase in productivity. Wage development of this kind is a vital part of a stable monetary production economy. On the one hand, this releases monetary policy from the fight against inflation because if a wage-price spiral commences in an inflationary direction the central bank must slow down growth and increase unemployment by imposing a restrictive monetary policy. More important in our discussion, however, is the wage anchor in the case of deflationary tendencies because under deflation the central bank loses its power to influence the economy: with a falling price level real interest rates rise without the central bank being able to do anything about it. If the central bank seeks to maintain a stable price level under inflation, a wage anchor may serve as a means of preventing the economy from succumbing to deflationary tendencies. A productivity-oriented development of the nominal wage level will be achieved only if a purely market-driven mechanism for wage determination is avoided.[7] This requires institutions which direct wage development. Different countries have developed different wage negotiation systems which meet these requirements more or less. A purely market-driven wage determination mechanism exists no longer and with good reason. National institutions become established over decades and reflect domestic historical specificities. What is decisive is not the historical form, but the ability to guide wage increases in accordance with productivity and a target inflation rate.

In most industrialized countries trade unions have been weakened by high and persistent unemployment and the dominance of neoliberal economic policies. They therefore face the danger that market forces in the labor market will hollow out a productivity-oriented wage development and so lead to wage reductions. This is accompanied by a dominant economic policy which seeks wage reductions in order to cope with unemployment.

5. Conclusions

The threatened deflation which accompanied the last cyclical decline was not merely a blip, but a sign that the world economy is moving into a new constellation which in a long-term perspective has deflationary dangers. The deregulation and globalization which gathered momentum in the 1990s led to a weakening of the institutions which had previously stabilized economic development and acted as buffers against deflation. Unregulated market forces, which lead to unstable and partially self-reinforcing processes, have gained ground.

The following mechanisms in particular are deflationary and may have a deeply negative effect on economic development:

1. The creeping erosion of the nominal wage anchor in many Western countries as a result of the weakening of the trade unions and an economic policy which focuses on wage reductions to solve mass unemployment.
2. The destruction of the nominal exchange rate anchor which began to disintegrate with the breakdown of the Bretton Woods system.
3. The building up of high foreign debts which threatens to destabilize or even destroy the financial system of countries which can incur debts only in foreign currencies and are affected by devaluation. Dollarization has become more and more widespread: along-

7 "The chief result of this policy [flexible nominal wages] would be to cause a great instability of prices, so violent perhaps as to make business calculations futile in an economic society functioning after the manner of that in which we live. To suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of *laissez-faire,* is the opposite of the truth" (Keynes 1936, p. 269).

side other negative effects it has the same effect as high foreign debt in foreign currencies.

4. The increasing role of stock markets and thus the danger of asset price inflation and deflation.
5. Intensification of currency competition both at the top of the currency hierarchy as a result of a multi-currency standard, and at the bottom of the currency hierarchy because of accelerating dollarization.
6. The increasing political strength of neo-liberal ideas and the greater political power of monetary wealth owners with the result that many countries strive for very low inflation rates, close to zero.

Each of these aspects has deflationary potential, although to a different degree. Taken together they signal that capitalism has undergone a profound transformation in recent decades. The stable market constellation of the first decades after the Second World War has changed into a very fragile market constellation with strong destabilizing forces. Without a fundamental reregulation on different economic levels, in coming decades we will face a serious and probably increasing danger of deflation in the world economy.

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Feasibility and timing of euro adoption by the new EU member states

1. The commitment to adopt the euro

The 10 new member states are now facing the challenge of framing and implementing policies for adopting the euro. They are all bound by the EU Treaty to replace their national currencies with the euro at some future time as they were admitted to the Union with a derogation to this effect. In order to prepare adequately for entry to the euro area, the candidates need to undergo fiscal and monetary convergence. In principle, they should refrain from lax fiscal policies that could skew the eurozone policy mix by forcing the European Central Bank (ECB) to tighten monetary policy. They should consistently reduce any public debt accumulation that could result in a banking crisis and subsequently put pressure on the ECB to monetize it. On purely technical grounds, to enter the European common currency system the euro candidates must satisfy the Maastricht fiscal and monetary convergence criteria. The original criteria are spelled out in the Treaty protocols dating back to 1991. Their viability and applicability to the new member states are currently subject to intense scrutiny, as they reflect the European Commission's apparent precept that the euro candidates should be treated as an isomorphic block, disregarding their structural and institutional differences (Kenen and Meade 2003).

2. Compliance with Maastricht

Despite the controversies surrounding the convergence criteria, they remain in place as strict requirements for euro adoption. At the present time, new member state compliance with the convergence criteria is diverse and, generally speaking, far from satisfactory, at least according to the European Central Bank in its recent Convergence Report (ECB 2004). The ECB concluded that satisfactory pursuit of the convergence process required that the candidates resolve their profound structural fiscal challenges and devise effective monetary policies aimed at securing price stability. The key convergence indicators are presented in Table 1.

A glimpse at the relevant country data reveals that new member states face a range of problems.[1] A comparison of data with the Maastricht benchmarks (reference values) suggests that the smaller new member states, particularly Estonia and Lithuania, appear to be ready for euro adoption, while the larger new member states have yet to achieve satisfactory fiscal and monetary stability. With the exception of Slovakia and the Baltic States, the new EU entrants do not fare well on *fiscal criteria*. General government deficits exceed the three-per cent limit stipulated by the EU Stability and Growth Pact (SGP), reflecting mainly large primary expenditures on social transfers, in particular substantial contingent fiscal liabilities in the form of guarantees and strong commitments to future pension obligations. Excessive fiscal deficits have clearly exacerbated the public debt to GDP ratios, which range from low levels in the Czech Republic and Slovakia, through borderline high in Slovenia, Poland and Hungary, to excessive in Cyprus and Malta. These countries are engaged in equally intense struggles in respect of achieving *price stability*. Inflation rates have been excessive in Slovenia, Hungary and, to some extent, Latvia and Slovakia. They have been on the edge of the reference rate in Poland and Malta, and successfully contained in the remaining four new member states. Nevertheless, headline inflation has increased, particularly in the aftermath of the May 2004 accession, although the recent price shock can be perceived as temporary, not threatening price stability in the long run. It stems mainly from EU accession-related increases in indirect taxes and administered prices, along with higher energy prices (ECB 2004). Some threats to price stability stem from renewed wage pressures that have contributed to rising unit labor costs. In light of these developments, policymakers in the euro candidate countries face the task of devising optimal convergence policies.

1 A detailed analysis of the individual countries' compliance with the official criteria is beyond the scope of this brief study, which is aimed solely at synthesising the main conjectures concerning optimal policies leading to euro adoption and not at examining the depth of the structural and systemic problems faced by the candidates.

Table 1: Fiscal and monetary convergence indicators for new member states (excluding the exchange rate stability criterion)

	HICP inflation[a)]	**Long-term interest rates[a)]**	**General government budget (share of GDP)[b)]**	**General government gross debt (share of GDP)[b)]**	**Percentage change in gross debt ratio from 2002 to 2004**
Czech Rep.	**1.8**	**4.7**	–5.0	**37.9**	+9.1
Estonia	**2.0**	n.a.	**+0.3**	**4.8**	–0.5
Cyprus	**2.1**	**5.2**	–5.2	72.6	+5.2
Latvia	4.9	**5.0**	**–2.0**	**14.7**	+0.6
Lithuania	**–0.2**	**4.7**	**–2.6**	**21.4**	–1.0
Hungary	6.5	8.1	–5.5	**59.9**	+2.7
Malta	2.6	**4.7**	–5.2	73.8	+11.1
Poland	2.5	6.9	–5.6	**47.2**	+6.1
Slovakia	4.1	**5.2**	**–2.3**	**30.8**	+1.3
Slovenia	8.4	**5.1**	–3.9	**44.5**	+1.2
Reference values	2.4 %	6.4 %	–3.0 %	60.0 %	–

Notes: a) Average annual rates for September 2003–August 2004. b) European Commission projections for 2004.

Reference values for monetary convergence indicators are based on average annual inflation rates in Finland, Denmark and Sweden (three lowest inflation EU members) in September 2003–August 2004 plus 1.5 per cent; and their average long-term interest rates during the same period plus 2 per cent.

Indicators satisfying the Maastricht criteria are in bold.

Source: European Central Bank, *2004 Convergence Report*.

However, it should be noted that finding a single comprehensive convergence policy and a uniform adjustment process for the 10 new member states may be an impossible task, considering their vast systemic differences. The Maastricht criteria are certainly insufficient to offer useful guidance to policymakers in this respect. Therefore, specific convergence policies need to be designed on a case-by-case basis and carefully tailored to national characteristics.

3. Monetary policies for convergence – no common prescription

Scepticism about "one-size-fits-all" policy prescriptions has emerged on the basis of a heated debate about optimal *monetary policies* for euro adoption. In essence, adoption of the euro will mean that the individual countries relinquish their monetary autonomy, which will entail certain short-run costs. These costs are likely to be minimized if adjustments to monetary policy regimes are properly designed and tailored to the individual country's circumstances in the course of active preparations for euro adoption. There is now a consensus in the literature that the smaller candidate countries, such as the Baltic States, that rely on a currency board arrangement to guide their monetary policies will be best served by maintaining their existing monetary regimes during their final passage toward the euro. This is because their financial markets are relatively less developed and thus susceptible to large, potentially destabilizing shocks. If greater monetary flexibility was adopted, it would precipitate financial volatility and so present investors with a higher country risk. A departure from the current hard peg would probably jeopardize direct investment and hamper economic growth in these countries. As a result, it would unnecessarily defer euro adoption by the smaller new member states.

In contrast to the smaller new member states, there is little consensus about effective monetary policies for euro adoption in relation to the larger new member states. The ongoing debate includes a variety of policy proposals, ranging from a leap to unilateral euroization to prolonged reliance on autonomous monetary regimes based on direct inflation targeting (DIT). Despite the controversies, there is a common belief that autonomous policies based on exclusive targeting of monetary growth or inflation would generate sub-optimal results. This qualm undoubtedly derives from the strict DIT policies currently being followed by the National Bank of Poland and the Czech National Bank.

The proponents of unilateral euro adoption, including Bratkowski and Rostowski (2001), Buiter and Grafe (2002) and Begg et al. (2003), have identified a number of benefits that could result from such a bold move. Certainly, prompt entry into the euro area would entail considerably lower costs for both current and capital transactions. It would also bring about lower interest rates, although they would not be fully aligned with those in the eurozone as banking systems in the new member states are considerably less competitive (Nuti 2002). Nevertheless, lending rates in a prompt euro entrant would still carry a risk premium as long as institutional convergence of the financial systems remained incomplete. Perhaps the least questionable benefit of prompt euroization would be the elimination of exchange rate risk. As a consequence, exposure to speculative attacks on the currency would be lower. However, similar effects can be achieved by implementing fully autonomous, yet disciplined fiscal and monetary policies. Possible direct costs associated with a rush to euroization may entail the initial drainage of international reserves, a loss of seigniorage revenues to the government and surrender of the central bank's lender-of-last-resort function. However, these direct costs may prove to be rather insignificant as seigniorage revenues or central bank emergency lending activities are negligible in new member states at present. More qualified reservations about the leap to euroization attach to rising unit labor costs and the danger of losing the ability to respond adequately to asymmetric shocks. Such disadvantages may be particularly pronounced in a country whose monetary, real and institutional convergence efforts are far from completion. If the candidate country moves swiftly to euroization while its convergence is only partially complete, it may initially experience considerable financial disintermediation, as both depository and lending activities shift abroad to more efficient financial centres. In addition, unit labor costs may increase as wage demands outpace productivity growth. As a result, rising production costs may curtail investment and economic growth, thus increasing unemployment. In any case, it will take some time for these short- and medium-term costs to dissipate. In essence, the timing of formal euro adoption should matter less than establishing a timeframe for successful completion of monetary, real and institutional convergence (Orlowski 2001; Nuti 2002). A few more years of monetary independence combined with disciplined fiscal policies to prepare adequately for euro entry may prove beneficial. This extra time would also allow for completion of the necessary institutional reforms.

Alternative proposals for more gradualist adjustments in monetary policy are based on extensions to the current rather strict DIT regimes, incorporating greater flexibility. In other words, they assign different weights to inflation and exchange rate stability targets. Infusion of the exchange rate stability objective is believed to be critical for achieving successful monetary convergence with the euro. Despite the different policy prescriptions among the proposals, the gradualist approach recognizes the importance of having sufficient time for the successful pursuit if not the full completion of monetary, real and institutional convergence.

A rather extreme solution – a far-reaching departure from the current strict DIT policies – is proposed by Bofinger and Wollmershäuser (2001, 2002) who advocate adopting a monetary regime based on flexible exchange rate targeting during the final passage toward the euro. In their policy scenario, exchange rate stability becomes the key policy objective, while price stability plays a secondary role only, as it is presumed to be derived from less volatile exchange rates. However, if financial markets in new member states are institutionally unprepared and, therefore, not resilient to nominal shocks, efforts toward achieving exchange rate stability may entail frequent and costly interventions. In addition, it is highly uncertain whether a monetary regime focusing on exchange rate stability (even in a stricter form than the one allowed by ERM II) would in fact contribute to price stability. This is because the exchange rate channel of monetary policy transmission in the larger new member states is ambiguous and unstable (Orlowski 2003 and 2005; Golinelli and Rovelli 2004). Therefore, a smooth transmission of more stable exchange rates into low inflation cannot be guaranteed.

A more balanced weighting of inflation and exchange rate stability targets is advocated by Jonas (2004). His "dual-target and one-instrument" policy scenario is an extension of the present DIT regimes as it calls for assigning equal importance to inflation and exchange rate stability targets. However, the implementation of such a policy may pose serious difficulties as several plausible conflict areas between both targets can be identified. Among them is a possible combination of currency appreciation and high inflation in the presence of large capital inflows to new member states. A proper response to a stronger national currency would require lowering interest rates that could subsequently jeopardize the inflation target. On the contrary, raising interest rates by a central bank in response to higher inflation may lead to currency appreciation and exacerbate exchange rate volatility. Nevertheless, the conflicts between both targets become pronounced only in the presence of the so-called Balassa–Samuelson effects, which are believed to be prevalent in transition economies (Buiter and Grafe 2002; Begg et al. 2003; Mihaljek and Klau 2004; DeGrauwe and Schnabl 2004). According to the Balassa–Samuelson phenomenon, an increasingly open, growing economy is likely to experience a productivity shock in the tradable goods sector that drives up wages in non-tradables, thus contributing to chronic inflation. If this is the case, early unilateral euroization would probably contain inflationary pressures from this source (Bratkowski and Rostowski 2001). However, there is compelling empirical evidence that the Balassa–Samuelson effect in new member states is rather insignificant (Égert et al. 2003), which may lead to the conclusion that the suggestion of potential conflicts between inflation and exchange rate stability targets has little merit, along with the arguments for early euroization derived from it.

Among the proponents of gradual policy adjustments, Orlowski (2004) assigns the highest priority to the inflation target. He proposes a policy framework based on targeting the differentials between the candidate country and the eurozone inflation forecasts. Such a forward-looking policy regime is viewed as conducive to euro adoption. In this monetary policy framework, the inflation forecast differential becomes the key operating target while exchange rate stability is treated only as a major indicator variable, and not as an auxiliary operating target. The proposed regime allows policymakers to focus exclusively on price stability as the main criterion of monetary convergence, so underpinning their strong commitment to price convergence prior to euro adoption. Moreover, the proposed policy regime would also underpin commitment to price stability when possible conflicts between disinflation and exchange rate stability arise. In essence, this forward-looking monetary policy regime advances the present DIT policies pursued by the Czech Republic, Poland and, to some extent, Hungary.

4. Fiscal consolidation – principal controversies

Equally intense controversies surround *fiscal policies* as fiscal discipline is believed to be particularly conducive to a successful final passage toward the euro, and necessary for aiding monetary adjustment efforts. There is a consensus in the literature that the three-per cent threshold prescribed by SGP as the maximum permitted government budget deficit in relation to GDP is rather demanding for new member states and that the European Commission should recast this benchmark (Szapáry 2000; Nuti 2002). The permitted deficit seems too narrow to enable governments to complete ongoing deep structural and institutional reforms. Moreover, the three-per cent limit applies to all countries equally, regardless of their public debt levels. This makes little economic sense and the focus should be shifted instead to government efforts to achieve debt sustainability (Rostowski 2004). Briefly stated, highly indebted countries should be required to balance their budgets or to run surpluses in order to gradually relax the debt burden. By contrast, those new member states that have low debt-to-GDP ratios should be allowed to overrun the mechanical three-per cent limit in order to speed up the structural adjustments necessary to deepen their economic integration with "old" EU members.

Furthermore, there seems to be a consensus in the literature that SGP rigidity and its one-dimensional character are counterproductive as regards the quality of fiscal consolidation in new member states. This criticism holds true particularly when the government debt in relation to GDP becomes very high, prompting the authorities to cut expenditures while avoiding revenue-based consolidation (von Hagen, Hughes-Hallett and Strauch 2001). The expenditure cuts are likely to hamper economic growth more severely than the alternative tax increases. Moreover, SGP lacks a clear analytical foundation due to its simplicity. For instance, its calls for equal efforts to contain the budget deficit regardless of business cycle conditions are evidently oversimplified. In consequence, deficit reduction during economic slowdowns may exacerbate business cycle fluctuations; in other words, SGP-driven fiscal tightening becomes pro-cyclical during economic downturns. The final, frequently criticized shortcoming of SGP is that its inflexibility reduces the ability to respond to asymmetric, country-specific shocks. Therefore, SGP does not allow for the consideration of proper structural and institutional adjustment, something which may vary substantially among individual new member states.

Challenges to fiscal policies in the final passage to the euro also derive from a number of internal factors. Among them, the most burdensome to policymakers are the rigidities associated with social subsidies and formula-driven social transfers (Schadler 2004). These commitments are prevalent in all new member states due to population ageing which is expected to put substantial pressure on pension systems that in several countries are still based on the pay-as-you-go principle. Moreover, projected population ageing is likely to put additional pressures on public finances if further necessary reforms of pension systems are delayed. Social rigidities will be hard to overcome if labor market and pension system reforms are carried out.

More manageable challenges to fiscal stability are associated with temporary, one-off adjustments in tax rates. In particular, EU accession has necessitated increases in indirect taxation in all 10 new member states. These increases contributed to renewed inflationary pressures in the second half of 2004. However, these effects are likely to dissipate in the near future and are not expected to jeopardize fiscal consolidation efforts and medium-term deficit-debt adjustments.

It can be further anticipated that fiscal policy will have to play an active role in restoring a proper balance between short-run accession costs and its more dynamic, long-run benefits. The immediate accession-related costs are likely to outweigh the benefits that will materialize only after some time. Consequently, the initial gap between large contributions to EU budgets and smaller EU transfers to new member states is likely to adversely affect public support for integration, including future euro adoption. An increase in domestic expenditures may be required to offset such temporary accession-related net costs.

Nevertheless, the ability to maintain fiscal discipline will be critical for successful convergence. More specifically, a disciplined fiscal policy is critical for lowering interest rates and achieving more stable exchange rates. In turn, lower interest rates and lower exchange rate risk premia will probably promote investment and income growth, and also allow more expansionary monetary policies. In contrast, a failure to maintain fiscal discipline will force central banks to apply a very restrictive monetary policy, which will hinder structural reforms and economic growth in new member states.

5. The road ahead – coping with ERM II

As argued above, the smaller new member states would be well served by maintaining their present currency board arrangements, while the larger ones that target inflation will have to modify their monetary policies in order to accommodate the objective of exchange rate stability. Regardless of the applied adjustment, the new member states can and should avail themselves of the exchange rate flexibility afforded by ERM II, providing that the "standard" plus-minus 15 per cent band of currency fluctuations holds rather than the "normal" band of 2.25 per cent prescribed by ERM I. Certainly, their participation in ERM II will necessitate a reorientation of their monetary regime in order to take account of possible exchange rate shocks. In essence, the standard band offers enough flexibility to accommodate these shocks, particularly in the absence of active interventions by central banks pursuing DIT policies.

This analysis clearly favors inflation-targeting policies as more conducive to effective monetary convergence with the euro than those based on exchange-rate targeting. Flexible inflation-targeting regimes offer attractive advantages over those based on currency stability objectives, particularly the ones based on soft pegs. An exclusive focus on the exchange rate target does not necessarily forestall large currency shocks, especially if the country's financial system is inadequately prepared for their absorption. In addition, a currency peg, particularly one associated with the narrow 2.25 volatility margin, increases the risk attributable to misspecification of the reference rate. If the official reference rate is too weak – that is, set well below the dynamic equilibrium rate – it could inflate the domestic value of foreign currency debt and raise the default risk. If it is too strong, it could precipitate significant short-term capital inflows, exacerbating inflation. In any case, a wider tolerance band would create a cushion preventing such undesirable effects. Thus, the candidate countries face the challenge of a careful specification of the ERM II official reference rate that roughly corresponds to the dynamic equilibrium exchange rate.

Equally challenging are fiscal policy efforts aimed at maintaining a proper balance between the stringent objectives of fiscal convergence and those necessitated by structural reforms and social obligations.

In hindsight, the tasks of monetary and fiscal convergence to the euro are very complex; their framing and implementation pose major challenges to policymakers in new member states. Their search for appropriate policies and practices that are appropriate for the final passage toward the euro find some support in the literature, which, has not arrived at uniform optimal solutions. On practical grounds, however, the new member states' convergence with the euro is unprecedented, as there is almost no evidence on comparable reforms and experiences with monetary integration in the economies of the world.

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Hubert Gabrisch

Preventing financial crises – the role of exchange rate arrangements in new EU member countries

1. The Maastricht criteria and the financial crisis problem

EU entry in May 2004 committed the new member countries to prepare for euro adoption. The preparation process comprises two stages: (a) adjusting monetary and fiscal policy to take account of the common objectives of eurozone members, and (b) entering the Exchange Rate Mechanism (ERM).[1] In the first stage, exchange rate stability is the minimum requirement for acceptance for ERM membership, and there is no clear postulation with regard to date of entry. Euro parity is to be negotiated with the EU authorities. However, ERM membership requires more, namely the fulfilment of the five Maastricht criteria: (1) stability of the exchange rate around a central parity, (2) convergence of long-term interest rates and (3) of the inflation rate, and the two stability criteria: (4) the planned government deficit must not be more than 3 per cent of GDP and (5) gross debt must be no more than 60 per cent of GDP. At the end of this period, the conversion rate for euro adoption is set jointly by the EU and the country in question. Once the euro has been adopted, the Growth and Stability Pact is binding, that is, members must continuously adhere to the stability criteria mentioned above.

Obviously, the Maastricht criteria are intended to ensure the proper functioning of the common currency. Seen from this perspective, the entire procedure is linked to monetary policy and fiscal policy requirements. Financial crises in South East Asia and Latin America during the 1990s (complemented by crises in Eastern Europe, some involving new EU members) and their handling in the scientific literature shed new light on euro adoption. It is well known that full capital account liberalization is hard to reconcile with a fixed peg plus independent monetary policy. Economists have recognized that exchange rate stability might not be defended by simple fiscal retrenchments or by adopting an appropriate monetary rule. The exchange rate arrangement (ERA) itself is a policy variable which particularly addresses such institutional factors as a weak financial system.

The new member countries will enter the ERM with almost full capital account liberalization. Under these circumstances it is debatable whether one jacket (eurozone monetary policy) will fit all countries, particularly those with a financial sector still in the making, unstable fiscal systems and only fragmentarily effective monetary policy systems. Does the move to ERM II disregard the experiences of the 1990s when currency crises emerged together with a covariate banking crisis?

2. On financial crises: macroeconomics and institutional constraints

After the almost complete liberalization of financial markets, a number of financial crises have upset South East Asia, Latin America and Eastern Europe in recent decades. A financial crisis is twofold, involving both a currency and a banking crisis. The modern economic literature provides us with three categories or generations of crisis models, each of them offering a different set of analytical and explanatory tools (see Figure 1).[2]

First generation crisis models explain an approaching breakdown of the peg in terms of domestic credit expansion. Assuming a given supply of money, the expansion of domestic credit, facilitated by fiscal expenditure, will change the composition of the money supply because foreign investors withdraw their assets. There is one equilibrium defined by the intersection of the fixed peg rate and Krugman's well-known shadow exchange rate (Krugman 1979). A typical feature of the pre-crisis period is a stable domestic interest rate and constant money supply. Inflation is not an explanatory variable in these models, and crisis countries indeed had moderate inflation rates. After the devaluation, interest rates

1 The usual term is "ERM II". ERM I originated in the 1980s with the European Monetary System, which served in the 1990s as euro preparation for the old EU members. I shall use the simple term "ERM".

2 For an overview see Flood and Marion (1998).

Figure 1: Financial crisis models: macroeconomic and institutional perspectives

	Monetary policy perspective	**Currency regime recommended**
Currency run	1. domestic credit expansion 2. inconsistency between monetary and fiscal policy	Corner solution: float or "pure" currency board
	Institutional perspective ('financial fragility')	
Bank run	Moral hazard + peg	Float
	"Original sin" + peg + float	dollarisation
	Commitment problems + peg	Lender Of Last Resort + flexible exchange rate
	Contagion + peg	dollarisation

increase and inflation accelerates. This approach offers two typical empirical indicators for the move to a peg and its sustainability: the public debt and the budget deficit – that is, two of the Maastricht criteria.

Second generation models are based on policy inconsistencies which are responsible for multiple equilibria (Obstfeld 1986). Fiscal and monetary policies might pursue different objectives (real vs. nominal convergence). As fiscal policy might be committed to real economic growth and full employment, expansion of government expenditure might be desired, forcing the central bank, which is committed to defend the peg, to raise interest rates in order to protect against the withdrawal of foreign investors. Interest rates would be higher than with a float. The trade-off between policy objectives becomes unsustainable when rational investors believe that the cost of defending the peg will be too high and short-term capital flows in, speculating on devaluation. A typical indicator of the approaching currency crisis is an interest rate climbing ahead of and falling after the breakdown of the peg. The standard recommendation for crisis prevention is again fiscal retrenchment. If this is not possible for policy reasons (the "weak government" argument), a so-called *corner solution* should replace the fixed peg. In case of a free float, the central bank is not obliged to defend the peg and may accommodate fiscal objectives. In the case of a currency board (the "very" hard peg), the money supply is linked automatically to foreign exchange earnings. The inflow of foreign exchange would simply constrain the financing of the fiscal deficit via the interest rate mechanism.

Fiscal and monetary policies were the main explanatory variables in first- and second-generation models. With the 1990s crises, the choice of the exchange rate arrangement entered the scene as the crucial variable because traditional currency crisis models had lost their predictive power. With more or less sustainable budget deficits, low inflation rates and moderate current account deficits, neither first- nor second-generation models were able to explain the outbreak of the crises in South East Asia in 1997. A new class of crisis model started from modelling institutional constraints to macroeconomic models. These constraints are rooted in a country's financial sector and become obvious after liberalization of the capital account. *Financial fragility* may cause a currency run even under corner solutions (see, among others, Calvo 1996; Chang and Velasco 1998) and choice of the ERA may increase vulnerability to a bank run. The formal institution of an "exchange rate arrangement" may conflict with values and behaviours (informal institutions) in the given financial sector. Eichengreen and Hausmann (1999) condense three hypotheses from the recent literature explaining financial fragility: moral hazard, "original sin" and the commitment problem.

Moral hazard means that agents feel certain that they will be bailed out if they encounter repayment difficulties. Explicit or implicit guarantees prevent them from hedging their foreign exposure against foreign exchange risk. A pegged exchange rate is an implicit guarantee given by the central bank, mainly to banks and to the government. With moral hazard, the banking sector might expand its balance sheet without being limited by its equity capital. The literature describes overborrowing abroad (McKinnon and Pill 1997) and a lending boom (Krugman 1998) as possible consequences. A high share of bank lending to the public sector is usually taken as an indicator of increasing financial fragility. With rising asset prices, the quality of bank assets deteriorates, and lending rates increase until the bubble bursts. It is not clear what causes moral hazard. Some experts posit asymmetric information between banks, their deposit holders and foreign lenders, luring them to take higher risks than usual. A weak corporate governance culture in the financial sector is another possible reason. When moral hazard constitutes the main source of financial fragility, an independent float would be the optimal solution because it forces agents to hedge their risks.[3]

"*Original sin*" means that borrowers in a given country are not able to hedge because there is no final lender who will accept debt in the borrower's domestic currency. Hedging might be too costly or the currency is generally not accepted. Why borrowers of a country are unable to hedge is not clear, hence the term "*original sin*". A free float could worsen the situation. If agents expect depreciation they might purchase foreign exchange to cover their exposure, leading to further depreciation. The likely outcome is highly volatile interest rates, which might trigger a currency run. Typical signs of an original-sin problem under a float are a maturity and/or a currency mismatch in the banks' portfolios. A maturity mismatch exists when long-term investment is financed by short-term international credit. A currency mismatch includes liabilities in foreign currency, but claims in domestic currencies. Depreciation would put under strain the banking sector's ability to serve the foreign debt. A fixed peg does not offer a solution. If the central bank tried to defend the peg with interest hikes, the liquidity situation of corporations, banks and the government would deteriorate, short-term capital would then usually fill the gap, and a maturity mismatch would increase financial fragility. The trade-off between defending the peg and other government aims might lead to multiple equilibria and self-fulfilling currency crises. The recommended ERA is a currency board or even no currency ("dollarization").

The *commitment hypothesis* is deeply rooted in the view that a modern capitalist economy is based on intertemporal financial contracts. The creditor can never be sure of being paid unless a complex system of financial derivatives and institutions, including the availability of collateral, boosts confidence. Without these institutions, the commitment problem would spread throughout the economy; weak regulation would worsen the situation. When property rights are not ensured by law, real assets cease to serve as collateral – obviously a problem for long-term financing in former socialist countries. A high share of bad loans in banks' portfolios and a wide spread between credit and deposit rates are typical indicators of commitment problems. The implications for exchange rate policies are less obvious compared to the other two cases. A currency board prevents a currency crisis, but not a bank run. The risk of a bank run is the main reason why pure currency boards are rare. Central banks keep some reserves out of circulation to ensure a certain lender-of-last-resort function and to retain some tools for managing the money supply (minimum reserve holding of banks, for example). Where the financial infrastructure is least developed and ownership is under question, as in transition countries, markets may most need a lender of last resort, which in turn requires the freedom granted by a flexible exchange rate policy (Eichengreen and Hausmann). However, with a float, commitment problems cause lenders to demand wider spreads, which might trigger a self-fulfilling crisis through expected devaluation. Obviously, when capital account restrictions are lifted the quality of supervision and monitoring of the financial sector (Williamson and Miller 1998) and the degree of international integration of the banking industry play a role in reducing financial fragility. Foreign ownership, for example, is commonly seen as improving monitoring and auditing and can even substitute the lender-of-last-resort function of the central bank, and thus a fixed peg becomes more sustainable. Chan-Lau and Chen (1998) note that countries such as Hong Kong (currency board) and Singapore (managed float) had better supervision and monitoring, had longer experience in financial business and were less prone to financial crises, if not immune to them.

Finally, contagion from a financial crisis in another region of the world economy might trigger off a bank run even with a sound banking system. The problem is that the portfolio cleanings of international investors might also affect the securities of third countries in their effort to achieve an optimal risk structure. The affected third countries are usually those with a rating similar to the crisis countries. In fact, there is no protection against contagion except an upgrading of the institutional environment.[4]

3 Another recommendation is to restrict capital account liberalization. This will not be discussed in this study since we are concentrating on the exchange rate issue.

4 To avoid too much detail, we do not consider the division into contagion and spillover. The latter would bring fundamentals back into the model, that is, fiscal retrenchment would be the proper response.

Equipped with this overview of exchange rate problems, we may assess the risk potential for new EU member countries when they move from their individual exchange rate agreement (ERA) to the exchange rate mechanism (ERM).

3. ERAs in new member countries and the ERM

In reaction to the twin financial crises, we can observe a shift away from ERAs controlled by the authorities (governments or central banks) towards floats and hard pegs (IMF 2000, Fischer 2001): that is, from so-called intermediate solutions to corner solutions. Few countries chose the non-mainstream solution of at least a temporary restriction of capital mobility – for example, Malaysia (IMF 1999). As in East Asia and Latin America after financial liberalization, most CEE countries experienced strong pressure on their currencies after the start of the transformation to a market economy, including a liberalization of capital accounts and financial markets. A number of financial crises – for example, in Bulgaria, Romania and the Czech Republic in 1997, and in Russia, Belarus and Ukraine in 1998 – led to several changes in the ERA. Having used a nominal exchange rate anchor for stabilization (= monetary) policy in the early transition period, many countries decided later to shift from intermediate exchange rate arrangements towards a currency board or a float (Figure 2). Other governments decided to start the transition with a corner solution (currency board: Estonia, Lithuania; float: Bulgaria, Slovenia). The general experience is that after adjusting the ERA in accordance with a corner solution, vulnerability to a financial crisis decreased remarkably. With the exception of some speculative attacks against the Polish zloty (July 2001) and the Hungarian forint (November 2003), vulnerability declined significantly in the pre-accession period. Euro adoption and the move to the ERM is for all countries a more or less significant change in the rules of the game. While the changeover to the euro is at least similar to a corner solution, ERM accession amounts to a move from both corners to an intermediate regime.

The ERM rules include:

a) A central parity of the country's currency against the euro within a relatively wide band of ±15 per cent and intra-marginal intervention points inside this band. The central parity is to be negotiated between the European Council (assisted by the European Central Bank's recommendations), and the government of the new member country; no country can set the parity autonomously. The bandwidth may be narrower, but this is also to be negotiated with the European Council (Denmark negotiated a band of ±2.5 per cent).
b) Voluntary intra-marginal interventions of the central bank with its own reserves.
c) Automatic interventions at the intra-marginal points with interest bearing credit facilities of the ECB (the central bank of the given country acts as an affiliate of the ECB).
d) A term of ERM membership of at least two years in which voluntary interventions should be only moderate (with successful convergence of interest and inflation rates and fulfilling the fiscal criteria). At the member country's request, the EU can consider shortening the two-year term.
e) Central banks are also obliged to defend the band by effective monetary policies, including sterilization.

Compared to the exchange rate arrangements in new member countries, ERM accession in almost all cases

Figure 2: Currency arrangements; rigidity scale

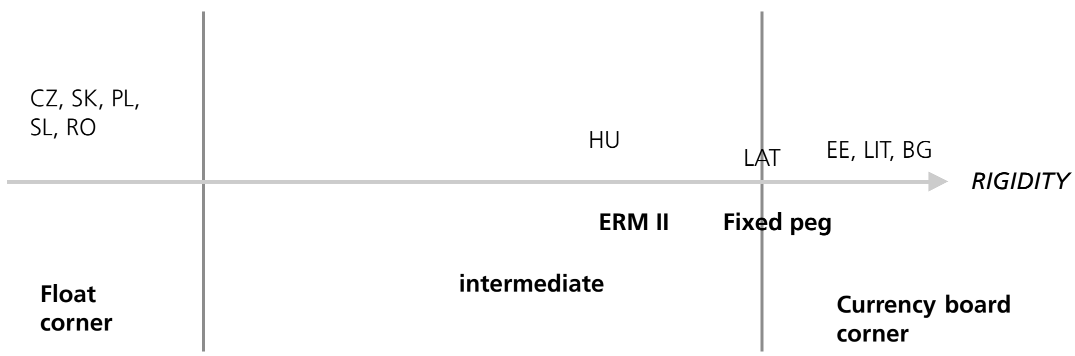


Table 1: Gross public debt and state budget in eight candidate countries, 2001–2003 (per cent BIP)

	Gross public debt			State budget[a)]		
Countries	**2001**	**2002**	**2003[b)]**	**2001**	**2002**	**2003[b)]**
Estonia	4.8	5.8	5.5	0.2	1.3	0.4
Latvia	15.7	15.2	16.0	–2.1	–2.8	–3.2
Lithuania	23.4	22.7	22.9	–2.2	–1.7	–2.4
Poland	37.3	47.4	50.8	–3.5	–3.8	–4.1
Slovak Republic	48.1	44.3	45.0	–4.5	–7.2	–4.9
Slovenia	27.5	28.3	27.8	–1.3	–3.0	–1.5
Czech Republic	23.3	27.1	30.5	–5.1	–6.7	–7.6
Hungary	53.4	56.3	57.5	–3.0	–9.3	–5.6

Notes: a) Consolidated budget. b) Estimated value.

Source: Eurostat, national statistics.

amounts to a change in the system. Figure 1 presents the degree of deviation from ERM on the eve of EU accession. Three countries – Estonia, Lithuania and Slovenia – entered the ERM a couple of weeks after EU accession from different corners.

At first glance, the wide ERM band seems close to a floating exchange rate, and from the currency board perspective this would include more flexibility. However, the EU accepted the currency boards of Estonia and Lithuania because a 0 per cent fluctuation band is allowed. From the float perspective, the automatic interventions and the requirements mentioned under (d) characterize the ERM rather as a test under a fixed exchange rate. ERM is least compatible with a floating exchange rate. Among the new EU members, the ERA of the Hungarian forint with a ±15 per cent band is closest to the ERM. It deviates in two important aspects: first, the central parity was chosen autonomously – the move from shadow to official ERM requires negotiation on the central parity; second, interventions must be made exclusively with the National Bank's own reserves.

4. Last-minute devaluation

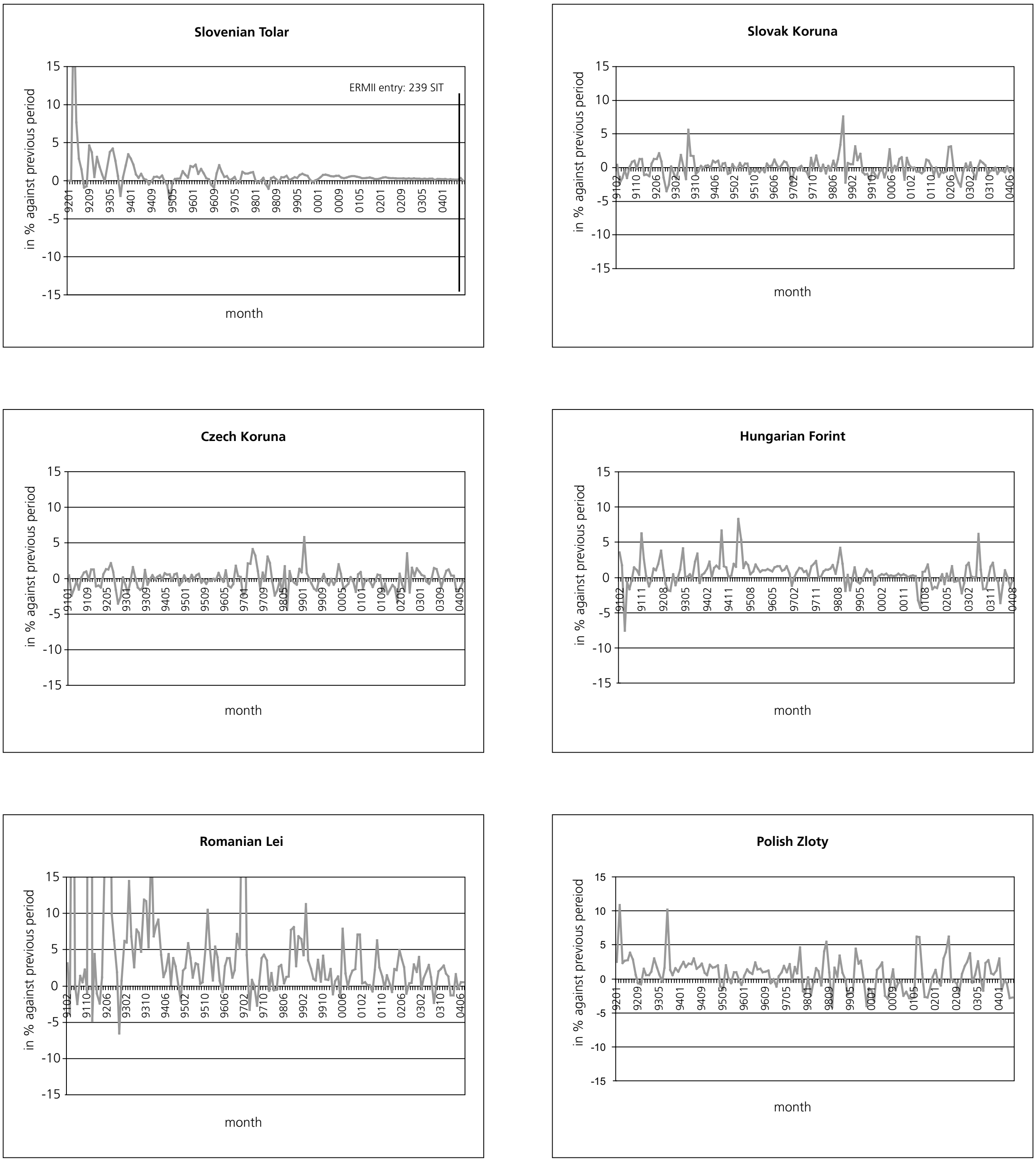
Budget deficit and public debt data underline the fact that the ERM entries of Slovenia, Estonia and Lithuania were backed by comparatively good performances (Table 1).

Once a country is a member of ERM, it is under the supervision of the European Central Bank with regard to the convergence criteria. Obedience to the two stability criteria – fiscal deficits and public debt – would diminish vulnerability to a fundamental (= first generation model) currency crisis. The critical points are ERM entry and exit to the euro when the central parity against the euro or the conversion rate must be determined after negotiations between the government and the EU authorities. A last-minute devaluation is possible and this uncertainty might trigger a speculative attack.[5] Here, present and accumulated historical budget deficits can have an impact on the entry rate. Much depends on how quickly negotiations on the entry rate are completed and the volatility of the exchange rate seems to be a decisive indicator.

Figure 3 compares exchange rate volatility within a ±15 per cent band of all floating and flexible currencies. It explains why negotiations with Slovenia could be completed quickly. Negotiations would last longer in all other cases, provoking doubts about the entry rate. Here, markets might expect last-minute devaluation. This also applies to Hungary where the forint became unstable after the introduction of the shadow ERM regime in October 2001. Latvia has a quasi-currency board: the Law on the central bank stipulates that the money base must be backed by foreign currency reserves. The problem is that the Lat is pegged to a currency basket including the SDR and the US dollar. Following Estonia and Lithuania into the ERM, the peg must be shifted to the euro, a technical exercize that might trigger uncertainty about the new exchange rate, however. Latvia must therefore get over this hurdle in early 2005 before it can enter the ERM.

5 The last-minute devaluation syndrome is not new, and has been discussed by, for example, Orlowski (1995) and Besancenot and Vranceanu (2003).

Figure 3: Exchange rate volatility against the euro

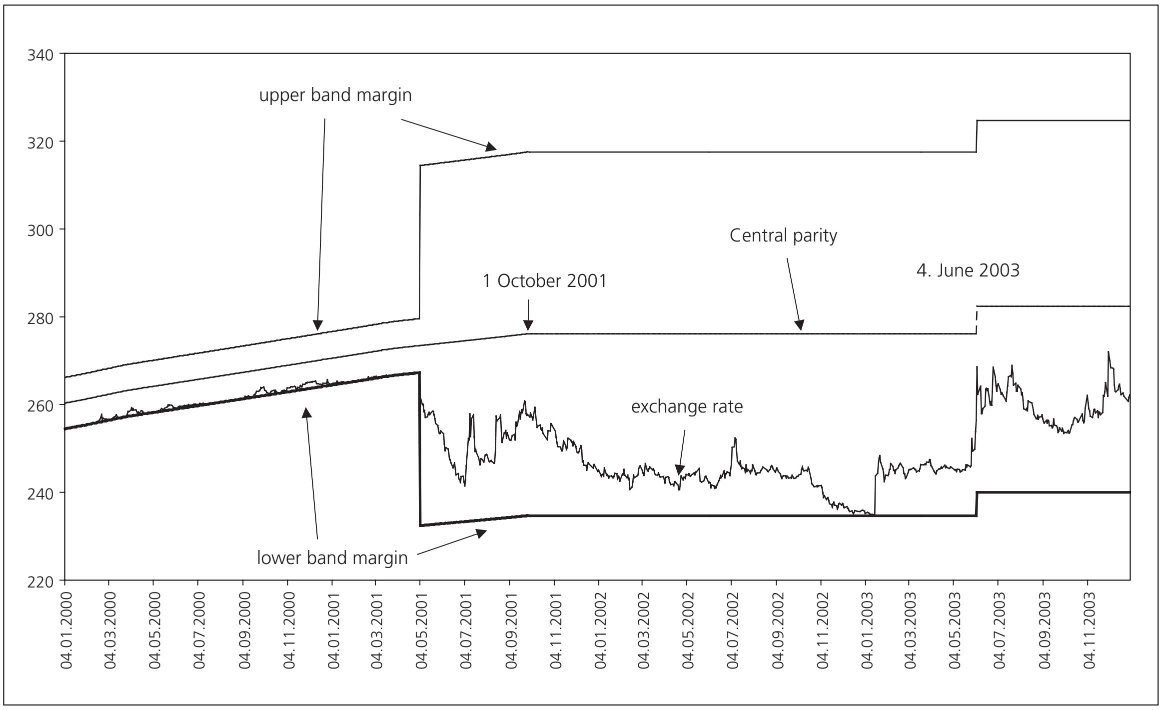


Source: National Banks, own figure.

5. Policy inconsistency

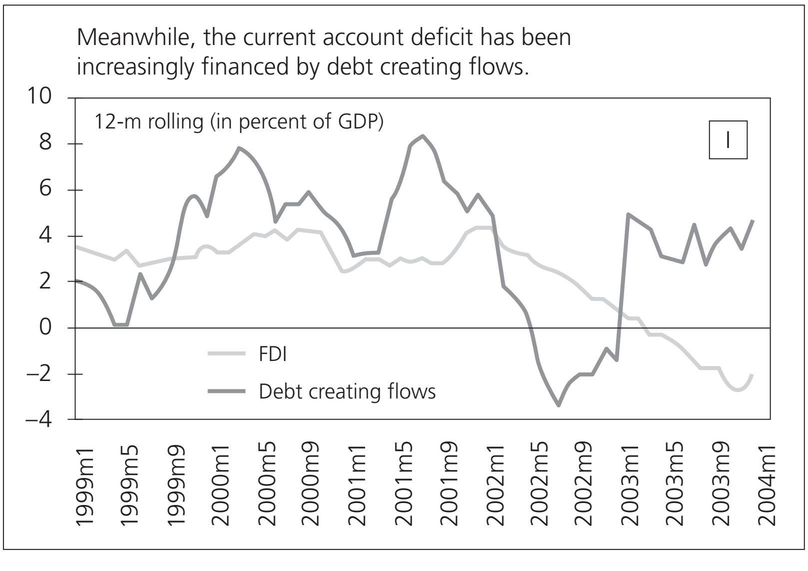
Although a country's fiscal and monetary policy will be under EU supervision, meeting the convergence criteria might become trickier. After ERM entry, the risk premium on foreign credits and other financial investments will fall. This will boost the country's demand for financial capital, followed by an appreciation of the currency. In order to defend the band, central banks must sterilize, leading to higher interest rates. Sterilization would impose more challenges on fiscal policy than staying outside the ERM. The recent Hungarian experience might be instructive to a certain extent (Figure 4).

Figure 4: Forint exchange rate against the euro



Source: National Bank of Hungary, own figure.

Figure 5

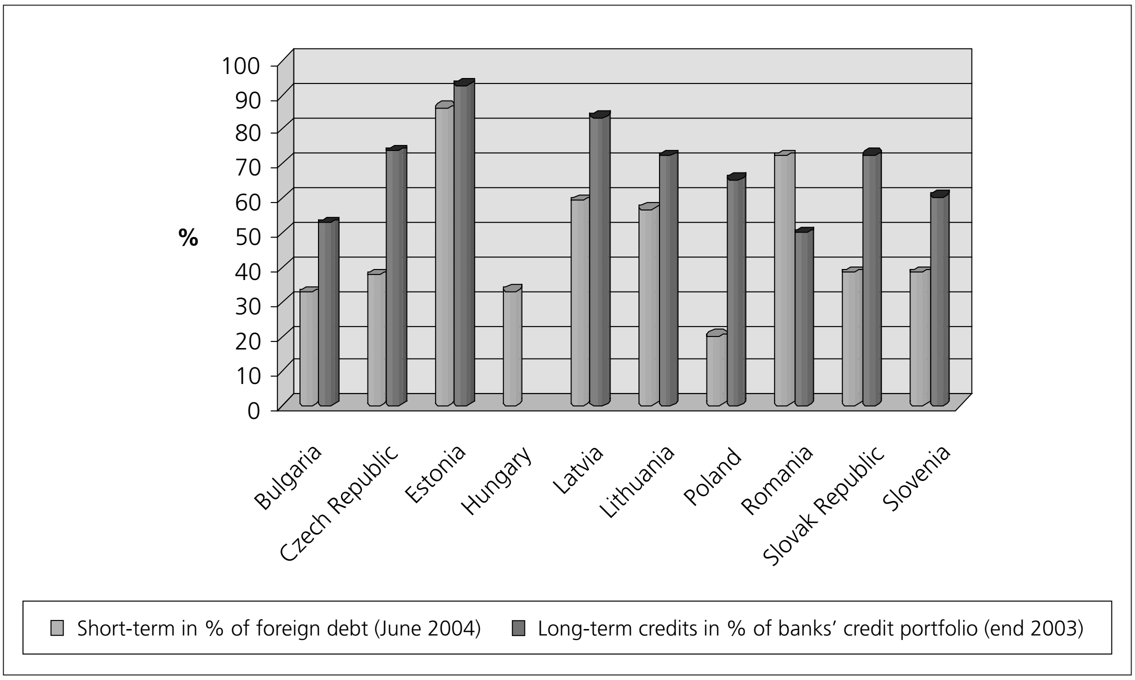


Source: IMF (2004a).

The Hungarian authorities decided on a move from a rather narrow band to the ERM bandwidth in October 2001 after a period of decreasing exchange rate volatility. Since then, the macroeconomic environment has changed dramatically. The first result was a change in the balance of payments. The deficit approached 6 per cent of GDP in 2003. While formerly the current account deficit had been financed by a strong FDI inflow, since then it has increasingly been financed by debt-creating inflows that can be especially volatile in the face of lost policy credibility (IMF 2004a).

The state budget deficit increased, as did the public debt ratio. The Hungarian forint became more volatile because foreign investors intensified transactions in domestic securities. The capital inflows forced the Hungarian National Bank into repeated interventions on the

Figure 6: Short-term borrowing and long-term lending



Note: For Hungary no data on long-term credits are available.

Source: Bank Austria (2004) (data); own figure.

foreign exchange market and strong discount rate cuts. These measures jeopardized the inflation target, and the National Bank intervened again, now selling foreign exchange. The government devalued the band unexpectedly a couple of months later, in June 2003, obviously in contradiction of the National Bank's actions. The outcome was a loss of confidence and a speculative attack on the forint in November 2003, followed by a hike in the central bank's discount rate. This course of events is typical of an approaching currency crisis within the framework of a second-generation model.

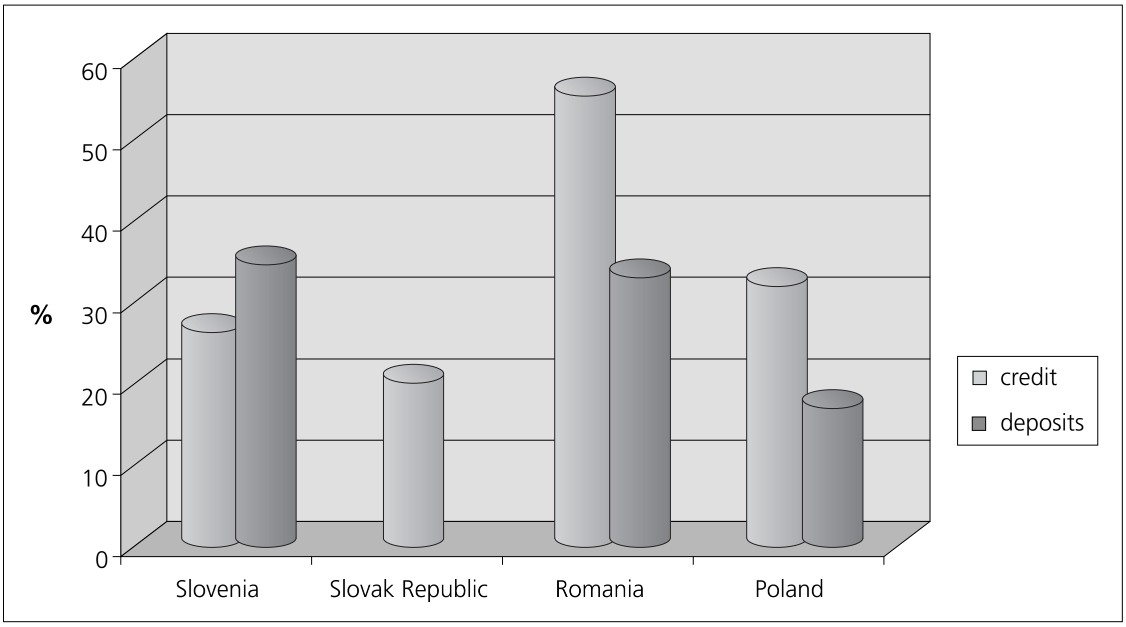
6. Fragility of the banking sector

When the capital markets of transition countries were opened up, an inflow of – particularly short-term – money and portfolio investments followed and the currencies came under revaluation pressure. In mature market economies, a developed financial sector is able to channel capital inflows to the real economy, ensuring that appreciation is followed by productivity gains. Without a capable financial sector, the risk structure of the banking system deteriorates. The breakdown of the Czech peg in May 1997 was preceded by bank turbulence. The Russian currency crisis in summer 1998 was preceded by the expansion of a poorly constituted banking sector,[6] which could not be efficiently supervized by the central bank.

Although recent reports on the banking sector (Bank Austria 2004; IMF 2004b) illustrate much progress in terms of its ability to avoid excessive risk, there are still many systemic risks. One of them is the high share of short-term credit in banks' foreign liabilities. Short-term borrowing is cheaper than long-term financing. Although this indicator has improved recently across the region, long-term credits in banks' portfolios are on the increase (maturity mismatch – see Figure 7). In the Baltic States, a strong inflow of short-term capital is causing huge current account deficits. In a number of other countries (Figure 8), a currency mismatch is jeopardizing the stability of the banking sector. Banks granted foreign exchange credits to the private sector, among them mortgage credits to private households.

6 Spontaneous privatization led to so-called "pocket banks" whose aim was to shift money to the government and to conduct illegal transactions.

Figure 7: Share of foreign currency credits in credits to private sector and share of foreign currency deposits in private sector deposits, 2003



Source: Bank Austria (2004); various IMF country reports; own figure.

7. Euroization

Currency substitution (spontaneous dollarization or euroization) is still a widespread problem among transition countries, although the central banks were able to soften the problem in the pre-accession period. Recently, it has been argued that the move to the ERM might re-strengthen spontaneous euroization, that is, agents would decide on a changeover to the euro. Declining demand for the domestic currency would increase the fragility of the banking sector: liabilities would carry a default risk premium. Exchange rate adjustments within the band would increase pressure on the banking system, and so a speculative attack might become a more realistic prospect. Spontaneous euroization is currency substitution. Among the possible causes of currency substitution, two seem to be relevant for ERM members (Krafczyk 2004): foreign currency deposits might be convenient for agents in investment and in foreign trade, and ERM could herald the return of high and unstable inflation rates. The first argument is aimed at investors whose investment horizon is longer than the expected deadline for euro adoption. It would be better to complete the changeover earlier. Also, exporting and importing agents might choose to use the euro purely for cost-saving purposes. The second argument might be related to non-fulfilment of the inflation criteria during ERM.

Official adoption of the euro would eliminate the problem. Official euroization seems to be bound to the formal procedure, with ERM as the intermediate period. However, at a country's request the EU authorities might consider shortening the two-year period. This might be a solution for Estonia, Lithuania and Slovenia, which have already entered the ERM.

In recent years, unilateral euroization has been discussed as a possible way of reducing financial fragility and binding governments' fiscal policies (Bratkowski and Rostowski, 2001). However, unilateral euroization is not allowed for an EU member and is not an option for the countries still outside the ERM. These countries should consider a currency board, a model of unilateral euroization which is accepted by the European Commission.

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The macroeconomics of neighbourhood policy

Lessons from the past – options for the future

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