



**TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH  
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI**

## **TIGER Working Paper Series**

**No. 46**

# **Policy (Institutional) Diversity and Economic Development**

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Warsaw, November 2003

## Policy (Institutional) Diversity and Economic Development<sup>1</sup>

### Summary

*Diversity*, or variety, is the essence of economic life in the sense of underlying choice; economic calculation gives numerical substance to how people make choices in their daily endeavours, either as consumers or entrepreneurs. How does variety/diversity takes shape in the realm of institutions and policy making? Is the range of choices open-ended? The last couple of decades have revealed an overwhelming offensive of the neo-liberal paradigm in terms of defining “best practices”. Even language was shaped accordingly with market reforms being seen in a quasi-single theoretical and policy framework. Are we heading towards increasing uniformity with regard to institutional and policy set ups, worldwide? An affirmative answer would underline the successful market based transformation of a series of command economies. Some convergence between institutional patterns in the USA and the EU economies might be alluded to in the same vein. A supportive argument for this line of reasoning could be that what matters for individual achievement, in the end, are equal opportunities. But this argument can be turned around when debating the merits of various institutional set ups in terms of creating fair chances for people. A sceptical answer would highlight the mounting challenges which confront societies, whether rich and poor, and the international community in general - in spite of the high hopes of not long ago. The demise of the “New Economy”, the series of corporate scandals in wealthy economies and the subsequent recourse to new regulatory legislation, recurrent financial and currency crises throughout the world, the controversies surrounding the activity of IFIs, should compel “ideologues”, of all sorts, to be more humble in their prescriptions. This essay argues that there is substantial scope for institutional and policy diversity to operate as a means to foster economic development; that there might be a paradigmatic cycle in the dynamic of economic policies.

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<sup>1</sup> Paper presented at the EACES workshop on “Institutional and Policy Diversity”, Debrecen, 3-4 November, 2003. This is an updated version of thoughts presented at several previous meetings. Comments made by Michael Keren, Jacques Pelkmans, Tsumeaki Sato, and Radu Vranceanu are highly appreciated. I bear sole responsibility for the content of the paper.

## 1. Introduction

*Diversity*, or variety, is the essence of economic life in the sense of underlying choice; economic calculation gives numerical substance to how people make choices in their daily endeavours, either as consumers or entrepreneurs<sup>2</sup>. As Kevin Lancaster pointed out years ago *variety* has value in itself<sup>3</sup>, for we enjoy a wider range of choices instead of a smaller one. How does variety/diversity takes shape in the realm of institutions and policy making? Is the range of choices open-ended? How does institution competition operate in the real world?

The last couple of decades has revealed an overwhelming offensive of the neo-liberal paradigm in terms of defining “best practices” and spreading the gospel of its policies throughout the world; this offensive was carried out by IFIs as well. Even language was shaped accordingly with market reforms being seen in a quasi-single theoretical and policy framework. Are we heading towards increasing uniformity –according to the logic of this paradigm- with regard to institutional and policy set ups, worldwide? An affirmative answer would underline the successful market based transformation of a series of command economies, some of which are going to join the European Union in 2004<sup>4</sup>. Likewise, some convergence between institutional patterns in the USA and the EU economies might be alluded to in the same vein A supportive argument for this line of reasoning could be that what matters for individual achievement, in the end, are equal opportunities. But this argument can be turned around when debating the merits of various institutional set ups in terms of creating fair chances for people.

A sceptical answer would highlight the mounting challenges which confront societies, whether rich and poor, and the international community in general – in spite of the high hopes of not long ago. The demise of the “New Economy” – the almost metaphysical notion of the 90s-, the corporate scandals across the Atlantic (and not only there) and the subsequent recourse to new regulatory legislation, recurrent financial and currency crises throughout the world (which evince major flaws of the international financial system), the controversies surrounding the activity of IFIs, should compel “ideologues”, of all sorts, to be more humble in their prescriptions. In this context one can mention the partial counter-offensive represented by the so-called “Third Way” paradigm<sup>5</sup>, the new vigour found by neo-Keynesian ideas, the powerful insights of the “New Theories”, as Robert Gilpin calls them, and last, but not least, the rising ambivalence triggered by unmanaged globalisation.

This essay argues that there is substantial scope for institutional and policy diversity to operate as a means to foster economic development; that there might be paradigmatic cycle in the dynamic of economic policies.

## 2. What influences institutional and policy diversity?

Institutional and policy diversity falls, arguably, under the impact of an array of factors and circumstances; some of these are enumerated briefly below.

### 2.1 *Institution and policy competition*

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<sup>2</sup> As Sherwin Rosen says, “Diversity is the stuff of economics”(American Economic Review, vol.92, no.1, March, 2002, p.1

<sup>3</sup> Kevin Lancaster, “Variety, Equity and Efficiency”, Oxford, Blackwell, 1979

<sup>4</sup> Albeit, notable differences among reform policies have existed At the same time, China provides a glaring example of successful market based gradualistic transformation.

<sup>5</sup> The guru is Anthony Giddens. The “new social democrats” talk about a worldwide political movement which should embrace their ideas.

Competition rewards better performance, which is revealed at both micro and macro/societal level<sup>6</sup>. The adoption of best practices illustrates the power of better ideas and institutions. But best practices have their own dynamic and are shaped by local conditions, which further implies that institutions evolve over time –some decay, some advance, some transform themselves<sup>7</sup>.

## 2.2 Ideology

John Maynard Keynes remarked that economists are intellectual prisoners of famous ideas. But ideas do not operate in a social vacuum. This is why, where democracy exists, it is not hard to detect linkages between the dynamic of political life (which is influenced by ideas/doctrines) and changes in economic policies. This is because the constellation of interests in society, which are articulated politically, drives policy formulation. When circumstances modify the texture of interests and entail also variations in the power (relevance) of ideas (some decay while others are resuscitated...) policies change and this can change institutions as well.

## 2.3 Values (culture) and institutions

Values influence individual and corporate behaviour, policies; they also modulate public intervention in the economy (society). Thence the debate on the merits and weaknesses of various brands of capitalism is not irrelevant<sup>8</sup>. But whatever cultural and social differences are people prize highly trust, honesty, loyalty. As J.K.Arrow<sup>9</sup> said in a beautiful essay these moral values have economic value, are basic institutions that oil the economic machinery and make it function better.

## 2.4 Complexity

Complexity does affect the ability of policy to influence economic outcomes. Undoubtedly, growing complexity magnified the costs of command-type planning in the former communist states and speeded up their collapse. Another example is provided by the European Union. Thus, the EU encounters mounting difficulties in its quest for institutional reforms (the Common Agricultural Policy included) due to its growing size and complexity. And it is clear that *enlargement* would not make this task easier. Japan achieved an economic miracle during the last century, especially after the second world war; her success was fuelled by an ingenious combination of market based economic structures and state intervention. Nonetheless, the increasing complexity and export orientation of the Japanese economy has entailed changes in its functioning and is forcing policy-makers to rethink their policy tools in order to cope with new policy dilemmas <sup>10</sup>(I refer here, in particular, to the decade long stagnation, and not, necessarily, to the consequences of the crisis in the banking system). And the late corporate scandals in the USA show the proliferation of conflicts of interest and the

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<sup>6</sup> Although, some (like Paul Krugman) would argue that nations do not compete; I still believe that nations, when seen as economic spaces (clusters of economic activities) compete. Otherwise, why would we care about national laws and norms and local networks.

<sup>7</sup> For a sharp analysis of evolving institutions in capitalism see Mancur Olson (1982). See also Douglas North (1981)

<sup>8</sup> In spite of convergence tendencies there are still important differences between American type and European type capitalisms. Asian capitalism has its own peculiar traits, as Latin-American economies also reveal specificities.

<sup>9</sup> John. Kenneth Arrow, "The Limits of Organization", New York, Norton, 1970

<sup>10</sup> For an excellent presentation of Japan's current economic pains and travails see Bai Gao (2001)

dangers of excessive market deregulation against the background of increasingly complex financial innovations<sup>11</sup>.

### *2.5 Economic openness*

The more open and smaller is an economy the more severely constrained is its national policy by external stimuli (phenomena). This is why open macroeconomics are quite different from macroeconomics in a relatively closed economy. Size matters considerably in explaining the intensity of transmitted effects, the power of interdependencies.

### *2.6 International agreements*

International agreements operate as a constraining factor unless a country's policy-makers obtain derogations, or enter into special arrangements with partners.

### *2.7 The rules imposed by the functioning of economic and monetary blocs.*

For example, the EU accession countries have to comply with the so called *Acquis Communautaire*. However, there is room for bargaining and the EU itself should be interested in better policy venues - in view of its own reform pains and the need to help accession countries catch up economically..

### *2.8 Policy conditionality*

In a world of growing interdependencies the effectiveness (performance) of policy making hinges on local expertise and the bargaining power of local negotiators in dealing with IFIs and other entities (such as the EU). Policy conditionality is to be linked to *policy ownership*. Lately, the IFIs have increased their concern for enhanced policy ownership, although, sometimes, this smells more of a rhetorical exercise or an attempt to diffuse the responsibility for failed programs.

### *2.9 Special circumstances*

Powerful adverse shocks force policy-makers to change their views and entrenched habits. Think about the rescue package mounted by the Republican Administration in the USA in order to help airlines companies (following the tragedy of September 11) together with the possibility (as aired by Ben Bernanke, who is a member of the Board of FED) of combating deflation by buying T-bills; or the credits granted by the central bank of Brazil to firms which were badly affected by credit lines withdrawn by foreign banks (during late 2002), etc

## **3. An historical perspective**

### *3.1 The high age of policy diversity*

Institutional and policy variety was quite obvious in the aftermath of the world war II. I am not referring to the philosophical and practical underpinnings of command (communist systems). What I have in mind is the wide spectrum of views with regard to economic

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<sup>11</sup> One can see here some bad effects of the repeal of the Glass-Steagall legislation.

development, the macro-management of capitalist economy, trade policy arrangements, foreign exchange regimes for dealing with capital movements etc. One can argue that a national economy-centred view dominated policy-making, as against the nowadays' conception of a "borderless world" (Kenichi Ohmae 1995).

That was a period in which Keynesism seemed to be hardly assailable in the realm of macroeconomic policy, structuralism got a high profile in relation with key problems afflicting developing countries, while the theory of the developmental state was embodied by Asian accomplishments. Trade policy, too, was used by various countries in order to acquire new competitive advantages, or protect domestic markets.

There was much confidence in the regulatory power of the state and in its ability to make the economy (markets) function better, a vision which had roots in the Great Depression. This vision may have been reinforced by the tasks of post-war economic reconstruction and post-colonialism. But these policies were frequently abused during that period and wishful thinking influenced policy-making often. Arguably, this policy thrust did undermine the vigour of market forces.

Nonetheless, the record showed positive results: there were economic reconstruction in Western Europe, a string of economic miracles in Asia, Brazil's impressive economic growth in the 50's and the 60's (however fractured and skewed that was), etc.

### *3.2 The neo-liberal Zeitgeist of the last couple of decades*

I would submit that globalisation is driven by both technological and institutional (policy) factors. Therefore, it can be seen as a facet, too, of the neo-liberal offensive which started a couple of decades ago<sup>12</sup>. But one should make a distinction between technological change (progress), which has economic and institutional consequences and which is, historically, of inscrutable vintage, and the range of policies initiated in the framework of wide-ranging financial and trade liberalisation, as well as of massive privatisation.

During this period one meets the retreat of Keynesism (against the background of rising inflation in several advanced economies and setbacks of profligate welfare policies) together with a belief in the preponderance of government failures in macro and micro-managing economies; market coordination failures are largely dismissed. Likewise, the poor record of economic progress in large areas of the world speeded up the sunset of *development economics*. As a matter of fact, mainstream (neoclassical) economics was seen as providing a valid toolbox for any circumstances. Thence emerged a policy framework -supported by the IFIs (the so called *Washington Consensus*)-, which supplanted the much wider conceptual policy approach of the 50s and the 60s.

In the 80s there was much talk about a clash of models: the Anglo-American model vs. a so-called continental model, and an Asian model. Nonetheless, trade liberalisation, market deregulation and privatisation contained ideological fervour and were pushed by the IFIs unrelentingly. The collapse of communism gave a further impetus to this vision and policy orientation.

The complete independence of central banks, fiscal conservatism and neutrality, rejection of macro-management of the economy, downsizing of the public sector, and market deregulation were seen as epitomes of sound economics and policy, to be generalised worldwide. And globalisation supplied the world arena for thinking that there is "one way, and only one way" in order to achieve economic progress and, eventually, *catching-up*.

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<sup>12</sup> George Soros, among others, calls it "market fundamentalism" (On Globalization, New York, Norton, 2002)

The natural inference would be that policy diversity in policy-making is senseless in a world which appears to have discovered the ultimate *best practices*, either at the macro, or the micro level.

#### 4. Examining the record

There are numerous facts, which invalidate the rosy outlines of the picture sketched above and invite to intellectual soul searching and honest debate.

4.1 *The Washington Consensus*<sup>13</sup> has performed much below expectations in not a few cases, and there is a significant number of top notch economists who question some of its working hypotheses; some theoretical premises have been severely questioned<sup>14</sup> and the work of the IMF and the World Bank has come under fire<sup>15</sup>.

- Policies aimed at fostering growth in developing countries seem to have fared quite poorly, in many respects, in the last couple of decades – at a time of widespread application of the main tenets of the “Washington Consensus”. According to a foremost development economist, William Easterly (who, for many years, was among the World Bank staff), during 1980-1998, average per capita income growth in developing countries was practically 0.0% (!), as compared to 2.5% during 1960-1979<sup>16</sup>. I would add that this discrepancy becomes even larger when singling out the economic performance of some Asian countries – which, as an increasing number of economists would concede, did pursue export orientation, but also implemented measures which, often, were at odds with the “orthodox” policies<sup>17</sup>; these countries shaped their own, particular, strategies. As Easterly also points out, “the increase in world interest rates, the increased debt burden of developing countries, the growth slowdown in the industrial world, and skill-biased technical change may have contributed” to this stagnation<sup>18</sup>. Easterly also stresses the inability of governments’ policies worldwide to make good use of incentives for growth. This state of affairs begs a simple question: why is it so difficult to use incentives in order to foster sustained growth?<sup>19</sup> Easterly goes on, “We economists who work on poor countries should leave aside some of our past arrogance. The problem of making poor countries rich was much more difficult than we thought”.
- Mainstream (neoclassical) theory has still to explain why divergence is so much prevalent in the world economy<sup>20</sup>. Moreover, endogenous growth models<sup>21</sup> and

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<sup>13</sup> The *Washington Consensus*, as a name, was concocted by John Williamson, with reference to the essence of IMF and World Bank’s policies pursued in the last couple of decades.

<sup>14</sup> Joseph Stiglitz (1994, 2002) is the most notorious critic, and the list includes Paul Krugman, Jeffrey Sachs, Jagdish Bagwhati and others.

<sup>15</sup> James Wolfensohn himself has indicated that he is not insensitive to what is wrong with the World Bank.

<sup>16</sup> Easterly’s results seem to contradict one of the main conclusions of the World Bank’s *Global Economic Prospects for Developing Countries 2001*, which asserts that “Developing countries as a group enjoyed accelerated economic growth over the past decade...” (World Bank Policy and Research Bulletin, April-June 2001, p.1). It is fair to say, however, that Easterly refers to per capita income growth.

<sup>17</sup> These countries achieved macroeconomic stabilization via low budget deficits and tight monetary policies, but did not refrain from targeting potential “winners”, through industrial and trade policies. A normal question arises whether such policies can be effective under the pressure of globalization and when public administration is weak, or captured by vested interests, as is the case in many transition economies.

<sup>18</sup> William Easterly, 2001, manuscript. See also his “The Elusive Quest for Growth”, 2001

<sup>19</sup> Op.cit., 2001, pp.291.

<sup>20</sup> See The World Bank’s Annual Conference on Development Economics, proceedings of 1999 and 2000 meetings. As the World Bank economist P.Richard Agenor put it, “the conventional neoclassical theory has

economic geography models have reinforced misgivings about the unqualified optimism on the distribution of benefits of free trade and free capital movements. Hence, a natural question arises: is opening (integration) to the outer economy advantageous, irrespective of circumstances?

- There has been an insufficient attention paid to the reality of asymmetries and informational problems in the functioning of both domestic and international markets, and to the key role of institutions. Partially, this is mirrored by the talk regarding “second-generation reforms”, “good governance” and “reinvigorating the state’s capabilities”. But as Dani Rodrik remarked, “The bad news is that the operational implications of this for the design of development strategy are not that clear”, and “There are many different models of a mixed economy. The major challenge facing developing nations is to fashion their own particular brands of mixed economy”<sup>22</sup>. In this respect, he stresses the key role of institutions of property rights, conflict management and law and order. This search for country-specific solutions does not clash with the need to use so called “best practices”, but one should equally acknowledge that “best practices” are not always clear. In this context, one has to give a fair hearing to Mauro Guillen, who argues that globalisation should not be understood as encouraging “convergence toward a single organizational pattern” and that “organizational outcomes in the global economy are contingent on country-specific trajectories”<sup>23</sup>. The implication is that *diversity* does matter and adds value. The issue of asymmetries acquires particular salience in the international economy, where there is increasing disenchantment with the distribution of trade gains<sup>24</sup> and the functioning of financial markets. In this respect, one has to stress both the *distribution* aspect of trade (which relates to the rules of the game and to the way in which industrial countries defend their own markets<sup>25</sup>), as well as the institutional dimension.
- Prominent voices argue that the world community needs new arrangements, new institutions, which should be capable of addressing the problems of world governance<sup>26</sup>. For instance, it is disconcerting to see that the efforts initiated in the field of financial markets reform, by the Financial Stability Forum, in 1998, subsided. As Larry Summers astutely pointed out, world integration demands financial integration, but, as the 20’ and the 30’s of the last century prove, recurrent financial crises can lead to world disintegration<sup>27</sup>.

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proved incapable of explaining in a satisfactory manner the wide disparities in the rates of per capita output growth across countries” ( 2000, pp.392

<sup>21</sup> Pioneered by Paul Romer and Robert Lucas. Lucas (1988, pp.3-42) explains why divergence, instead of convergence, does happen.

<sup>22</sup> Dani Rodrik, 2000, manuscript. Rodrik emphasizes five functions that public institutions must serve for markets to work properly: protection of property rights, market regulation, macroeconomic stabilization, social insurance, and conflict management. He also underlines that “there is in principle a large variety of institutional setups that could fulfill these functions”(p.3)

<sup>23</sup> Mauro F. Guillen, 2001

<sup>24</sup> As the World Bank’s Global Economic Prospects and the Developing Countries 2001 report says, “trade barriers in industrial countries represent a major roadblock for developing countries”(Ibid., pp.2)

<sup>25</sup> The preparations for the Doha WTO conference were quite telling in this respect, with the USA, the EU and Japan having basically set the Agenda. The failure of the Cancun meeting (in October 2003) point at the same policy attitude.

<sup>26</sup> This is the message of George Soros’ book ( 2002). Lord Dahrendorf is also very critical of the way in which the existing international institutions address these issues (for instance, in his lecture delivered at the New Europe College, Bucharest, October, 2001).

<sup>27</sup> Larry Summers, 2000, p.1.



4.2 *Post-communist economic transition* has had very mixed results and the mantra of quick privatisation and liberalisation has clearly indicated its limits and simplicity. Under the term “the second wave of reforms” there has been an attempt to renew transformation economics by acknowledging the role of institutional change (and its consuming nature), the importance of competition and structures of governance (in the public and the private sectors), the need of public goods (which cannot be supplied by the private sector), etc.

4.3 *The backlash against globalisation* is a stark reminder of the perils of succumbing to a simplistic economic cosmology. Growing economic gaps in the world<sup>28</sup>, increasingly unstable financial markets and recurrent crises, the deterioration of the environment and the challenge of sustainable development in the world, spreading diseases, etc. have brought home many pieces of bad news. There is now talk of the need to manage (correct) globalisation and reform the international financial system.

4.4 The fading away of the myth of the “*New Paradigm*” and “*the New Economy*” in the USA, the spate of corporate scandals across the Atlantic<sup>29</sup> and the plunging bourses worldwide (during 2001-2002), the rocky recovery in the USA together with poor growth in the EU, are not without policy consequences. In the USA, the Bush Administration has resorted to a heavy dose of Keynesian economics in order to stem recession whereas the heavyweight economies in the EU are flouting the Stability Pact provisions on budget deficits.

4.5 The discrepancy between preaching and practice, particularly in the case of advanced economies<sup>30</sup>, should give much food for thought, apart from its hypocritical undertones.

## 5. Where do we stand?

### 5.1 *Basic rules and contentious issues*

One can hardly question basic rules of the economic game, which underlie a sound functioning of economies. Such rules are:

- free prices are essential for proper resource allocation;
- there is need for clearly defined and protected property rights in order to foster entrepreneurship and commercial transactions;
- hard budget constraints need to operate ubiquitously in order to have financial stability;
- over the longer term low budget deficits are better than large ones;
- money printing is bad for monetary stability,
- outward-orientation of the economy is essential for making good use of comparative advantages..

These basic rules, however, do not extinguish the battle of paradigms and resulting advocated policies. Moreover, intellectual bigotry and doctrinal fundamentalism are detrimental to good policy-making, for the latter needs to be pragmatic and not skewed to vested interests.

At the start of the new century the jury is still out on central issues, which have divided economists over the decades. This ambiguous reality and theoretical situation should trigger

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<sup>28</sup> The 2002 annual report of the World Bank furthers the debate on the inadequacies of current policies for dealing with poverty reduction (Financial Times, 23 August, 2002)

<sup>29</sup> Following these scandals the Anglo-American model has lost some of its luster (see also Eric Orts, “Law is never enough to guarantee fair practice”, Financial Times, 23 August, 2002)

<sup>30</sup> Think only about farm subsidies provided by both the USA and the EU and steel protectionism on the part of the USA.

more candid debate in the places where policy is formulated or among those instances which advise governments. Let me single out some of these central issues, as they relate, particularly, to emerging economies.

### The macroeconomic policy-mix

The Asian crises of the late 90' have revealed the shortcomings of using budget retrenchment as the primary means for balance of payments adjustment at a time when the main source of high external indebtedness is the private sector. Likewise, overly restrictive monetary policies for supporting the local currencies proved to be quite damaging to the corporate and the banking sectors since they entailed lasting sharp rises in real interest rates – which accentuated *adverse selection* and, often, made things worse. For this reason some form of financial repression may be necessary in exceptional circumstances, as it is the imposition of smart capital controls. These insights get more salience against the backdrop of the revival of Keynesian-type policies in not a few places (when inflation is very low, or deflation turns threatening).

### Trade

Although free trade is deemed desirable by most economists (as a weapon of satisfying consumers and making good use of comparative advantages), the existence of big asymmetries and dynamic effects (including increasing returns in ascending industries) provide a rationale for developing countries to seek some protection –in this respect some distinguish between free and fair trade. .As Dani Rodrik put it, free trade is not always conducive to economic growth .<sup>31</sup> One has to stress also here the discrepancy between what some rich countries preach and what they practice. Let us think about trade in agricultural products and not only.

### Capital movements

Free capital flows have revealed to be quite threatening for emerging markets, and. the IMF no longer recommends the opening of the capital (KAL) account unless proper regulatory and institutional prerequisites exist. KAL was strongly recommended by the IMF to developing countries in the 90s, following the logic of free capital flows and the creation of a 'level playing field" in a, supposedly, increasingly global world economy. It is fair to acknowledge that capital account liberalisation has exposed many institutional and policy weaknesses in various countries; but it is also correct –for those who advocated this policy drive—to acknowledge that KAL was, frequently, a mistake in view of the turbulence it caused in many countries and the contagion effects it entailed<sup>32</sup>. Nowadays, the IMF admits, both explicitly and implicitly, this mistake when it links KAL with sound macroeconomic policy, proper institutions (including the banking/financial system) and solid prudential regulations.

### Exchange rate policy

The financial debacle in Argentina and the demise of its currency board question another tenet of the late 90s (following the financial crises): that the corner solutions are inescapable exchange rate regimes in a world of free capital flows. Life shows again its complexity and the danger of oversimplifications.

### Provision of domestic public goods

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<sup>31</sup> Paul Krugman developed the concept of “strategic trade”, which is rooted in the behavior of large enterprises.

<sup>32</sup> For an illuminating account of this issue see Barry Eichengreen (2003). For the case of transition countries see D.Daianu and R. Vranceanu (2003).

The role of government in dealing with market coordination failures is widely debated and there is acknowledgment that there is scope for public intervention in the economy; the proliferation of financial and currency crises, gross irregularities in the functioning of other markets (energy trading, for example) are making a compelling case for strengthening regulatory frameworks and law enforcement by the state.<sup>33</sup>

### Tax policy

Fiscal neutrality can be deceptive in a world of huge asymmetries. Developed countries used a different level and structure of taxes when they were at an inferior level of economic development. How does this fact bear on the suggestion –which some make- to use their current taxation systems as signposts for tax reform in developing/transition countries? Several questions can be raised in this respect: a/ which *best practices* does one have in mind? Can an economy leapfrog development stages by just trying to imitate (import) institutions? b/ do *best practices* mean uniform rates? c/ does it make sense to look at the experience of economies, be they very few, which scored remarkable economic progress during the last decades (the successful catching-up stories), too? d/ to what extent globalisation and the rules and regulations of the international economic system (WTO, etc) allow an economy room for using fiscal devices with the aim of fostering growth -the case of Ireland is conspicuous in Western Europe; and among transition countries, the Visegrad group, which attracted most of the FDI by fiscal incentives as well, is pretty well known. But one can broaden the discussion and look at Asian economies, too. The developmental challenge may be less relevant for the accession countries (albeit, they, themselves, have to close major gaps vis-à-vis the West), but it is certainly becoming of paramount importance for South east Europe. The conventional wisdom (and the advice provided by the IFIs) stresses the need for fiscal neutrality. But how can least distortionary effects of taxes be judged in a world in which there are numerous externalities, asymmetries, adverse external shocks, multiple equilibria, etc? How can one deal most effectively with the frequency of second-best situations? And what are policy implications, in general, and for taxation, in particular?

Policy conditionality was mentioned already as a high profile issue. The IFIs seem to be ambivalent in this respect; on one hand they seem to concede to the need for allowing governments more room in formulating their own national policies; on the other hand, the IFIs have a hard time in devising new procedures to this end and, also, show a sort of organisational/intellectual inertia in absorbing new ideas. Thence comes out a major challenge for the IFIs when they are seen as a repository of knowledge and providers of sound advice. The IFIs would have to engage in a more candid debate on the policy challenges facing the developing world (The World Bank is, apparently, more open in this respect...) and explore new policy venues by assimilating what Robert Gilpin called “the new theories”. As a matter of fact, these new insights hook up with some of the main ideas of the classical development economics.

### International public goods

Who is accountable for the provision of public goods in the world economy? Do the major economies have a moral and operational responsibility in this respect, including the coordination of various policies in order to avert bad equilibria? Most of the time the IFIs and officials of rich economies talk about the need of good governance in developing economies as a means to foster development and avert major crises. But what can small open economies do when confronted with large upswings in capital flows and other adverse external shocks.

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<sup>33</sup> As Prof. Tsumeaki Sato argued at a Zagreb conference, the “market oriented regulatory state” gets an increasing profile.

As some contend, big changes in the flow of international liquidity may be more responsible for understanding financial crises in emerging economies than other causes.<sup>34</sup>

### The role of IFIs

What about the IFIs? Perfection does not exist in life and criticism is part and parcel of what prods progress. This reality does apply to the activity of large organisations as well, including the IFIs; the latter are supposed to provide public goods to the world community and, for this reason their endeavours is constantly examined by governments, NGOs and citizens at large –in a world increasingly under the pressure of globalisation. The activity of IFIs has been surrounded by rising controversies starting with the late 90s. The recurrent financial and currency crises worldwide, the disappointments of trade liberalisation (particularly in developing countries)<sup>35</sup>, the record of economic development in poor countries, the ambiguous effects of globalisation, have brought the IFIs more under the scrutiny of public debate in academic, policy and wider circles.

The IFIs and other international organisations would have to come to grips with the issue of “global governance”; this involves their own operations as well as some substantive institutional reform –as in the case of the international financial system. But here one meets the vested interests of the main players in the international economic system, which may delay changes unless a major event (as a major crisis) forces a radical shift in their policy propensity.

### *5.2 Values, institutions and policy*

Lately, the issues of ethical behaviour and social responsibility of firms and individuals have come prominently to the forefront of public debate. Widespread corruption and unethical behaviour are primarily seen as features of institutional fragility and lack of democratic credentials, which are to be found in the developing world, in particular. Nonetheless, the late spate of corporate scandals across the Atlantic and similar cases in the rich part of Europe illustrate a more complex reality. One should remember that a similar wave of scandals gripped the USA in the 80s. Is there a cyclical pattern in advanced economies, linked with unavoidable behavioural excesses during periods of exuberance, which would subside over time following policy and institutional adjustments? Or, can one establish institutional circumstances and peculiar policies which enhance unethical behaviour, and which do not trigger adequate/counter-acting responses automatically. Can one link social and economic dynamics of capitalism to apparent shifts in some of the values which drive entrepreneurs’ behaviour? Is the profit motive similar to greed, to use Alan Greenspan’s famous words, to “irrational exuberance”? What is the role of norms (formal and informal) in constraining socially irresponsible behaviour?

Post-communist transition is replete with cases of corruption and unethical behaviour. The handy answer in explaining them would be the very institutional weakness of post-communist societies, a precarious functioning of checks and balances and a corrupted judiciary together with very feeble law enforcement capacity. In an optimistic vein, the same reasoning would highlight the advance of structural and institutional reforms, which would allow these societies to diminish considerably malign (unethical) behaviour gradually. Joining the European Union can be seen through the lenses of this upbeat logic. A more broadly defined

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<sup>34</sup> See Michael Pettis, 2001, and Padma Desai (2003).

<sup>35</sup> The way rich economies have attempted to link trade issues with the so called Singapore issues (on investment policies) has also disappointed the developing world.

answer would look at the issue of governance in both the public and the private spheres and scrutinise lessons worldwide, both in rich and poor countries. Differently, a pessimistic answer would talk about a bad “path dependency” and point at the persistence of widespread corruption, precarious institutions and malfunctioning markets in large parts of the world.

In transition societies the prospects of joining the EU has operated as a catalyst for reforms and a strong support for dealing with the pains and frustrations of social change. But not a few citizens are disappointed by the results of reforms, and the widespread corruption and unethical behaviour incense most of the population; some citizens relate these phenomena to market reforms, and this perception shows up unabashedly in the polls. Once the first wave of accession would take place benefits would accrue to many citizens, but disappointments, too, are likely to become more intense. Such likely outcomes beg a candid discussion on the linkage between values, morality and the dynamic of capitalism and what it takes to make it more fulfilling for most of the population. This is why the public debate on effective regulations (law enforcement)/institutions, which should strengthen the ability of markets to deliver for the satisfaction of most citizens (consumers) and avoid massive social exclusion has not lost any relevance. The scope of the state in providing public goods should be judged in the same vein, albeit this role should be judged in conjunction with the need for a streamlined and more efficient public sector, which should not crowd out (undermine) the proficiency of the private sector.

The public debate on ethics and economy acquires new overtones when looking at the world under the impact of globalisation and other forces at work. Aside from international terrorism, one can point at the dark side of globalisation: inability to cope with global issues (such as global warming), massive illegal immigration, increasing poverty in many areas of the world, poor functioning of international financial markets, etc. In this context, the issues of governance, both in the public and private spheres, get more salience. And governance cannot be dissociated from the values, mindsets of those who make decisions.

The years following the Great Depression brought about new regulations, aimed at restraining excesses and unethical behaviour in markets’ functioning. An example was the Glass-Steagall Act in the USA, which split investment banking from commercial banking. The recent scandals in corporate America and on Wall Street raise questions on the wisdom of wide deregulation which occurred in the banking industry in the late 90s. Institutional adjustments followed the end of the second world war as well. History seems to indicate a cycle of policies and institutional adjustments following large economic dynamics. It may be, that after the “deregulation euphoria” which featured so highly on the agenda of governments, especially, in the Anglo-Saxon world, during the last couple of decades, a new phase is about to set in; this phase would underline the need for effective market regulations and a more enlightened working together between the public and the private sphere. This logic would have to apply to the international economy as well, which needs public goods so badly, which further demand reshaped international institutions -capable of ensuring global governance. The latter, clearly, asks for more international cooperation and a common vision on how to tackle the major challenges confronting mankind. These challenges cannot be dealt with unless economic rationality blends with social and moral values<sup>36</sup>, which should preserve the necessary social cement of societies.<sup>37</sup>

### *5.3 Reinterpreting Globalisation*

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<sup>36</sup> In order to “reinvent” capitalism, or its soul.(William Greider, 2003). See also Claude Bebear (2003).

<sup>37</sup> Deepak Lal talks about the importance of shame-based and guilt-based cement in explaining cultural traits of long run economic performance (1999)

There can hardly be a concept in international life that has triggered more controversy than globalisation, in recent years. Some, particularly in the rich countries, see in it a *deus ex machine* for doing away with misery and conflict in the world. Others, especially in the poor countries, see it at the roots of mounting tensions in the world. Why is it so? What lies behind this stark cognitive dissonance? There can be two ways to look at this dispute: one is to examine facts which, directly or indirectly, rightly or wrongly, are related to *globalisation*; another is to judge the concept itself, its very content.

Facts give highly conflicting signals. Technological change has reduced transportation and transaction (information) costs and speeded up the transfer of know how, albeit in a highly skewed manner, among regions of the world; the internet connects instantaneously hundreds of millions of people; the world trade has expanded tremendously and broadened the scope of choice for individuals throughout the world. The collapse of communism has expanded the work of market forces and democracy in a large area of the globe. And the very dynamic of the European Union can be seen as an alter ego of globalisation on a regional scale. But, at the same time, the distribution of wealth in the world seems to be more unequal nowadays than, let's say, twenty years ago<sup>38</sup>; the myth of the "new economy" has dissipated and corporate scandals in the affluent world shows that cronyism and bad governance are a more complex phenomenon that is usually assumed and ascribed geographically; financial and currency crises have been recurrent in emerging markets and have produced economic and social havoc in not a few countries; trade liberalisation has favoured primarily rich countries, which, most of the time, preach what they do not practice; social fragmentation and exclusion have been rising both in rich and poor countries; there is sense of disorder and a rising tide of discontent and frustration in many parts of the world; non-conventional threats, the use of mass destruction in particular, are looming menacingly.

Arguably, to make sense of the facts is to look at the conceptual underpinnings of globalisation. And here there is an interpretation of globalisation, which is pretty much overloaded ideologically. I refer to the paradigm which extols the virtues of unbridled markets, privatisation and extreme downsizing of the public sector (state intervention in the economy); this philosophy widened to international markets -finance and trade- and, often, the IFIs did champion it. This paradigm has retreated, somewhat, in recent years following disappointing economic performances around the world and the nefarious functioning of financial (and energy) markets; but its resilience is powerful and is visible even in how it shapes the language used by some media (I was always puzzled by the use made of the term "market-friendly": is a neo-Keynesian a foe of the market economy?).

I submit that globalisation can be understood in a different vein, which looks at the functioning of real markets - with their goods and bads—and which takes into account insights of advanced economic theory such as: informational asymmetries, increasing returns (while technological progress is intense), agglomeration effects (clusters), multiple (bad) equilibria, the role of economic geography, etc. Thence come important lessons to the fore: the need for effective regulation of markets, the role of the state in providing public goods, the role of institutions (structures of governance); the need of public goods and good governance in the world economy, the importance of diversity and policy-ownership in policy-making, etc. To some, this interpretation may sow seeds of confusion. But, in this way, one can dispel a biased interpretation of globalisation. Moreover, globalisation would no longer be assigned an ideological mantra and one-sided policy implications. Instead, it becomes an open-ended concept, which purports to define the mutual "opening" of societies, under the impetus of technological change and the many fold quest for economic progress. Moreover, it rids itself

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<sup>38</sup> Stanley Fischer, the former deputy managing Director of the IMF and a leading macroeconomist, says that "The overall challenge to economic globalization is to make the global system deliver economic growth more consistently and more equitably (2003, pp.23)

of a perceived western-world-centred origin. Such an unconstrained interpretation of globalisation would have major repercussions for national public policies and international politics.

Thus, national public policies could be fairly pragmatic and varied (not succumbing to fundamentalism) and geared towards the traditional goals of economic growth, price stability, and social justice. Markets would have to be properly regulated and the state would have to provide essential public goods, which crowd in private output. As the rigged financial and energy markets in the USA have shown, these theses are valid for rich and poor countries alike. Dani Rodrik aptly observed that there is no modern economy which does not blend the public and the private spheres. An inference would be that going to the extreme with privatisation can be more than deleterious, which is particularly valid in the case of public utilities.

The international economy is replete with problems which beg adequate answers. Financial markets –under the pressure of volatile capital flows—function precariously, and the system needs repair. It appears that one of Keynes’ intellectual legacies, which is enshrined in the Bretton Woods arrangements (namely, that highly volatile capital flows are inimical to trade and prosperity) has not lost relevance. Those who say that it is hard to fetter capital movements in our times make a strong point, but do not solve the issue. The volatility of financial flows imparts a deflationary bias to policies worldwide, enhances trade protectionism and competitive exchange rate devaluations. Ultimately, the international financial system would have to undergo substantive changes in order to avert lethal crises.

*Free trade* cannot benefit poor countries when rich economies subsidise heavily their agriculture and use trade barriers whenever they feel like being “injured”; double talk and hypocrisy make a mockery of the virtues of free trade and give moral ammunition to advocates of *fair trade*. Likewise, the diminishing aid to the very poor countries is hard to justify when acknowledging the huge asymmetries in the world. And a keen sense of urgency and pragmatic visionarism would demand a different policy in order to deal with the threats of spreading epidemics, massive illegal migration, abject poverty, and environmental disasters. Not to mention the scourge of international terrorism. All these challenges make up an agenda, which can be assumed by an enlightened interpretation of globalisation.

#### 5.4 *Would developmental economics stage a comeback?*

Can the neo-liberal framework foster economic development, irrespective of circumstances? In certain respects it can, as is the case of stimulating entrepreneurship and fighting excessive welfare measures and central regulation. But, as some argue, this framework is far from sufficient in enabling policy-makers to deal with the complexity of development efforts in a world which is replete with asymmetries, market imperfections, and precarious equilibria

Economists, nowadays, while underlining the pre-eminence of markets in resource allocation and rewarding of entrepreneurship debate fiercely about the economic role of governments. This debate has been fuelled by theoretical insights brought about by “The New Theories”<sup>39</sup>: the theory of multiple equilibria, which posits the possibility of persistent bad equilibria; the theory of *endogenous growth*, which undermines some basic constructs of neoclassical economics (such as “the law of diminishing returns”); the thesis of “path dependency” (the role of history), the importance of geography; the role of information costs and asymmetries, the importance of *clusters* for achieving competitive advantages<sup>40</sup>, etc.

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<sup>39</sup> Robert Gilpin, “Global Political Economy”, 2001

<sup>40</sup> Michael Porter’s use of clusters in explaining competitive advantages makes a link with Gunnar Myrdal’s concept of *cumulative causation*.

“The New Theories” rely, or bring back to the limelight, theses of the old development economics. For Albert Hirschman, Paul Rosenstein Rodan, Ragnar Nurkse, Gunnar Myrdal, Harvey Leibenstein, all of them highlighted the role of institutions, structural features of poor countries, which keep them hostage to various types of traps, the need for assistance (what Rodan termed as the “Big Push” in a famous article written in 1943<sup>41</sup>).

To sum up: the current debate on development economics has rediscovered several of its old issues and, in this context, it re-emphasises the existence of externalities, multiple equilibria, bad path-dependencies, vicious circles and “underdevelopment traps”, all of which pose numerous challenges to public policy. For, it is increasingly obvious that public policy (at the national and the international level) has a role to play in order to address *market coordination failures*. This is because “There may be a social equilibrium in which forces are balanced in a way that is Pareto improving relative to one in which the government’s hands are completely tied – and certainly better than one in which the private sector’s hands are completely tied”<sup>42</sup>. In this context, one needs to underline the importance of good institutions, of proper structures for public and corporate governance, which condition the overall performance of the economy.

It is increasingly clear that the wide variety of economic performance in transition (post-communist) countries has to be related to the different functioning of institutional set-ups and policy diversity.

It may be that we are on the verge of a new age of development economics against the backdrop of the very disappointing record of economic advance in most of the developing world (if one excludes China and parts of India), transition failures and in many post-communist countries, and the backlash against globalisation. Olivier Blanchard, Paul Krugman, Dani Rodrik, Joseph Stiglitz, and others form a remarkable platoon of brilliant economists, who can inject more realism and creativity into development policy-making.

## **6. Transition economies and institutional and policy diversity**

### *6.1 Performance differences*

For most of the past decade, policy makers, in transition countries, have been concerned with the construction of the main building blocks of the new economic system. Institutional disarray (*disorganization*<sup>43</sup>), and the effects of the collapse of the former COMECON trade area, brought about the first transformational recession and high inflation in the early 90s. Macroeconomic stabilization, privatisation, opening, formed their main policy thrust in the early years of transition. Figure. 1 illustrates the collapse of output in these economies at the start of transition period.

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<sup>41</sup> Paul Rosenstein Rodan,, 1943

<sup>42</sup> Karla Hoff, 2000, pp.170

<sup>43</sup> Concept used by Olivier Blanchard (1997)



**Fig. 1. Annual GDP growth rates in CEECs, % on previous year**

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	-9.10	-8.40	-7.25	-1.48	1.82	2.86	-	-6.94	3.50	2.51	5.8	5.0
							10.1					
							4					
Czech R.	-1.22	11.4	-3.29	0.57	3.21	6.36	3.91	0.98	-2.50	-0.21	3.1	3.5
		9										
Estonia	-8.10	-	-	-8.51	-2.00	4.29	3.98	10.5	4.06	-1.39	6.9	4.7
		10.0	14.1				3					
		1	5									
Hungary	-3.50	-	-3.06	-0.58	2.95	1.50	1.34	4.57	5.07	4.27	5.2	3.8
		11.9										
		0										
Latvia	2.90	-	-	-	0.65	-0.81	3.34	8.61	3.56	0.47	6.6	7.5
		10.4	34.8	14.8								
		1	6	7								
Lithuania	-3.30	-5.68	-	-	-9.77	3.29	4.71	7.28	5.15	-3.07	3.9	4.7
			21.2	16.2								
			6	3								
Poland	-	-7.00	2.63	3.80	5.20	7.01	6.05	6.85	4.80	4.04	4.0	1.1
		11.6										
		0										
Romania	-5.58	-	-8.77	1.53	3.93	7.14	3.95	-6.07	-5.43	-3.19	1.8	5.3
		12.9										
		2										
Slovakia	-2.47	-	-6.45	-3.70	4.90	6.91	6.58	6.54	4.42	1.90	2.2	3.1
		14.5										
		7										
Slovenia	n.a	-9.0	-5.0	2.8	5.3	4.1	3.5	4.5	4.0	4.8	4.6	3.0

Source: Based on *Economic Survey of Europe, 2000, vol. 2, UN-ECE, Geneva; WIIW Research Report 283/2002*

But even so, one can easily discern a major difference between macroeconomic dynamics in CEECs (Central and Eastern Europe) and in the CIS (Community of Independent States) countries. In Central and Eastern Europe, inflation was brought down much more rapidly and output recovery started earlier. What lies behind this difference? A World Bank study remarks that “while initial conditions are the dominant factor in explaining the output decline at the start of transition, the intensity of reform policies explains the variability in output recovery thereafter”<sup>44</sup>. I would argue that initial conditions and geography played a major role during all this period, and that bad path dependencies have evolved in the meantime.

The World Bank study mentioned above highlights four major lessons of transition, namely:

- the key role of the entry and growth of new firms (the strategy of encouragement and discipline);
- the need to develop and strengthen legal and regulatory institutions;
- the need for more aggressive use of the budget during a reform program, in order to protect the most vulnerable social groups;

<sup>44</sup> Pradeep Mitra and Marcelo Selowsky, 2001

- the recognition that initial winners may oppose later stage reforms.

However, what seems to be underplayed in this enumeration, is the time consuming nature of institutional development, which is at the root of various path dependencies. In this regard, one needs to highlight the relationship between precarious institutions and the persistence of bad equilibria, which hamper long-term economic growth. Likewise, the World Bank study seems to underplay the very severe budget retrenchment in most transition economies (due to collapsing revenues), which badly impaired the ability to protect low income population against the pains of transformation. But not the whole of the CEECs area has had similar macroeconomic dynamics. A salient feature is the boom and bust dynamic of Romania and Bulgaria during the 90s; both countries have been undergoing economic recovery in recent years.

Over time, and in conjunction with reform consolidation, new concerns have emerged for the CEECs. Thus, economic growth has become of paramount importance in the quest to join the European Union, and also, as a means to solve increasingly sensitive social difficulties – at a time of rising unemployment. The main features of economic dynamics in the CEECs, which have relevance for the debate on catching-up, are summarized below:

- steady high growth rates have proved to be quite an elusive goal for CEECs;
- in all CEECs, there have been substantial fluctuations of GDP growth rates, besides the impact of the first transformation recession.
- moderate (not high) growth rates seem to be characteristic for the better performing CEECs ;
- boom and bust cycles did appear in a few cases, and this type of dynamics may appear again unless severe balance of payments crises are avoided. Arguably, for the countries which are likely to join the EU in the near future this danger would largely disappear.
- saving and investment ratios are not impressive, whereas the inflows of FDI were concentrated in a few countries.
- all CEECs trade extensively with the EU; for all of them, the EU is by far the largest trading partner. Arguably, therefore, output dynamics in the CEECs has benefited from increased openness and integration with the EU.
- substantial inflows of FDI foster growth, but they need favourable accompanying circumstances;
- persistent large current account deficits cause balance of payments crises and harm sustainable growth.

The features highlighted above cast some doubt on the thesis that catching up is looming at the horizon, or that it is likely to happen as an automatic outcome of current policies<sup>45</sup>. This inference should sober us, particularly in view of the kind of growth rates that CEECs need in order to catch up with the EU area. It may well be that what is realistic to achieve are more moderate rates of income per capita growth; however, even such moderate growth rates require heavy advances in structural and institutional reforms. Higher growth rates may occur if steady FDI flows are substantial (and profits are reinvested), investment ratios stay around 30%, and there is constant upgrading of production. But, at the same time, the CEECs would have to avoid, as much as possible, adverse external shocks.

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<sup>45</sup> For a thorough analysis of catching up prospects of transition economies see Grzegorz W. Kolodko (2002).

**Fig. 2 Per capita income levels in Europe (1998, in PPP terms as % of EU average)**

Country	Per Capita income level	Country	Per Capita income level
Greece	66	Latvia	27
Ireland	101	Lithuania	31
Bulgaria	23	a	
Czech Republic	59	Poland	36
Estonia	37	Romania	27
Hungary	49	a	
		Slovakia	46
		a	68
		Slovenia	
		a	

Source: "Progress Towards the Unification of Europe", World Bank Report, 2000, p.40

## 6.2 The EU factor

In the above context, a related question appears: are the current negotiations and the efforts to adopt the 'Acquis Communautaire' the equivalent of an effective strategy for economic catching-up? In many domains, they may well be so, to the extent that good institutions are smoothly "imported" and function effectively, and to the extent that technology transfer and upgrading of production (via FDI) occur intensely, for the benefit of a majority of the citizens (and *social cohesion* is not impaired).

The EU, as a phenomenon, is exceptional, in a historical perspective; it is unique both economically and politically in modern history. This is why one can hardly establish an analogy between NAFTA and the Europe agreements, which the accession countries have with the EU. As a matter of fact, the accession countries see in the EU enlargement an historical chance to speed up their economic development and modernization. Can integration into the EU be viewed as a Grand Strategy for economic catching-up (*beta-convergence*) and modernization – for the "Big Push", which most of CEECs have been seeking during the last century?<sup>46</sup> It is worthwhile reminding what Paul Rosenstein-Rodan had in mind when he wrote his famous article in 1943. In that article, he referred to key inter-dependencies in an economy, which may preclude its development, unless there is effective coordination among its constituent parts (industries); development asks for complementary changes of action and resources. And such simultaneous endeavours may not be possible in the absence of a strong stimulus, of a "big push". This is a crucial question to be addressed by policy makers.

Central and Eastern European societies do not look poor in important respects (e.g. the literacy rate of the population and general educational standards, behavioural patterns), but most of them face a set of challenges, which are specific to poor countries: still fragile institutions, perturbing growing inequality<sup>47</sup> (precarious *social cohesion*), incompetent governments (political elites), endemic corruption, which distorts and taxes business, etc. Therefore, these countries need to formulate policies, which should tackle poor countries-type problems as well; they need development (catching-up) strategies

Empirical analyses show that the opening of the economy and integration with the outside world have better chances to foster economic growth when there is an intense inflow of

<sup>46</sup> P.N.Rosenstein-Rodan (1943, 1961)

<sup>47</sup> It should be acknowledged, nonetheless, that much of this growing inequality is unavoidable, as a result of the change from a command (highly equalitarian) to a market-based economic system.

foreign direct investment, which upgrades the capital stock and human capital of the recipient countries –while it does not crowd out domestic investment. It is no surprise, therefore, that the frontrunner accession countries have received a disproportionate share of FDI.

Equally, a strategy of economic development (catching-up) requires policy ownership, which refers to both domestic intellectual capabilities (expertise), as well as to the capacity to formulate policies. This is the lesson of the most impressive cases of catching-up of the last century (whether one thinks of Japan, South Korea, Singapore, and more recently, Ireland). It may be that the EU arrangements could supplant partially the need for domestic policy capabilities. But, as the reports of the European Commission consistently document, particularly in the case of the less performing accession countries, public administration reform is critical for development, which is a clear indication of the essential tasks of domestic policy. It is true, however, that, within the constraints of the institutional functioning of the EU, domestic policy formulation acquires a new connotation. But the problem remains as such, since Brussels cannot be a substitute for key decisions at the national level.

Here is a caveat about the linkage between EU integration and convergence. Some of CEECs' premises for catching-up may clash with the strict conditionality of the Maastricht Treaty criteria, in case the accession countries intend to join the Exchange Rate Mechanism (ERM2) and, later on, the Monetary Union. A related situation is entailed by the implications of the *Balassa-Samuelson Effect*, which may make it impossible for accession countries to comply with the requirement of a low inflation rate in order to fit the EU (ERM) area<sup>48</sup>. And, should they try to attain a very low inflation rate, this may undermine growth and, therefore, catching-up. If this is the case, should some of the accession criteria be made more flexible?<sup>49</sup> How would the EU member countries view such a weakening of criteria? To what extent can the logic of a “variable geometry” play a role in this context? Would such a variable geometry process of enlargement be manageable?

For the EU candidate countries, the low inflation criteria (and, further, the Maastricht Treaty provisions) and the negotiations with Brussels raise two main sets of questions: one regards trade links and, more specifically, the capacity of accession countries to withstand competitive pressures when trade protection asymmetries and other adjustment instruments disappear; the other issue regards the possibility for the candidate countries to accommodate the stern exigencies of a very low inflation environment, even if they do not adopt the single currency.

It should be also highlighted that, against the backdrop of vagaries in an increasingly uncertain world environment, the EU can provide a shelter, which should be seen in the context of attempts, worldwide, to form economic and monetary blocks.

### 6.3. *A few thoughts on South East Europe*<sup>50</sup>

The tragedy of September 11<sup>th</sup> has stimulated the debate on the linkage between poverty, social destitution and what breeds deep resentments, inter-ethnic conflicts, terrorism. Europe, too, is not devoid of dismaying events, with the Balkans' last decade epitomizing much of what is evil in the contemporary world.

What can puzzle an observer of Western Balkans<sup>51</sup>, in particular, is a visible clash of perceptions on the recent social, political and economic dynamics of this area. There has been,

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<sup>48</sup> Dariusz Rosati (2001). See also Laszlo Halpern and Charles Wiplosz (2001)

<sup>49</sup> One can make an analogy with the current debate on the adequacy of some of the provisions of the Stability Act of the European Union –the 3% budget deficit upper limit at a time of very slow growth in the Eurozone.

<sup>50</sup> For more on economic policy in the Balkans see also my paper (2001). I do not address herein Turkey's situation, which is highly complex and overloaded with geopolitical content.

thus, a series of positive developments, which are hardly questionable and which do influence perceptions in an optimistic vein: wars and violent inter-ethnic clashes have stopped, democratically organised elections took place region wide, inflation was brought under control, and some economic recovery has occurred lately, just to name just a few such developments. As a matter of fact, South East Europe, which includes Western Balkans, overstripped Central Europe in terms of GDP growth in 2001, and would do the same, apparently, this year. Such tendencies are frequently highlighted by not a few local politicians, by international representatives. It would be foolish to underestimate these positive tendencies and not try to capitalise on them. On the other hand, it would be equally foolish to ignore the dark side of the story and the tensions which continue to strain the Region.

Western Balkans, as a whole, is plagued by huge unemployment, which reaches about 40% of the entire active population in Bosnia-Herzegovina and over 70% in Kosovo; this unemployment breeds the underground economy and criminality. There is an increasing addiction to foreign aid, which is of a debilitating sort to the extent external assistance does not focus on the creation of viable economies and it finances mostly consumption. Migration of young and skilled labour is gathering pace, which is depleting the most valuable asset of the region. Low saving and investment ratios throughout the area indicate that current economic recovery has a low chance of turning into sustainable economic growth. In addition, the region is rife with organised crime, and criminality, often, reaches the upper layers of government. Many citizens are disappointed with the results of reforms and this shows up in the polls; there is growing apathy among the electorate and nationalistic parties are staging a comeback. And not least, constitutional and status issues and continuing inter-ethnic strife could easily unleash new crises. Against this still very complicated background it does make sense to keep policy makers in the region and abroad alert to the danger of complacency and underestimation of what maintains the region as Europe's hotbed.

Some pundits are tempted to make an analogy with the end of the second world war in evaluating the Balkans. Even the putting forward of the idea of a new Marshall Plan for the region sources part of its justification in such an analogy. But one should rather be cautious in making such a comparison, in over-stretching the relevance of history. There are several motives in adopting a cautious approach. Firstly, at that time there was no process of state-formation (state dissolution) and, thence, no ensuing conflicts; this fact favoured, in a few years time, the start of the process of economic integration by the setting up of the Coal and Steel European Communities. Secondly, there was a clear distinction between victor and loser in the war, which did not involve revision of borders.<sup>52</sup> This is not the case in the Western Balkans nowadays, where borders have been and, still are questioned by some. Thirdly, the Marshall Plan meant, primarily, an infusion of funds for energizing economic reconstruction in an area which did possess the institutional ingredients of a market economy. This is clearly not the case with large parts of the Balkans, in spite of the decades of market experience of many of the inhabitants of the states, which previously made up Yugoslavia. Fourthly, there was, at that time, a big common enemy: communism, external and internal. Who is the big common enemy of the peoples in the Balkans, at the start of the new century? The prime candidate would be poverty, underdevelopment and criminality in an area which, yet, belongs to a prosperous Continent. But this is an imprecise enemy and not easy to deal with by looking at worldwide experience.

Assistance is badly needed in the Balkans; whereas it needs to be considerable, it should also be wisely calibrated and provided. Aid needs to take into account the complexity of intra-

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<sup>51</sup> This excludes Bulgaria and Romania, which were invited to start accession negotiations with EU and, at the Copenhagen Summit of December 2002, were set 2007 as a possible time entry date.

<sup>52</sup> Certainly, the division of Germany could be mentioned as a counterexample, but it does not change the thrust of the assertion.

regional relations, the still murky political geography in parts of the region, the existence of latent conflicts, the prevalence of weak (sometimes *failed*) states, etc. This extremely complex situation links inextricably national economic objectives with other goals, such as peace and security. At the same time, the stability of the region as a whole can be viewed as a collective good, a *public good* for Europe.

It should be said, however, that whereas goals can be easy to define in abstract terms (peace and security, social cohesion, economic growth, etc) they are much harder to formulate and pursue practically –particularly when they imply hardly reconcilable objectives of governments which do not show a high propensity to cooperate, or when these goals have to be pursued under very adverse circumstances. In the western Balkans this situation is quite ubiquitous and explains the heavy presence of outsiders (including the provision of economic aid), the existence of protectorates, “hard” and “soft”.. But foreign presence does not simplify the solution to problems automatically, as the experience of Bosnia-Hertzeogovina, and not only, amply indicates.

Tackling the problems of South east Europe, of Western Balkans in particular, demands a vision which should frame the policies of both domestic (local governments) and external actors. This vision (and ensued policy) needs to consider: a/. the consequences of the years of immense destruction brought about by military conflicts; b/ the failures of reform efforts; and c/ the still very complicated nature of relations inside the region –all these in conjunction with a developmental challenge. For what is less talked about is the relative backwardness of the area when judged according to European benchmarks. For instance, the income par capita, in many parts of the Balkans, does not exceed 3,000 euro(measured at the purchasing power parity), whereas the EU average is higher than 21,000 euro In this respect policy-makers and the aid agencies need to take into account main lessons of development experience and the insights of “the new theories” infrastructure is very precarious.

A development focused policy needs to consider what is realistic to achieve without shunning bold action; it also needs to put the whole endeavour into a longer term timeframe, keeping in mind the intricacies of the situation on the ground. Policy-makers would have to cast their endeavours under three major headings: crisis-management; economic reconstruction; and the change of the regime of functioning of economies (institutional change) without succumbing to policy fundamentalism. In this respect it can be said that dealing with the Western Balkans needs to be judged from two inter-related perspectives. One is the exercise in dual (short- and long-term) crisis-management, which aims, *inter alia*, at arresting (reversing where it is possible) bad dynamics/path-dependencies. The late years in Macedonia are an obvious case of this type of crisis management The second perspective concerns development, which would have to be a two-pronged strategic endeavour: physical reconstruction (after the years of military ravages); and development proper, that includes institutional change and the political process. In all of this aid has a critical role to play.

The inherent difficulties of dealing with the unsolved and, often, seemingly, intractable challenges posed by Western Balkans, could be compounded by events taking place outside the Region. One such event is the effort to deal with non-conventional threats, which sets new priorities and redirects resources among the major outside players. The USA, for obvious reasons, is likely to reduce its military and material presence in the region, which would ask for an offsetting act on the part of the European Union; the latter would have to increase its involvement accordingly. But this is not a clear option/solution at a time of major economic strain in Western Europe as well, and at a time when “the big game in town” seems to be EU enlargement. On this line of reasoning one points at another major event, which has a bearing on the concrete attention paid to Western Balkans. It may be that economic pain in the West, combined with a less smooth unfolding of *enlargement*, could keep the region off the immediate radar screen of western chancelleries. This could undermine EU’s attention paid to

the region, its overall assistance, at a very sensitive period in time, when there is acute need to support the still very fragile local democracies and help economic reconstruction.

## 7. Concluding remarks

The past decade has been suffused with claims that economic policy, in the advanced countries, is being driven by an emerging new consensus on principles and practice. The ideological fallout was pretty obvious in Anthony Giddens' concocted "The Third Way" formula, which connotes neither traditional social-democracy, nor blatant liberalism –in the European sense; this formula was adopted by the "new" Labour Party in the UK as its quasi-philosophical mantra and other social democrats have tried to foray deeply into it. Highly glamorous seminars featuring Clinton, Blair, Schroeder, Persson, Jospin, and others were quite en vogue in the late 90s. In the United States George.W. Bush used "compassionate conservatism" as an ideological means to enhance his presidential quest, which may have helped him in the end. It appeared as social-democrats (in Europe) and democrats (in the USA), on one hand, and centre-right parties (in Europe) and republicans (in the USA) were coming closer, in terms of both principles and practice of economic policy.

The sources of this apparent "new" consensus are, arguably, several. One origin could be traced to the ever longing desire of Man to control his environment (nature) and be more efficient. Thus, in the first quarter of the past century Max Weber's "rationalisation of life" referred to rational accounting, rational law, rational technology, which by extrapolation, can be extended to "rational economics", as a form of *hard science*. Later on (in the seventies), another famous sociologist, Daniel Bell, upheld the primacy of knowledge and theory-related activities in ordering our life, man's technological and economic ascendancy - which would imply that economic wizards can secure a fool-proof policy.. Even the clash between Keynesianism and monetarism, as the two main competing macro-economic paradigms, could be seen in the vein of searching the ultimate piece of wisdom. Another origin of policy amalgamation comes out of the death of communism. Francis Fukuyama's "End of History" was seen by many as an embodiment of the, presumably, single ideology (liberal democracy) which was meant to rule the world. Last, but not least, globalisation –as an incarnation of unfettered markets and downsizing of government, operating worldwide— also provided an impetus to the vision of the ideal' type of economic policy.

At the start of the new century facts are disavowing over implications. There are numerous examples which prove that conflicting ideas matter a lot, that reality cannot be encapsulated into a procrustean ideological bed; that economics continues to be softer than some of us try to make people believe. Policy wise, it is increasingly clear that trimming the welfare state and the public sector is not enough in order to achieve the expected efficiency gains; this endeavour needs to be accompanied by effective regulations of markets (financial and energy, for example), which, otherwise, can easily be rigged; "the new economy", the "new paradigm" (which claimed to combine high growth rates with very low unemployment), proved to be, simply put, a mirage of the 90s. The developments of the last couple of years in the USA and elsewhere, offer ample proofs in this regard – which motivated public authorities to initiate the Oxley-Sarbanes Act. Likewise, as against the prevailing tenets of not many years ago, economic policy, as it is currently undertaken in the USA and Europe, does not preclude running larger budget deficits during a downswing of the cycle; this is the explanation for some basic Keynesian recipes returning to the limelight. It should be said, nonetheless, that, while Keynesian macroeconomics seems to get a higher profile nowadays, the EU member countries are trying to make their markets (labour, production, services, financial) more flexible.

How does globalisation fit into this picture? The pressure of more intense competition forces governments to streamline their public sectors, which does frustrate trade unions and many citizens, at large. But rich countries, in the West, remain welfare states, *par excellence*, albeit in an evolving manner. One can detect here a rising/returning Keynesism in macroeconomic policy-making with a retreat when it comes to social policy; there is an apparent policy contradiction herein. Another consequence of globalisation is the creation of an international policy agenda. By omission and commission, some of wealthy countries' less inspired policies have given renewed high profile to issues such as: fair vs. free trade; dealing with abject poverty in the world; protecting the environment as a public good for mankind; the code of conduct for international corporations, how to manage contagion effects in the world economy; policy coordination among the leading economies of the world, etc.

As a matter of fact, the traditional ongoing battle between left and right - within the framework of democratic politics - is being shifted, partially, into the international arena. The debate on global governance (which institutions and policies) reflects a growing awareness that there are issues which need to be addressed internationally, in a multilateral context and using collaborative approaches. Arguably, the choice between globalisation and "managed globalisation" is between accepting the effects of completely free markets -with total policy disregard for market failures and their social consequences-, and trying to construct an international policy, which should address/prevent massive coordination failures. The debate on which form of capitalism, and what type of state intervention in the economy, turns, partially, into a debate on which form of "global capitalism".

The second policy route does make sense in a global economy, in which there is acceptance of the need for international public goods. Otherwise, under increasing pressure from foreign markets and other threats (including terrorism, illegal immigration, spreading diseases, etc), governments would resort to national means of protection -such as trade protectionism and trade clashes, competitive devaluations, etc.

Ideology is not dead, and it does shape social and economic policies -although in subtler forms and following cyclical patterns. It may be less felt nationally to the extent the battlefield of ideas expands increasingly beyond national borders. In any case, globalisation is likely to reflect ever more the battle of ideas, with traditional politics delving increasingly into the international domain. How would policy-makers address the hot issues in the international economy would provide clues regarding its dynamics.

Moving away from doctrinal fundamentalism in policy-making would enhance the room for institutional and policy diversity. Having said that I do not mean governments reneging on basic rules of sound behaviour in economic policy-making. Instead, I have in mind creative policy-making, which should shun policy fundamentalism and acknowledge particular circumstances. Clearly, "bad governance" in poor countries would have to be fought against unswervingly. The IFIs would have to be more candid about past and present failures in development policy and be faithful to the idea of *policy ownership*, which, it should be said, does not preclude policy conditionality. Likewise, rich countries' governments should practice more what they preach in order to be more credible in their dialogue with the developing world. This would regard policy making at the national level and the production (protection) of public goods for the benefit of mankind (current and future generations).

One should also re-examine the functioning of the international economic system, which should draw on the insights of "the new theories" and try to deal with the proliferation of bad equilibria, recurrent financial and currency crises, growing economic gaps, the deterioration of the environment, and conflicts in the world. Unless the production of international public goods takes place on a proper scale it would be hard to convince developing countries that the "disciplining" pressure of world markets is positive and in their interest. Institutional and policy diversity does have a meaning and a future.



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