CHAPTER 1

OVERVIEW AND SELECTED POLICY ISSUES

1.1 The current economic situation in the ECE region

The crisis that hit the world economy in 1997 with the devaluation of the Thai baht persisted through 1998 with powerful boosts from the Russian devaluation and debt moratorium in August and the Brazilian crisis in the second half of 1998. Although the particular circumstances of each incident are different they have been linked by financial contagion and its subsequent effects on real activity and international trade. In early 1999 the crisis is by no means over: despite a large emergency support package from the IMF, Brazil was forced to let its currency float and, by the end of February, it had depreciated by about 40 per cent against the dollar, which in turn is likely to have ripple effects on other countries in the region. The collapse in commodity prices, especially of crude oil, is creating serious stability problems for oil producers, not least in the Middle East, and there is still much uncertainty over the economic outlook in China and the possible implications this might have for policy in that country, especially with regard to the exchange rate.

Although its weight in the world economy is relatively small, Russia's currency and debt crisis last August had a much greater destabilizing effect on the international financial markets than the Asian crisis of 1997 and its repercussions for other countries in the ECE region, especially the transition economies, were generally more serious. Some of the financial effects – such as the drop in stock market prices, including in some of the central European economies – were due to portfolio adjustments as investors liquidated positions in healthier markets to offset their losses in Russia. But the key element was a fundamental re-assessment by investors of the risks and attractiveness of investing in emerging market economies. Much of the foreign investment in Russia had entered when an IMF supported programme was being followed and no doubt investors assumed that if anything went wrong any losses would be avoided with the help of a bail-out organized by the IMF, as was the case in South-East Asia. That assumption was proved false in the Russian case and consequently there were considerable fears in September-October of a global recession being triggered by the falls in stock prices and the threat of a "credit crunch" as credit conditions were tightened significantly, not only for borrowers in emerging markets but also in developed market economies such as the United States where the spreads over United States Treasury Bills for corporate borrowing rose significantly. There were also large fluctuations in the value of the dollar against the European currencies, especially when there were exaggerated fears for a short while for the stability of the German banking sector because of its exposure to Russian borrowers. These tensions were eased by the series of cuts in United States interest rates between the end of September and mid-November, and by the coordinated cut in interest rates in early December by the 11 future members of the EMU. Stock prices have recovered, especially in the United States, from their levels of last autumn and a measure of calm has returned to the financial markets. But this may well be deceptive. The financial turbulence of the last 18 months or so has plunged large areas of the developing world into recession and the deflationary consequences for trade in goods and services, and investment income, has led to a steady lowering of growth forecasts for 1999 both in western Europe, where the steady deterioration in net export growth has not been offset by stronger domestic demand, and in many of the transition economies, where the slowdown in the growth of import demand in western Europe, together with the increased costs of international borrowing (for those who still have access to it), imply a tighter balance of payments constraint on their growth rates in 1999.

Throughout 1998 the adjustments to the crisis continued to be supported by strong growth in the United States where GDP grew by just under 4 per cent for the second year running. This was underpinned by the continued willingness of United States consumers to spend virtually all their disposable income and by the buoyancy of business investment especially in information technology. But it becomes increasingly uncertain as to how long this benign process can continue. Although inflation has not picked up, one consequence of the consumer boom is a record trade deficit which is increasing rapidly and depends on the willingness of foreign investors to continue financing it. In the short run this may not be a problem since the increased aversion to risk means that for investors there are few other safe havens capable of providing liquid assets on a large enough scale – but this cannot last indefinitely if the deficit continues to widen. Similarly, private expenditure has been supported by the fall in oil prices, equivalent to a large tax cut[1] and which is unlikely

[1] One estimate is that the fall in oil prices by over one third between the fourth quarters of 1997 and 1998 added a full percentage point to the increase in consumer spending. WEFA, *US Financial Markets Outlook*, 11 January 1999.

to be repeated in 1999, and by very high levels of borrowing against stock market gains. The growth in the latter cannot continue indefinitely and when the correction eventually comes there is likely to be a swift return to positive savings rates. The question is not whether this will occur but when and whether the adjustment will be mild or impose a sharp shock on the economy. In fact, the projected further widening of the United States current account deficit to quite a high level in 1999 requires, in principle, a change in domestic policies to bring about an increase in net exports. This will have to rely on both a reduction in domestic absorption and a depreciation of the dollar. Given the tight labour market, a weakening of the dollar alone would lead to mounting inflationary pressures. The ensuing tightening of monetary policy would then risk pushing the economy into recession (the "hard landing" scenario). The extent of domestic policy and exchange rate changes, however, will depend on the strength of domestic demand in Asia and western Europe. Given the well-known problems in Japan and the Asian emerging economies, this explains why the United States authorities are keen to see a faster rate of growth in western Europe.

Like the United States, western Europe initially benefited from the hardship suffered by the rest of the world: the large fall in the prices of commodities and, to a lesser extent of a range of Asian manufactured goods, led to a substantial improvement in their terms of trade which, in turn, kept down the already small rates of increase in consumer prices and boosted real disposable income. In addition, the "flight to quality" in the financial markets made it easier to reduce interest rates in a number of countries. However, in sharp contrast to the United States, growth in western Europe was well under 3 per cent in 1998 and was slowing down throughout the year, particularly in the third and fourth quarters. The failure of domestic demand to offset the weakening of net exports largely reflects the tighter stance of macroeconomic policies over the last few years. Fiscal policy was for the most part broadly neutral in 1998, but this follows two years of severe fiscal retrenchment in the run-up to the introduction of the euro and the present stance of policy makes no allowance for the weakening cyclical position in the region. Moreover, the rules of the Stability and Growth Pact for EMU members leave virtually no room for fiscal manoeuvre should the cyclical slowdown become more severe. In order to prepare for a fiscal response to a future downturn in the next millennium, the authorities appear to be prepared to tighten fiscal policy to reduce structural budget deficits during a possible slowdown now. Monetary policy also appears to be too tight in the euro area: although nominal interest rates are at historically low levels, real rates are still relatively high. A cut in interest rates and a postponement of the target dates for reducing structural budget deficits would improve the prospects for economic growth in western Europe. If this is achieved progress in reducing the budget deficits would be greatly eased, as the United States experience has shown, and it would also strengthen investment and lower unemployment. The unemployment rate averaged 10.9 per cent in the euro area last year and was starting to rise again towards the end of the year. The situation is especially worrying in Germany where economic growth slowed sharply in the second half of last year and where the unemployment rate was 9.1 per cent in January 1999. Given the importance of the German economy both for western Europe as a whole and for many central European economies, the concerns of the German authorities about the current stance of economic policies should be seen as a European, not simply a national issue. Expectations for growth in western Europe in 1999 were still being lowered in the closing months of last year and the average forecast has now slipped below 2 per cent. On past experience, this implies no further reductions in unemployment and in all likelihood it will start to rise again.

The global economic crisis and the associated financial instability have begun to have a severe impact on the transition economies. At first, the principal direct effect of the Asian crisis was on the primary commodity producers of the Commonwealth of Independent States (CIS) and notably on Russia where the falling oil price has had a significant impact on export earnings and contributed to the crisis last August. For most of eastern Europe the direct impact was small because their predominant trade links are with western Europe. But the subsequent collapse of Russian imports was nevertheless significant for a number of east European exporters in 1998, and especially for the Baltic states which still have relatively large trade shares with Russia. With the weakening of west European import demand in the course of the year, there has been a rapid deterioration in the economic performance of the transition economies since the Russian crisis of last summer, a process which appears to have accelerated in the closing months of 1998 and in early 1999. The financial contagion from the Asian and Russian crises was relatively limited, even for the few countries which are relatively more integrated with the international financial markets but the real threat, as was pointed out in this *Survey* last year, lay in the real economy and the possibility of a sharper than expected slowdown in western Europe. Unfortunately this is what has occurred and the highly export-dependent economies of central and eastern Europe are being subject to a severe external demand shock.

The slowdown in economic growth in 1998 occurred in virtually all the east European and Baltic economies and, generally, was more severe than was expected earlier in the year. (Hungary is the principal exception, so far, to the general recessionary trend.) Instead of improving on the relatively weak performance in 1997, GDP in eastern Europe rose on average by just 2 per cent, less than half the rate implied by the official forecasts and nearly a percentage point lower than in 1997. The Baltic economies did rather better for the year as a whole (just over 4 per cent) but the deceleration from the 1997 rate was considerable.

For the leading reform economies and the Baltic states the relatively strong growth of the last few years was broken in mid-1998, largely by the deterioration in external conditions; but weak domestic factors also played a role, especially in south eastern Europe. Some slowdown had been expected in some of the faster growing countries because of measures taken to check a too rapid growth of consumer spending and rising current account deficits, but the deceleration was much more than anticipated. The full extent of the slowdown is still not fully reflected in the statistics, partly because many of the data are not yet available and partly because of lags, for example, between the inflow of export orders and actual deliveries. But the industrial production figures point to a rapid deceleration through the year, from a year-on-year average growth in eastern Europe of just over 6 per cent in the first quarter to 1.4 per cent for the year as a whole. These aggregate figures conceal a wide variation in national economic performance but, broadly speaking, in most of the faster-reforming and faster-growing economies of central Europe and the Baltic states the growth rates of industrial production have fallen considerably, while in south eastern Europe the recession in industry worsened in the second half of the year.

The deterioration in economic performance is also reflected in the labour markets where the modest improvements in the levels of employment slowed down or were reversed in most of the transition economies during 1998 and unemployment rates rose sharply from mid-year. In December the unemployment rate averaged 12.6 per cent in eastern Europe, up from 11.6 per cent in June; in the Baltic states it ended the year at 7.3 per cent, a full percentage point higher than 12 months earlier. Unemployment has also continued to rise sharply in January and February 1999, although this partly reflects the seasonal effects of a hard winter.

In the CIS, the picture is also one of sharply deteriorating economic performance. Particularly hard-hit by both the Asian and Russian crises, output has fallen (or at best growth has been severely weakened) and the slender gains of 1997 more than offset.

One of the crucial elements in the situation now facing the transition economies is the deterioration in their current accounts, all of which are in deficit. These deficits averaged about 4.5 per cent of GDP in eastern Europe in 1998 but the range was considerable from 1.5 per cent in the Czech Republic, which is now in a deepening recession, to some 7 per cent in Croatia and Romania and to around 11 per cent in Slovakia; in the Baltic states the proportions range from nearly 10 to 13 per cent. The majority of these deficits were deteriorating throughout the year and towards the end of 1998 most of them were much larger than even the more pessimistic forecasts made at the start of the year. For most of the east European and Baltic economies imports were still rising faster than exports last year and given the deterioration in their export prospects, the question arises as to how long the present deficits can be sustained.

The more rapidly growing economies of the last few years – Croatia, Hungary, Poland and Slovakia, for example – have all had large increases in their current account deficits, underlining the dependence of the transformation process on imports and foreign borrowing. But this import-dependent growth could be increasingly constrained in 1999 by at least three factors: the risk of a tightening of policy in some of the transition economies, shortfalls in capital inflows and the increased cost of foreign borrowing, and the slowdown in west European growth. The official forecasts for the transition economies (table 3.1.1 below) still point to an average rate of growth of just under 3 per cent in eastern Europe in 1999 and some 4.5 per cent in the Baltic states. But these are now looking very optimistic and it is increasingly likely that the actual outcomes will be much lower.[2] In the CIS, a fall in the average level of output appears unavoidable, but how large it will be is greatly dependent on what happens in Russia.

Given the sharp slowdown that now appears to be underway, this is not the moment to tighten fiscal policy in the transition economies, although the discussions in some of them suggest that this may be the intention. Such action, combined with an external demand shock, would intensify the downturn and ultimately be self-defeating by creating larger rather than smaller budget deficits. If anything, there is room for a loosening of monetary policy, as in a number of countries real interest rates rose sharply last year and were one of the domestic factors that contributed to the slowdown.

A faster rate of growth (and of import demand) in western Europe is highly desirable as the best way of supporting growth in the transition economies and also heading off the increasing pressures for protection from eastern imports, pressures which have already led to anti-dumping actions being started for a number of products. Western Europe is not only running a large current account surplus with the world but also with the transition economies. In the first nine months of 1998 the EU alone had a trade surplus of about $16.5 billion in its trade with eastern Europe and the Baltic states. If a faster growth rate in the EU cannot be achieved, ways should be found of recycling part of the EU current account surplus to the transition economies, especially to those which face increasing difficulties in raising funds on the international capital markets. This could involve official transfers or loans, but however it is implemented, the key point is to recognize that the west European current account surplus is having a deflationary impact on the countries of eastern Europe and the Baltic states. If the EU, as the major economic power in the region, acts with a broader sense of responsibility towards all the countries in the area, such measures would not only help to sustain growth and structural change in the transition economies but they would also provide positive feed-back to the EU

[2] The possible effects of the armed conflict in Kosovo are, of course, not reflected in this assessment of the outlook in 1999.

itself: in 1998 eastern Europe and the Baltic states imported about $100 billion worth of goods from the EU – that would seem to be large enough to be worth preserving and expanding.

1.2 Strong policies and weak foundations

Apart from their deleterious effects on the world's economies, the Asian and Russian crises have led to increased questioning of the economic policies which have been pursued for the last two decades or so, principally under the aegis of the G-7 leading market economies and the Bretton Woods Institutions. What became known as the "Washington Consensus" was a set of policies that were developed in response to the inflation crises in the developed market economies in the 1970s and 1980s and to the Latin American debt crisis in the 1980s. The "consensus" comprised two major elements, one concentrating on macroeconomic stability and the other on so-called supply-side reforms which would underpin both macro-stability and create the basis for spontaneous and sustained economic growth. Macroeconomic stability, reflecting the experience noted above, focused essentially on lowering inflation and then pre-empting any further outbreak with strict and attentive monetary policies. At the same time not only were general government budget deficits to be lowered in order to support the objectives of monetary policy but the level of government spending was also to be reduced as much as possible, the assumption being that the smaller the role of the state, whether in the actual production of goods and services or in its attempts to intervene in the workings of the economy, the better would be the economic performance of the private sector and of the economy as a whole. The programme of supply-side policies followed from the latter point: product and factor markets should be deregulated as far as possible, state owned assets and supply of services should be privatized, and international trade and capital markets liberalized. More recently, a proposal to change the IMF's Articles of Agreement to include capital account convertibility as an ultimate objective for all members was made by the Fund's Interim Committee in September 1997 – this would enable the Fund to insist on a country liberalizing its capital account as one of the conditions for receiving IMF assistance.

This "mainstream" policy framework was firmly in place when the communist regimes of eastern Europe and the Soviet Union collapsed between 1989 and 1991. Confronted with economies dominated by state owned enterprises and widespread government intervention and characterized by high levels of economic inefficiency and extensive restrictions on private initiative, the advice from most western governments and the international financial institutions was derived directly from the Washington Consensus: the transition to a market economy could best be made by liberalizing and privatizing the economy as quickly as possible while macroeconomic policy should establish and maintain low rates of inflation and balance in the general government and current accounts. Previous issues of this *Survey*[3] judged that this approach greatly underestimated the task of *creating* a market economy: it focused on too narrow a set of exclusively economic variables and ignored the risk that liberalization without the appropriate institutional infrastructure was unlikely to establish a functioning and "efficient" market economy. Macroeconomic stabilization was unlikely to lead to sustainable development unless accompanied by a carefully sequenced programme of structural reforms. Moreover, in many transition economies, and Russia was a prominent but not unique example, it was difficult to see how the standard macroeconomic policy package could easily be applied when the banking and financial sector was so underdeveloped that the links between the real and financial sectors of the economy were too weak to support the use of traditional monetary instruments or when governments were unable to control their expenditure and revenue because there was no functioning fiscal system.

In several respects many of the policies recommended by the "mainstream" consensus have come dangerously close to being dogmas based on oversimplified models and incomplete evidence. The certainty with which they are proposed and pursued is not reflected in the available empirical evidence. This tendency to simplification is not confined to the policy recommendations for transition and developing economies.

(i) Unemployment

Unemployment in the European Union is by all accounts its major political and social problem and its major economic failure. The standard analysis from most of the international economic institutions and from western Europe's central banks is that the problem is essentially structural and that it must be tackled by measures to make labour markets more flexible rather than by policies to boost demand and output. However, comparisons with the United States, the usual exemplar in matters of labour market flexibility and lowering unemployment, do not suggest an unequivocal difference between Europe and America. Real wages in Europe appear to have been flexible in the 1980s and do not appear to have been more rigid than in the United States;[4] and, more recently, one leading labour economist has concluded that the assertion that "European unemployment is high because European labour markets are "rigid" is too vague and probably misleading. Many labour market institutions that conventionally come under the heading of rigidities have no observable impact on

[3] For example, UN/ECE, *Economic Survey of Europe in 1989-1990*, chap. 1.

[4] UN/ECE, "Wage rigidity in western Europe and North America", *Economic Survey of Europe in 1987-1988*, pp. 99-113.

employment".[5] There is little evidence that reducing employment protection is a solution to high unemployment although active labour market policies may help people to find work. Virtually every fall in unemployment in western Europe in the last two decades or so has been accompanied by an easing of macroeconomic policy (either fiscal expansion, or lower interest rates, or devaluation, etc.). Thus without demand, increased flexibility can have no effect. Restrictive macroeconomic policies over a long period,[6] linked more recently to the objectives of the Maastricht Treaty, have kept growth well below the 3 per cent annual average forecast when the Single Market was completed and, in turn, have led to an adjustment in productive capacities consistent with a lower expected rate of growth and an unemployment rate of around 10 per cent.[7] Lowering unemployment will therefore need stronger demand, but to be sustained there will also need to be more investment. Profit shares are now higher than they were in the 1970s and the 1980s, but real long-term interest rates, which were very high for a long time, have fallen only slightly below those in the United States (which is at a very different stage in the cycle) and need to fall further if investment is to rise and capacities to expand sufficiently to absorb the unemployed. In sum, a significant cut in unemployment in the EMU area requires a period of above-average rates of investment and of output growth.[8] This goes against the grain of the ruling policy prescription but, as one leading macroeconomist has observed, "it is necessary to underline that the international policy makers' "story" about the rise in unemployment and the way to cure it might be badly flawed. The confidence with which the prescription is administered does not yet correspond to a convincing mass of evidence".[9]

(ii) Inflation

The reduction and control of inflation occupies a prominent position in the "Washington Consensus" and has clearly been given high priority in western Europe and in the transition economies. This was a reaction to a general acceleration of wage pressures in Europe in the late 1960s and the cost-push effects of the two major oil shocks of the 1970s. The key argument for focusing on inflation as a principal objective of macroeconomic policy is that it distorts the information content of the price mechanism and by disrupting the basic coordination system of the market economy reduces the propensity to invest and hence economic growth. Also high rates of inflation are often accompanied by high rates in its variability and this also has a negative effect on expectations. The justification for continuing to give priority to inflation control, even when it has virtually disappeared in western Europe, is that without an attentive monetary policy it can quickly accelerate and veer out of control again. But both the costs of inflation and the dangers of acceleration once any slippage is allowed may be exaggerated.

The evidence suggests that inflation is costly in terms of lost output only when annual rates exceed 40 per cent – then there is a danger that high inflation will lead to low growth rates.[10] Below this rate, growth and investment can recover even though inflation is still in double digits: the important element is that there are expectations that it will remain on a downward trend. In most of the transition economies annual inflation rates are now below 20 per cent, with many in single digits, but, paradoxically, there appears to be a positive relationship between output growth and the average inflation rate between 1993 and 1998.[11] However, this reflects differences not so much in the rate of inflation but in its rate of deceleration over the period: where a more gradual approach has been adopted, conspicuously among the leading reformers, output growth has been rapid and investment encouraged. In contrast, the excessive emphasis on rapid price stabilization in Russia, for example, involving increasingly tight monetary policy, has had highly negative effects on the real economy and has contributed to the growth of payments arrears and other perverse outcomes.[12] Moreover, the persistence of moderate rates of inflation in much of central Europe reflects a continuing adjustment of relative prices as administrative controls are gradually lifted, adjustments which actually represent improvements in the market system. It would not be sensible to react to such price increases with tighter monetary policy. Nor is it necessarily desirable to accelerate the process of freeing controlled prices. (It is well known and accepted that public and semi-public housing rents are heavily subsidized in the transition economies and that a move to more economic levels is necessary for an improvement in the housing stock.[13] But this cannot be done abruptly as the subsidies are an important part of the social safety net in these countries.)

In western Europe inflation rates are practically zero at the present time yet policy is still deeply concerned

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[5] S. Nickell, "Unemployment and labour market rigidities: Europe versus North America", *Journal of Economic Perspectives*, Vol. 11, No. 3, Summer 1997, pp. 55-74.

[6] G. Worswick, "The scope for macroeconomic policy to alleviate unemployment in western Europe", *UN/ECE Discussion Papers*, Vol. 2 (1992), No. 3 (United Nations publication, Sales No. GV.E.92-0-27).

[7] J. Michie, "Unemployment and economic policy", *Development and International Cooperation*, Vol. XII, No. 22, June 1996, pp. 57-69.

[8] R. Rowthorn, "Globalization and employment", *Employment Institute Economic Report*, Vol. 11, No. 10, January 1998.

[9] M. Artis, "The unemployment problem", *Oxford Review of Economic Policy*, Vol. 14, No. 3, Autumn 1998, pp. 98-109.

[10] M. Bruno and W. Easterly, "Inflation crises and long-run growth", *NBER Working Paper*, No. 5209 (Cambridge, MA), 1995.

[11] Chap. 3.4 below. Although it is not suggested that high inflation leads to higher output growth.

[12] UN/ECE, *Economic Survey of Europe, 1998 No. 3*, pp. 31-40.

[13] Chap. 3.4 below.

that small monthly increases could set off another inflationary surge. But the evidence suggests this concern is misplaced: there appears to be no grounds for believing that inflation is related to previous rates of increase[14] and therefore little risk of an acceleration getting out of control. Moreover, this pre-emptive stance of monetary policy, at insignificant rates of inflation, appears to make no acknowledgement of the fact that inflationary expectations have changed significantly since the 1970s and 1980s, and that the structural and technical changes that have occurred in the developed economies since then have reduced the likelihood of present wage and price setting behaviour being quickly reversed. However, the belief that monetary policy will be tightened in response to minor upward deviations from set targets has a depressing effect on expectations of output growth and the propensity to invest. The view that close to zero inflation is a necessary, and even a sufficient, condition for strong, sustained growth and falling unemployment is not based on historical evidence. But continuing to focus on such an objective is likely to have deleterious effects on the prospects for reducing the currently high rates of unemployment in western Europe.

(iii) Trade liberalization

The weak links between strong policy recommendations and the supporting empirical analysis are not confined to the labour market and domestic prices. The transition economies were advised in 1989 that price and trade liberalization could not be introduced gradually despite the experience of western Europe which phased out its wartime price controls in line with supply-side improvements to avoid boosting inflation and which, together with North America, started to liberalize its foreign trade gradually over a long period starting in the 1940s and which is still not complete.[15] The recommendation for rapid trade liberalization was supported by an influential World Bank study of 17 countries which concluded that a bold liberalization tends to be more sustainable than one which is staged. But in a careful review of this seven-volume study it was pointed out that the great diversity of experience of the individual countries did not support the extravagant claims made for the generality of the study's conclusions.[16] A similar degree of uncertainty surrounds the relationship between trade liberalization and faster economic growth, a crucial issue since liberalization is essentially an instrumental policy, not an end in itself. Some economists[17] find a close and positive relationship, emphasizing the benefits of removing the static and dynamic costs of import substitution; others[18] contend that the presumed relationship depends on the validity of specific microeconomic assumptions which rarely appear in reality and that once increasing returns to scale and productivity-boosting investment are brought into the picture the standard case for liberalizing trade to boost growth breaks down and a plausible case for interventionist policies can be made. Again, a careful review of the empirical evidence underlines its inconclusiveness – it is possible that trade liberalization may in fact favour output growth but not in a straightforward manner and that in the short run the adjustment costs may predominate over the benefits.[19]

The argument for trade liberalization is that exposure to increased competition will force domestic enterprises to be more efficient, and the more quickly this is achieved the better. However, there are two points to emphasize here. First, the scale of the adjustment shock of liberalizing trade will depend on how far the domestic output, employment and relative price structures have to change in response to the new competitive pressures. For many transition economies the scale of restructuring required by the shift from central planning to competitive markets is so large that the domestic economic, political and social institutions, which are also in a state of transition, are unable to cope with the adjustment costs, which in turn may generate large-scale resistance to reform. (The study of Romania in this *Survey* provides a telling example of this.)

Secondly, economic growth and development is a highly complex process, the causes of which are still poorly understood; but economic historians, and economists outside the neo-classical persuasion, have always emphasized the crucial role of institutions in stimulating and facilitating the process of change and of mobilizing and expanding the resources available for development. In the presence of a heavily distorted output structure, weak corporate governance and the absence of appropriate institutions – the situation in many transition economies – rapid trade liberalization may be more likely to lead to unemployment and stagnation rather than economic growth and positive structural adjustment. But generalizations are difficult. Poland, Hungary and, to a lesser extent, the Czech Republic appear to have gained from opening their economies to international trade, but there is little sign of similar

[14] J. Stiglitz, "Reflections on the natural rate hypothesis", *Journal of Economic Perspectives*, Vol. 11, No. 1, 1997, pp. 3-10. Despite popular beliefs to the contrary there was no persistent acceleration in the rate of inflation in the market economies between 1945 and the late 1960s.

[15] Israel also demonstrated in the 1960s that unilateral trade liberalization could be introduced gradually.

[16] D. Greenaway, "Liberalizing foreign trade through rose tinted glasses", *The Economic Journal*, 103(416), January 1993, pp. 208-222. See also, D. Rodrik, "Closing the productivity gap: does trade liberalization really help?", in G. Helleiner (ed.), *Trade Policy, Liberalization and Development* (Oxford, Clarendon Press, 1992).

[17] A. Krueger, "Why trade liberalization is good for growth", *The Economic Journal*, Vol. 108(450), 1998, pp. 1513-1522.

[18] L. Taylor and J. Ocampo, "Trade liberalization in developing economies: modest benefits but problems with productivity growth, macro prices, and income distribution", *The Economic Journal*, Vol. 108(450), 1998, pp. 1523-1546.

[19] D. Greenaway, W. Morgan and P. Wright, "Trade reform, adjustment and growth: what does the evidence tell us?", *The Economic Journal*, Vol. 108(450), 1998, pp. 1547-1561.

responses in Romania or Russia or many of the other countries that are lagging behind in the process of reform.

It is sometimes argued that the transition economies where GDP growth has been most rapid are those where liberalized trade and current accounts emerged quickly, where structural reform was rapid, and where inflation was falling. "It is very clear today that the countries that are succeeding the best are the countries that followed the [IMF] policy closest, and the countries that are lagging behind – Romania is an example – are the countries that were least able to stick to the strategy."[20] But such cross-country comparisons do little to establish the direction of causation. An alternative view is that the most successful reformers appear to be those where the initial conditions – in terms of both the required scale of restructuring and the institutional capacity to handle it – were more favourable to a faster rate of transition. In other words, governments were able to implement – and their electorates were willing to tolerate – a faster rate of change than in other transition economies. But this means that the pace of reform is largely determined by the historical legacy and not only by the choice, or the "political will", of governments.

(iv) Liberalization of international capital flows

The liberalization of the international capital markets is perhaps one of the most controversial elements in the ruling orthodoxy, especially since the Asian crisis broke in August 1997. The official case for free capital movements is that it is merely an extension of the argument for free trade in goods – countries with insufficient domestic savings to finance their own investment can draw on the surplus savings of others,[21] and by searching out the most profitable projects foreign capital will lead to a more optimal allocation of world resources and a convergence of per capita incomes. However, although the estimated benefits from free trade may also be controversial, there is no doubt that serious efforts have been made to quantify them and there is a body of evidence which points to significant gains even if these range considerably in size. In the case of capital account convertibility attempts to quantify the benefits, as Professor Bhagwati has pointed out,[22] are virtually non-existent and are more a matter of repeated assertion than careful analysis. In fact the available evidence casts doubt on many of the presumed major benefits of free capital movements. Contrary to expectation, domestic investment and domestic savings rates tend to be closely correlated across countries: different rates of return on capital persist and are not equalized by foreign capital flows.[23] This is not so surprising if it is recalled that different rates of return will affect the flows of foreign capital, *other things being equal*. But "other things" are not equal in most of the transition and developing countries: legal and institutional structures are often inadequate to attract foreign investment, while economies of scale and conglomeration in the highly integrated economies of western Europe and North America still provide the major attraction for investors. Some 80 per cent of OECD FDI still flows to other OECD countries[24] and despite the large absolute flows to the rest of the world in the 1990s most portfolio investment in the United States and western Europe still goes into United States and west European shares respectively. Despite popular claims to the contrary, both capital flows and international trade are still more regionally concentrated than truly global.[25] This helps to explain – but only helps since there are many complex factors involved – why there is little evidence in favour of income convergence in the world economy.[26]

Nor do the great benefits claimed for free international capital markets appear to be reflected in better economic performance, irrespective of its distribution. Growth rates of GDP in the last two decades have generally been much lower than in the 1960s, in both the developed and developing countries, and investment ratios (to GDP) have generally fallen. Although there are many factors involved in this deterioration, and it should not be denied that some countries have benefited from increased liberalization, the proponents of unfettered international capital movements cannot claim that they have been generally associated with higher growth rates, more efficient resource allocation, or a more equitable distribution of incomes per head.

What is clear, however, is that the liberation of international capital flows, particularly by the developed market economies, has been accompanied in the 1980s and 1990s by a considerable increase in financial market volatility – interest rates, exchange rates and capital flows themselves all exhibit very much larger fluctuations than

[20] M. Deppler, remarks made at a Symposium organized by the IMF and the Bundesbank, 2 July 1998, reported in *IMF Survey*, 27(14), 20 July 1998, pp. 225-226. See also, P. Desai, *Going Global. Transition from Plan to Market in the World Economy* (Cambridge, MA, MIT Press, 1998).

[21] S. Anjaria, "The capital truth. What works for commodities should work for cash", *Foreign Affairs*, November/December 1998, pp. 142-143. (The author is Director of the External Relations Department of the IMF.)

[22] J. Bhagwati, "The capital myth", *Foreign Affairs*, May/June 1998, pp. 7-12.

[23] M. Feldstein, and C. Horioka, "Domestic saving and international investment", *The Economic Journal*, Vol. 90(358), 1980, pp. 314-329.

[24] OECD, *International Direct Investment Statistics Yearbook* (Paris), annual.

[25] UN/ECE, "Structural changes in North-South trade, with emphasis on the trade of the ECE region, 1965-1983", *Economic Bulletin for Europe*, Vol. 46 (1994); R. Kozul-Wright and R. Rowthorn, "Spoilt for choice? Multinational corporations and the geography of international production", *Oxford Review of Economic Policy*, Vol. 14(2), Summer 1998, pp. 74-92.

[26] UNCTAD, *Trade and Development Report 1997* (United Nations publication, Sales No. E.97.II.D.8), chap. II; R. Kozul-Wright and R. Rowthorn, "Globalization and economic convergence: an assessment", *UNCTAD Discussion Papers*, No. 131, February 1998.

in the 1960s and early 1970s. Sudden inflows, and equally sudden outflows, of foreign capital create considerable difficulties for the management of domestic monetary policy;[27] the resulting uncertainty and higher risks implied by financial volatility lead to caution on the part of governments (which tend to set interest rates higher than they might otherwise have been) and of private business (faced with increased costs of capital and increased uncertainty over future demand). The net result is a tendency for growth rates to fall below what is feasible,[28] a particularly serious consequence for the transition economies intent on closing the considerable income gap between themselves and the members of the EU.

The other aspect of financial volatility is its propensity for contagion, the tendency for a financial crisis in one country or region to spread to others largely irrespective of the state of the economic fundamentals in the latter. Contrary to the textbook model of large numbers of investors making careful, independent judgements as to profitable opportunities, the capital markets are subject to bouts of "herd behaviour" – that is, investors follow one another without forming their own judgements or expectations about individual economies. Contagion is reinforced by the adjustment of portfolios whereby losses or margin calls in one market are balanced by the liquidation of assets in other markets which may very well show no weakness at all in the real economy – indeed, in this context, the stronger and more liquid markets may be the more vulnerable. "Herd" behaviour turns into a classical financial panic when foreign investors rush for the exit when their expectations change, for whatever reason. This can trigger a run on the currency, a collapse in the domestic bond market and a liquidity squeeze on the domestic banks, as happened in Asia in 1997 and in Russia last summer. Although the origins of the crisis may be due to faults in the domestic economy where it began – clearly the case in Russia[29] – the "panic" tends to amplify the crisis beyond anything that might be justified by the original causes.

In the immediate aftermath of the Asian crisis there was a tendency to put the blame for it, not on the instability of the capital markets, but on the countries themselves: internal weaknesses such as weak regulatory frameworks, poor systems of corporate governance, a general lack of transparency in the financial and banking sectors, "crony" capitalism, and so on. The question is not whether such deficiencies exist but whether they played a significant role in causing and propagating the crisis. The argument that lack of transparency etc. somehow deceived foreign investors into placing their funds in these countries is difficult to accept since these weaknesses have long been known to be part and parcel of the definition of economies as "developing" or "in transition". Weak financial and banking sectors may make the crisis worse, but capital flow reversals appear to be the main culprit in amplifying the initial crisis and transmitting it to other countries.[30] What countries are affected, and how badly, will depend on the extent of their integration into the international trade and financial structures. On the whole the transition economies of central and eastern Europe were less severely hit by financial contagion from the Asian and Russian crises than by the increased cost of borrowing on the international markets and the subsequent real economy effects on their exports, a reflection of the fact that their integration in world trade has proceeded much further than in the financial markets.[31]

The policy question that arises from the above is whether it is possible to reduce the instability of the international capital markets and, if not, whether countries can protect themselves against surges in capital inflows and their sudden reversal. Proposals to improve regulatory systems, improve transparency and generally improve the flow of accurate information in – and between – national economies are desirable in themselves as means to more effective market systems but, as suggested already, it is unlikely that deficiencies in these areas in the transition and developing countries played a major role in causing the crisis. The more serious weaknesses of governance and regulation would instead appear to be located in the developed market economies of North America and western Europe. The collapse of the LTCM "hedge" fund in September 1998, for example, focused attention on the excessive leverage available to such funds under the available regulations and the fact that at the same time such funds were able to escape from all regulation by the United States Federal Reserve. Also, there appear to have been "cosy" relationships between hedge funds, on the one hand, and the investment and commercial banks on the other. This is another area where there have been frequent and justified calls for more effective monitoring and regulation by central banks; and questions have been raised about western banks' credit evaluation procedures that allow excessively large exposures to hedge funds and other institutions to develop without proper monitoring. Swift action to repair some of these deficiencies in the developed market economies could make an important

[27] See below, chap. 3.2(ii), and UN/ECE, "Surges in capital flows into eastern Europe, 1990-1996", *Economic Bulletin for Europe*, Vol. 49 (1997), pp. 99-147.

[28] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 9-10.

[29] See, UNCTAD-UN/ECE, "The Russian crisis", paper prepared by the secretariats of UNCTAD and ECE for the UNCTAD Trade and Development Board (Geneva), October 1998, available as *Press Release*, ECE/GEN/98/2 (16 October 1998), and UN/ECE *Economic Survey of Europe*, *1998 No. 3*, pp. 31-40.

[30] M. Fratzscher, "Why are currency crises contagious? A comparison of the Latin American crisis of 1994-1995 and the Asian crisis of 1997-1998", *Weltwirtschaftliches Archiv*, Vol. 134(4), 1998, pp. 666-691.

[31] This is not to deny, however, that some transition economies are more integrated than others in the international financial markets (as shown, for example, by the large shares of domestic securities held by foreigners). In these cases, high levels of reserves and high real interest rates helped to reduce the contagion effects.

contribution to reducing instability: not only are these the principal sources of international capital flows but they are also the countries where both the urgency and the capacity for reform are greatest. There does not seem to be any reason why such reforms should have to wait for the more comprehensive proposals for reforming the international financial system.[32]

Another reaction to the consequences of the Asian crisis has been for greater stress to be placed on the need for a more gradual approach to the liberalization of capital accounts and for effective financial institutions to be in place before capital account convertibility is introduced. Since the Russian crisis the impression is often given that this has always been the approach but, in his resignation letter in mid-1998, the Chairman of the Interim Committee of the IMF's Board of Governors felt it necessary to warn that it was important "to proceed cautiously and with good advice. No country should be forced to liberalize immediately, or to remove controls when they are justified by legitimate reasons".[33] There is also increased acceptance of direct capital controls of the type applied by Chile, for example, but only as a temporary and emergency measure.[34]

In most of the reactions to the Asian crisis and the proposals for reform, only some of which were mentioned above, the underlying assumption is that capital market instability can be tamed by better institutional frameworks, better supervision, greater transparency, and a more careful preparation of transition and developing economies before they enter the liberalized international environment. Although all these steps may help, a more fundamental question is whether instability is inherent to the international capital markets or whether it arises from inappropriate institutions and unwarranted interference in the market mechanism. This is in fact a variation on one of the basic issues over which economists have divided for most of this century, namely, the origins of uncertainty and the source of dislocation in the system of market coordination. One view, exemplified by von Hayek, is that uncertainty is created by the distortion or suppression of information by interfering governments and central banks; left alone, individuals will show a natural tendency to coordinate their various plans in an orderly and predictable manner. The other view, exemplified by Keynes, located uncertainty and coordination failures not in exogenous sources but in the system itself. Contrary to Hayek, Keynes thought government could play a role in reducing uncertainty and raising expectations. The influence of these two very different points of view about how a market economy works has dominated the postwar period in roughly equal halves, the Keynesian for some 28 years from 1945 and the Hayekian from roughly 1973.

The Keynesian view of the inherent instability of capital markets was reflected in the original design of the IMF and the postwar international monetary system. Both Keynes and White[35] saw the new institution's primary function as promoting growth via an open international trading system and the preservation of financial stability. International capital flows, which of course were considerably smaller than now, had to be subject to controls because, otherwise, it was feared they would develop an independent existence of their own and disrupt rather than support international trade. From the perspective of 1999, when international monetary transactions massively exceed the value of international trade, those fears seem exceptionally prescient.[36]

If the view that instability or volatility is inherent in international capital markets is accepted, although it may be reduced by better regulation, etc., it may be desirable to accept capital controls as a permanent instrument in the national policy tool-kit and to abandon attempts to include capital account convertibility as an ultimate objective for all IMF members. Under present arrangements legitimate attempts to control foreign capital flows are in fact made, by changing interest rates, but these are clumsy tools for this purpose as they may conflict sharply with other national objectives such as growth or macroeconomic stability.[37] More direct controls, such as those employed in Chile, would help to contain the disruptive effects of surges in short-term capital flows on economic growth, which if successful would actually make the environment more attractive for longer-term direct investment.[38] It should also be stressed that most transition economies possess extremely small financial sectors in relation to global capital flows, most of which come from the more advanced market

[32] On the broader agenda for reform see United Nations, "Toward a new international financial architecture", *Report of the Task Force of the Executive Committee on Economic and Social Affairs of the United Nations*, New York, January 1999 (known as "the Ocampo Report"); and J. Eatwell and L. Taylor, *International Capital Markets and the Future of Economic Policy. A Proposal for the Creation of a World Financial Authority*, paper available at www.newschool.edu/cepa.

[33] Resignation letter of Philippe Maystadt addressed to the Managing Director of the IMF, *IMF Survey*, 20 July 1998, pp. 227-228.

[34] The Chilean approach includes sterilized intervention, to avoid excessive appreciation of the exchange rate, supported by restrictions on short-term capital flows as to minimum entry amounts and a one-year delay before they can be repatriated. In addition there are reserve requirements which differentiate in favour of long-term as against short-term capital inflows. The advantage of these types of control over the much-discussed Tobin tax on foreign exchange transactions is that they can be applied by individual countries whereas the tax requires wholesale international compliance.

[35] Harry Dexter White was chief international economist at the United States Treasury in the early 1940s and, with Keynes, one of the two principal architects of the IMF and the World Bank.

[36] Capital controls came to an end with the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s; that collapse, by transferring the management of foreign exchange risk to the private sector was a major factor behind the general move to financial deregulation in the 1970s. Eatwell and Taylor, op. cit.

[37] See chap. 3.2(ii) below.

[38] The distinction between short- and long-term investment becomes increasingly less significant with full capital account convertibility as access to modern derivatives markets can be used to reduce the differences in liquidity between different assets.

economies. A minor portfolio adjustment for a large hedge fund such as LTCM could deliver a major shock to such an economy. If import surcharges and import disruption clauses can be provided for under WTO rules for merchandise trade it is difficult to see why similar provisions cannot be allowed in the case of foreign capital flows, especially when the strongest supporters of capital liberalization claim that the arguments for liberalizing trade and capital are equivalent.

One of the standard objections to such controls is that it is too late to "turn the clock back", that the process of capital liberalization is unstoppable. This is often little more than self-interested determinism by market operators and there seems to be no reason why Chilean-type controls could not be adopted by a country if it so chooses,[39] although it is probably advisable to introduce them during a period of relative calm in the financial markets rather than as an emergency measure during a crisis. More to the point, however, is that the majority of central European transition economies still retain a wide array of capital controls;[40] for the most part inward direct investment is generally free but controls remain on many portfolio flows. These have helped to insulate these economies from the worst effects of financial contagion by the crisis in emerging markets elsewhere and it would appear to be unwise to abandon them hastily, if at all.

Another objection to direct controls is to argue that if countries dislike the results of foreign capital inflows they should simply let the exchange rate rise. But this is not very helpful – how far it would have to rise is uncertain and may increase rather than ease the country's problems. In fact if direct controls are ruled out of court, countries will inevitably seek alternative ways to protect themselves from instability in the international capital markets which may be more damaging to the market economy system. In the absence of alternatives, the need for such protection will lead to attempts to increase the levels of reserves, which implies aiming for a current account surplus. By definition, not every country can achieve this, but if they all try there will be ever stronger pressure to resort to the traditional range of "beggar my neighbour" policies which will risk undermining the liberal trading system – precisely the consequence that was feared by Keynes and White in the 1940s but ignored by the liberalizers of the 1970s.[41]

(v) Conclusions

This brief review of a selection of current policy attitudes suggests that they share a number of characteristics. None of them in themselves can be said to be "wrong" or undesirable, but the confidence with which they are pursued and applied ignores the fact that the empirical support for them is more uncertain and more ambiguous than is usually recognized. In particular, the tendency to downplay or even ignore the differences in institutional structures, which would appear to be a major source of the intercountry variations in their acceptance of and response to market forces,[42] increases the risk of outcomes which are not only less than optimal but actually opposite to those intended. Without the appropriate institutional infrastructures in place premature liberalization can cause considerable damage to economic and social systems and create a severe backlash against programmes for reform and transition to a market economy. (There are signs that since the Asian crisis this is increasingly recognized vis-à-vis the financial sector[43] but the lesson applies across the board. Failure to deal with monopolistic structures, to create appropriate legal (and enforcement systems), to build patiently popular support for the reform programme,[44] and so on and so forth, can all undermine attempts to create a market economy and drive the existing system into stagnation or recession rather than create a new basis for sustained growth.) Adapting policies to the particular conditions of individual economies and taking into account a wider range of factors undermines the simplicity of the ruling paradigm, but that may well be a price worth paying if the transition process is ultimately strengthened and opposition to market reforms diminished by more optimistic expectations.

The other characteristic that most of these policies share is a tendency towards deflation. This is fairly clear in the case of current policies directed at inflation and unemployment but is less often acknowledged in the case

[39] On the effectiveness of capital controls in a number of developing countries and on the dangers of capital account liberalization in a global system that has still to find ways to prevent the international transmission of financial shocks, see UNCTAD, *Trade and Development Report, 1998* (United Nations publication, Sales No. E.98.II.D.6), especially chap. IV.

[40] Slovenia is often singled out as an economy where capital controls have helped to maintain stability in the domestic economy. See H. Davidson, "Slovenia's splendid isolation", *Central European*, November 1998. A useful summary of selected capital controls in 11 transition economies is given in R. Feldman, et al., *Impact of EMU on Selected Non-European Union Countries*, IMF Occasional Paper, No. 174 (Washington, D.C.), 1998, table 2.9. According to the IMF's index of capital account liberalization (varying from zero to 100, the latter representing maximum liberalization), the least liberalized country was Romania (12.5) and the most was the Czech Republic (73.7). For Hungary it was 59.5 and for Poland 55.3; for all the others it was under 50.

[41] The Secretary-General of UNCTAD recently emphasized the role of financial instability in bringing about the collapse of world trade growth from almost 10 per cent in 1997 to some 3.7 per cent in 1998. R. Ricupero, *Keynote Address to the High Level Symposium on Trade and Development*, WTO (Geneva), 17 March 1999.

[42] Although some of these institutional arrangements are inimical to market forces and decentralized decision-making, there is no unique set of institutions which describe a market economy. Capitalism comes in a number of institutional variations.

[43] "*Now we know* that the incentive structure – critical for the behaviour of people and firms – is not only indicated by prices. Prices are critical, markets are absolutely essential, but they are not the only things that create the incentive structure of the economy. It's institutions as well" – "Institutions matter, says chief economist for Latin America", *World Bank News*, 2 July 1998, p. 5 (emphasis supplied).

[44] UN/ECE, *Economic Survey of Europe in 1992-1993*, pp. 10-15.

of attempts to implement structural reform at a pace which is too rapid to be supported by a country's institutional framework. When the required adjustment in structure is very large – and for most transition economies the requirements are far from the marginal changes assumed in standard economics textbooks – and the institutional support for transition very weak, rapid liberalization is unlikely to lead to growth.

The broader conclusion, however, is that growth and employment have to be restored to a more prominent position among the objectives of policy. The idea that liberalization, structural reform, and economic growth can be tackled in a temporal sequence is as mistaken for the transition economies as for the mature western market economies. Instead, measures directed at supporting growth need to be introduced alongside stabilization and reform programmes in order to establish a mutual support between them.[45]

The triumph of capitalism in the second half of the 20th century was largely based on its ability to regain popular legitimacy via the intervention of government to ensure low levels of unemployment and more acceptable distributional outcomes – capitalism with a "human face". This, essentially, was "the third way" and derived from a conjunction of the welfare state with "Keynesian" economic policies. (Keynes, it should be remembered, was a liberal who was acutely aware in the 1930s that if ways were not found to make capitalism more socially acceptable then the likely outcome would be a swing to one of the two totalitarian alternatives then on offer.) To put it crudely, for any economic system to survive it must deliver the goods and distribute them in a reasonably equitable manner. The former centrally planned economies failed this test and they have been dismantled; but there are many people now living in some of the transition economies who are wondering whether the new market economy, however embryonic, will fail the test as well.

Another aspect of late 20th century capitalism is that it comes in many varieties and is supported by different institutional arrangements. This tolerance of national varieties, however, is increasingly under threat from those who see globalization in normative terms and insist that transition and developing economies should adopt all the values and institutions of the currently dominant market economies. This approach, which is partly reflected in the post-Uruguay agenda of the WTO and which seeks to harmonize policies and to set rules in areas which have traditionally been regarded as matters for national policy and national preferences, carries considerable risks. It represents a radical change from the original philosophy behind the creation of the Bretton Woods institutions which was to create an environment of international financial stability that would underpin the development of world trade and allow countries to develop according to their own preferences, subject to their avoiding actions that would "beggar their neighbours". The pursuit of the globalization agenda, however, increasingly appears to deny much room for any national preferences which clash with those of the major market economies.

The crucial danger from this is to the market economy system itself, because economic and social preferences are closely entwined in the broader framework of social and political values which underpin a country's institutions including its form of economic organization. This is why in previous issues of this *Survey* there has been repeated stress on the problems of institutional hiatus in transition economies and on the necessity to allow them sufficient time – and to provide them with significant support – to enable the new market institutions to become embedded in the social and political values of the population and to give the institutions time to start working effectively. In a few of the central European economies this process is well advanced, but in many others it is not. If the process does not advance, the new market economies will not function properly and they will not achieve popular legitimacy. But, equally, if those social and political values – and preferences – are attacked in the name of the new global economy, the chances are that there will be a backlash against that economy rather than a change in values. It is therefore not surprising that an increasing number of distinguished market economists have recently warned of the dangers of pushing the liberalizing agenda too rapidly and too widely.

The stability of any socio-political-economic system ultimately rests on three crucial conditions: *one*, on whether it has *legitimacy*, i.e. whether the rules and procedures according to which authority is conferred and exercised can be justified and can be seen to be rooted in Adam Smith's "moral sentiments of the population"; *two*, on whether the agreed rules, conventions of behaviour, etc., maintain *order* in the system by encouraging acceptable behaviour and penalizing the unacceptable; and *three*, on the *welfare outcome*, which recognizes that popular support for institutions and economic arrangements will not be sustained if the distribution of costs and benefits is considered by too many of the population to be unjust. The instability in the international financial system in the last decade, the aggressive pursuit of an ever-widening liberalization agenda, and the enormously costly turbulence of the last 18 months or so all suggest that the present global system may be moving closer to violating all three conditions.

[45] On this see J. Kornai, "Lasting growth as the top priority: macroeconomic tensions and government economic policy in Hungary", EBRD, *Working Paper*, No. 15 (London), December 1994, and the quotation therefrom in chap. 3.4 below.