

Small Economies' Adjustment to Global Challenges

Edited by

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László CSABA

Small country adjustment to international economic disturbances

Introduction¹

One of the most challenging tasks of transition economics is the need to be integrated into international economics. This is not only due to the fact, (which could be highlighted years ago (Csaba [1995, p. 280-291]), that with the progress of systemic change successful countries are likely to become increasingly akin to already available models of the European market economy. The international financial contagion of 1997-1999 has even more accentuated the circumstance that *transition countries* - Russia included² - are all *small open economies*, whose progress and well being is to a large extent beyond their control, a function of the ups and downs of their global economic environment. If anything, this has been proven unambiguously by the Russian currency crisis of August 1998, when a domestically *per se* successful policy line proved unsustainable in the context of

¹ Comments by Ms Kamilla Lányi, with the usual caveats, are gratefully acknowledged.

² Russian imports from 'far abroad' - i.e. the effective demand of Russia against the global economy - were 29.8 Bn\$ in 1999, (cf. *Ekonomika i Zhizn*, 2000/6) thus hardly exceeding the respective Hungarian figure of 25.5 Bn\$.

the Asian contagion, and of course, the then collapsing world oil market. It was probably the first time since World War II, that the Russian great power was exposed in its total defencelessness, of its extreme vulnerability to non-state market agents, whose herd behaviour simply overwhelmed international coordination, culminating in the unsuccessful IMF rescue package of 1998. Likewise, concerted policy efforts could do little to help the Suharto regime in the Thai economy, or to sustain the level – if not the *regime* – of the *real exchange rate* in Brazil.

What is to be done? Most of the international literature has taken the *top-down approach*, focusing on possible reforms of the international financial architecture, improving bank supervision, the overhaul of the Basle Core Principles of 1988 (accord (Bonte [1999]) and on devising international institutions for reducing financial instability, (Rogoff [1999]). By contrast, in the present volume we have attempted to make a *bottom-up approach*. Either by relying upon the individual country experience, or by highlighting the corporate experience, we search for answers *from the point of view of price takers*, not from the point of view of price makers or regulators. This might prove to be a fruitful addendum to the previously available literature on the subject.

The political economy of country size

But does country size matter? In standard – introductory – textbooks on economics and on political science this item does not show up in the subject index. However, at times of political earthquakes, when country borders are redrawn and exogenous conditions of economic activity, including the norms and rules of the game, or the geographical territory on which it may be extended automatically change, such as in times of transformation, a sizeable amount of theorising emerges and re-emerges on the subject.

It is not at all trivial why the national issue has resurfaced with the collapse of the Soviet empire with such an extreme and mostly unforeseen intensity. International relations theory lists at least ten factors having contributed to the resilience of nationalism all across Europe and not only the ruins of the Soviet empire (Balogh [2000]). This includes i.a. the negation of the existence of

problem, particularly in the post World War II period, the suppression of any non-universalist idea in the fight against Nazi mental heritage, the over-estimation of non-European and universal humanistic ideas, lack of earnestly facing one's own history (*Vergangenheitsbewältigung*), and last but not least, the loss of previous values and related stabilisatory enforcement mechanisms. In the ideological and power vacuum the west positively lost its legitimating enemy, while the east was left in a vacuum, without relevant points of orientation for many, or even most, political forces. And above all, in many areas, especially in south-east Europe and in the newly independent states, nation-building and state-building, having dominated western Europe in the 18–19th century, is just belatedly, but unmistakably, taking place in post cold war context.

This is, i.a. an outcome of the collapse of not only the post-Yalta system, but also the post-Versailles system of international relations. Thus, it is hardly surprising that theorising about small countries and their viability has a long history to look back. By the same token, the more one had been impressed by arguments focusing on scale and scope economies, the more tended one to be sceptical about the longer-term viability and welfare potential of the newly formed small political entities. While the Austrian economist Kurt Rotschild [1944] highlighted the importance of international trade for the well being of small nations (in direct defiance of the economic nationalism of the inter war period), the more typical view was formulated by the Hungarian post-war political theorist, István Bibó [1946/1991]. He talked about the misery of small nations. In this approach only a larger community of regionally close and possibly like-minded democratic nations stand a chance to meet the challenges of a modern economy. Only they are able to provide welfare and overcome the historic dead alley of the interwar period. This was obviously not a far cry from the Adenauer–Schuman idea of the united states of Europe, making way in reality to the compromise of European Steel and Coal Community in 1951, with the obvious idea of making any war, waged against each other, impossible.

It is worth noting that much of the theory of economic *integration* has been arguing with the obsolescence of nation state, with the narrowness of national boundaries, with the incongruence between full-scale and sophisticated demand and specialised national production. And in terms of *finalité*, the idea of a supranational Europe has been re-emerging ever since the 1950s.

Since this *finalité* has proved unattainable, two types of answer emerged to the question of viability of small nations. One was the already quoted integration theory, which called for *political and institutional integration* as the precondition to a way-out. The 1974 world congress proceedings of the International Economic Association (Machlup (ed.) [1975]) comparing economic integration in east and west. For obvious reasons, integration under the red banner, Comecon, was missing

³ The tripling of oil prices and statist measures, producing primarily stockpiling instead of marketable output, lie behind the Russian 'success story' of 1999. (D/W [1999])

some of the earnest idealism of its west European counterparts. Therefore adherents of eastern integration were not at all so ready to sacrifice national sovereignty in order to attain more (planned) efficiency. But if we subtract the political component,⁴ the integrationist stance was *fundamentally sceptical about the viability of small national economies* on the longer run. Thus the real question is basically not about sustaining it. To paraphrase them, *being small is virginity: a virtue where the basic question is how to lose it properly and in civilised fashion, with mutual benefits to the partners.*

There has also been an alternative, a softer view, especially in Britain and the US (Robinson (ed.) [1960]). This called only for more *specialisation and trade* to offset the inherent weaknesses and vulnerabilities of price-taking small economies. The conceptualisation of smallness is an economy below 10–15 million inhabitants, characterised by *inherent diseconomies* of scale and scope, a resulting enhanced *vulnerability* to external shocks, and *limitations* to conduct *endogenous* policies, and last but not least, by shallow local linkages.⁵

From today's perspective, the 'Golden Age' of the 50s and 60s did not have empirical support to either of these approaches. Some small economies exhibited quite *exceptional resilience that could not be attributed to either EU or Comecon*, and these were not the United States either. Austria, Switzerland, Sweden, Finland, Spain all exhibited robust economic development without being a member of any regional political integration grouping. They all had varying and dissimilar developmental path *heritage*, and a dissimilar *policy mix*, also a dissimilar *social model*.

Hungarian economics highlighted the possibility of small country breakthrough *vis-à-vis* the mainstream of the day. Béla Kádár [1971] presented a forceful proof of the continued viability of national economic success stories, provided they followed the political of outward orientation, against the then dominant import substituting view of development economics. Later, Kádár [1984] this point was re-stated against the background of two oil shocks, when the idea of self-reliance enjoyed new popularity. In the 'second world' as attempts at regional Comecon autarky, in the third world as attempts to create a new international economic order and the adoption of the basic needs approach by various UN fora. This insight was quite in line with contemporary international economics highlighting outward

⁴ There was, of course, an economic component supporting it, i.e. the lack of meaningful prices that could have guided macro- and microeconomic decisions. For expanding this point, originating with Ludwig von Mises, and discussion of related literature c.f. Csaba (1990).

⁵ This is what Joe Brada in this volume terms the industrial era view, where large organisations, large production units, large quantities seem to have mattered more than anything else has. Thus and the conceptualisation of the national economy followed this "microfoundation".

orientation as the clue to sustaining economic progress against external disturbances, especially for small open economies (Balassa [1981]). The secret of newly industrialising nations was precisely in their ability to get loose of the predetermination of natural endowments, and follow policies not constrained by regional or historic considerations. This required a *de-emphasis of overpoliticised regional integration projects* and the braveness to *choose partners overseas*, should these be more forthcoming and solvent for the products, manufactured in line with the changing comparative advantage of the exporting nation.

In a way, this insight was not in line with the liberal mainstream of economics, since outward orientation did require strong states, sometimes even picking winner strategies, and extensive régimes of export promotion. Some of the European success stories were not based on resorting to such interventionist policies. Meanwhile global and regional trade liberalisation in the framework of GATT and the EFTA, but also the opening up of much of the non-farming markets of the US and the EC have contributed to the success of 'outsiders', consisting not only of Japan, but also several small nations, like south Korea, Taiwan, Hong Kong, in this period.

While the EC stagnated and Comecon decayed during the seventies and the eighties, small economies exhibited extraordinary resilience, and not even primarily as resource based economies. By 1998 among the ten leading economies of the world in per capita terms we find Norway, Switzerland, Denmark, Iceland, Belgium, Austria and the Netherlands, but according to the traditional definition, cited above, Canada would also count as small in terms of inhabitants, leaving only the US and Japan among the top ten as large economies (*Wall Street Journal Europe*, 4 January, 2000). Size and wealth creation does not seem to be intertwined.

Disintegration of the bipolar world during the nineties led to quasi-automatic dissolution of a large number of old and to the creation of new states. To cut a long story short, some of these were regaining their independence, while others, like Ukraine, Bosnia-Herzegovina, Moldova, Macedonia, Slovakia or Slovenia were entirely new state-constructs for contemporary history. Given the predominance of the integrationist school as well as the traditions of international relations theory, these developments were mostly ascribed ruinous, destructive features.

While the political science argumentation cautioned against the power vacuum and the generalised erosion process – sometimes termed Africanisation – economic arguments focussed on the conceived need to preserve intraregional trade, and advocated currency and payments unions. The view was predominant that disintegration may though be a nationally or politically virtuous deed, its economic consequences must be *per definitionem* deleterious. International agencies have invested considerable amount of time and energy in trying to forestall the process

and discourage all actors from 'going astray'. IMF support for the pre-crisis rouble zone was probably the most extreme example.

These approaches usually abstracted away from the most salient features of 'pre-crisis' systems, i.e. the blatant *lack of efficiency at both macro and micro levels* and the *lack of freedoms*, both individual and collective, otherwise enshrined in the UN charter, as well as in all pan-European (OSCE⁶) documents. The lack of proper prices was of course not the single most evil of the *ancien régime*. However, this factor made, by definition, impossible to make proper decisions in terms of allocative efficiency. Therefore abolition of such systems, irrespective of the liberties, was bound to have some efficiency-enhancing elements. The more important we see the role of money as a co-ordinating instrument in a modern economy (Dietz [1991] and Riese [1990]), the greater the dangers of a demonetised and overcentralised system for efficiency and welfare. Thus abolishing deficiencies and the mere introduction of decentralisation and relevant money was bound to improve both co-ordination and welfare.

This puts the problem of *viability* of smaller units of a former giant into a completely *different perspective*. We could expect at least *some* of the potential efficiency and welfare gains to *materialise* by way of spontaneous adjustment. Should conscious policies of institution building promote the transformation process had to be dynamically efficient and self-sustaining.

The experience of the respective countries is mixed. Bert van Selm [1992] was among the first to highlight the inherent duality in the process. While some parts of the former Soviet Union managed to capitalise on the newly acquired freedoms, Ukraine missed this opportunity. The analysis referred above underscored the importance of policies and institutions supporting spontaneous adjustment and limiting the search for, otherwise *potentials* and *outcomes* were bound to differ substantially.

This finding has been retroactively supported by the analysis of transformation in the Baltic states, (Haavisto (ed.) [1997]). These small countries would have seemed to be the most ill-suited for independence in the globalising world economy. In fact, the contrary proved to be the case, if and when appropriate policies aiming at and actually delivering stabilisation, liberalisation and privatisation have been put in place. Estonia has secured the country's edge over Latvia and Lithuania, where similar policies were put in place with considerable delay. All in all, the segregation from the previously unified Soviet economic space could be mastered, and the institutions of the market economy could be put in place with reasonable success. The sustainability (or failure) of the respective reform policies were contingent upon success (or the lack of it) in terms of *institutional*

building, rather than on the *endowments* with raw materials or from the degree of previous integration to the Soviet economic space (Haavisto (ed.) [1997]). This finding receives an in-depth empirical backing allowing for extending the conclusion to other transition countries by the chapter of Attila Soós disentangling the components of success in joining global trade relations.

Introduction of *new currencies* has probably been the most palpable sign and instrument of success, one of the least controversial achievements of the small Baltic countries against Russia and most other post-Soviet states. The sustainability of both convertibility and low inflation rates for the Baltic currencies stands in sharp contrast to the Russian disinflation, which proved unsustainable. The same goes for the proliferating currency restrictions instituted by Centrobank in the post-currency-crisis period. While the Baltic states did run into serious current account disequilibria, these never lead to rescheduling, as happened in the case of resource-rich Ukraine in February 2000. To sum up, the story of the Baltic is one about the relevance of institutions and policies over endowments, including size.

Comparing postsocialist and other trends towards disintegration Dallago [1995] adopted the *Olsonian* theory of collective action to prove, that *disintegration may well be efficiency-enhancing*, and that breaking up old states and creating new ones does not necessarily lead to an endless process of decay (Africanisation), since the nation, as a special kind of public good, is likely to set limits to this process. Nationalism, in this approach, is an investment into the redistribution of property rights, and aims at new equilibria that may be beneficial to those initiating the change. Meanwhile, it can not be taken for granted that this game is zero sum, i.e. that other players should necessarily loose out, as the integrationist school mostly implies. Disintegration may be positively efficiency enhancing if it creates a more immediate link between marginal productivity and wages, further if it helps overcome information asymmetries that used to characterise oversize and overcentralised arrangements of the *status que ante*.

This analysis is supported by the growing regionalisation inside the European Union. The devolution laws of the Blair government in Britain have resulted in one of the most far-reaching decentralisations in contemporary Europe. Limits to secession may be set by the rationale of the EU in its currently evolving form, making full independence largely impractical. Likewise, the far-reaching decentralisation in Spain in the 1990s has overcome much of what used to be the potential for secessionist movements. In Germany the autonomy of provinces has always been considerable in many areas, from education to funding practices. All in all, it seems democratic policies and market-driven institutions did allow for a

⁶ OSCE stands for Organisation for Security and Cooperation in Europe, established at the November 1990 pan-European conference in Paris.

very large degree of *regionalisation*, without however, breaking up existing states.⁷

By contrast, both the Yugoslav and the Soviet disintegration is attributable to the lack of both democratic forms of interest representation and reconciliation, and to the lack of truly market driven forms of economic activity. The integrating role of foreign capital and supranational arrangements, softening up traditional borders, were equally missing.

In the course of disintegration most new independent states resorted to traditional statist policies to help foster *nation building*, and reflecting protectionist policies to fund *state building*. An earnest belief, built on the socialist and nationalist doctrines, in the 'inevitability' of crisis management by bureaucratic means has also had a role to play. This drive has been supported by the advice of international agencies, i.e. clearing arrangements, licensing, go-slow strategies in opening up. *Michalopoulos and Tarr* [1994] have already underscored the success of free market Estonian policies, and contrasted this to hesitant Russian and Ukrainian reform practices (not promulgations).

The causes of the failure of the Commonwealth of Independent States could be summarised as the *lack of market-based institutions*, the *lack of market-promoting policies* and the *lack of democratic interest harmonisation* among the major factors of failures (*Olcott et al* (eds.) [1999]). It is not the pure diversity, but rather the similarity among the CIS states, in terms of lacking reforms, protracted restructuring and a resultant lack of (foreign and domestic) capital for restructuring and a reconstruction, that hinder their recovery and prosperity, (*ibid* 238–243). It is not the size of the respective states, rather their *policies* and institutions which lay at the root of a lengthy and self-reproducing series of crises. (*Olcott et al* (eds.) [1999]) advocate the introduction of WTO rules, convertibility and SLIP strategy to remedy the problems, rather than any form of enchanted regional co-operation based on geographical closeness or re-establishing historic ties.⁹

To sum up the contrast, while western Europe managed disintegration parallel with integration to global flows of information, capital and technology, lacking

⁷ Later produced monographic analyses (*Bartkus* [1999]) continued to have difficulties in establishing how far secession can go; similarly these approaches – as all purely economic theories – have difficulties in delineating what a nation is, or what is the optimal/minimum unit for which cost-benefit calculations in the spirit of Gary Becker can meaningfully be made. Likewise, it hard to generalise in quantitative terms when devolution pre-empt, and when it fosters, secession.

⁸ SLIP = stabilisation + liberalisation + privatisation

⁹ If we take incremental growth as the sole success indicator, the EU has not been much of a success either. As *Vanhoudt* [1999] demonstrates, impacts of a large market were negligible against traditional items in the *Solow* model.

these external conditions rendered disintegration in eastern Europe more destructive, ruinous process. In fact, as the examples of Slovenia, Estonia, the Czech Republic and Slovakia indicate, disintegration may be parallelly freedom and welfare enhancing. Echoing the western experience, also in central and eastern Europe small, rather than large, countries have proved to be the true success stories. This is explained, to a great extent, by changes in technology, capital and information flows, making scale economies less important, while rendering both corporate and country boundaries relative, i.e. issues taken up by several contributors to this volume.

These findings do not, however, invalidate the relevance of country size for economic analysis. Country size does effect trade patterns (*Torstensson* [1998]). Small countries, relatively better endowed with skilled labour, are more often exporters of R+D intensive products. Meanwhile the presences of large internal markets do not necessarily favour specialisation in industries or activities with scale economies. Small economies' health is often crucially dependent on their constituent region's (*Amstrong and Read* [1998, p. 578]). This is demonstrated by the modest success of Kyrgistani economic reforms, where remoteness of the country seems to overarch any other consideration for international investors. By contrast, neither Slovenia nor Slovakia are particularly highly regarded for their reformist fervour, still, their embeddedness in flourishing regional economies – Friuli–Veneto and Bavaria–Austria, respectively – seems to have had a highly beneficial impact on both their actual performance and on their perception abroad.¹⁰

Small countries obviously benefit from multilateralism, both in the trade and defence areas. In the former, generalisation of any concession waged by stronger partners allow small countries to free ride, while multilateral arbitration procedures limit the unilateral use of force, figuring high e.g. in traditional US trade policy practices. Individual defence is though possible, however it is definitely more costly, in terms of both armament and mobilisation, than collective defence, where small countries may specialise on certain activities, while benefitting from the umbrella provided by an alliance.

Small countries also face a problem in defining the optimal degree of their freedom in terms of monetary and exchange rate policies. While the official creed of the 80s and 90s were pegged rates, combining stability with flexibility, the lessons of the Asian crisis prompted both theorists (*Schuler* [1999]) and policy advisors (*Goldstein* (ed.) [1999, 178]) to reject this option, as a panacea for runs on currencies, due to asymmetric risks and decentral information. However, free floating may be practically unacceptable to small countries with large – sometime:

¹⁰ Cf. the econometric exercise in the chapter by *Attila Soós*.

over 100 per cent – shares of foreign turnover against their GDP, which may offset all the fundamentals. Since exchange rate movements are not related, if at all, to fundamentals (Rogoff [1996]),¹¹ there is no good reason for this to happen. Therefore Armstrong and Read [1998, p. 571] consider it a great evil to give up sovereign monetary policy in exchange for an automatic stabiliser. The more one is concerned with the usefulness of discretionary interventions and of the authorities' ability to fine-tune economic processes, the weightier this argument may count in policy-making. The current rush of candidate countries for taking over the euro is a clear sign how widespread this conviction has become among policymakers. Greece's recent victorious announcement of its joining the euro from 2001 has been a clear indication of the same, notwithstanding the severe economic costs the preparation for this step implied.

Experiences of transition economies as well as other European countries support the insight drawn from developing country experience (Sachs [1986]) that *being small is not necessarily a recipe for failure*, dooming countries to monoculture, going for niches, and generally being imitative rather than innovative in the international economy.

The challenge of international economic disturbances of 1997–1999

1997–1999 saw a series of events that may qualify as international economic disturbances for small open economies. Let us reflect only upon four of them. The *first disturbance* was the chain reaction of stock market crises, setting off an attack on the Thai *baht* in June, 1997 and ending with the halfway-successful attack on the Brazilian *real* (where the currency had to be devalued, but the dollar could be maintained) in January–March 1999. It has questioned the shape and future of international financial system and put the viability of arrangements of small countries to the limelight. The truly new and interesting feature in this series of events was, at least, twofold. First, *fundamentals* seem to be in particularly bad shape, especially in east Asia, where current account deficits were small, or often the balance was in surplus. Thus traditional reference to flawed fundamentals neither precautioned, nor *ex post* warranted the events.

¹¹ Though this finding is well established both through theory and empirical evidence, it is still provoking to the majority departmental views, that it is still contested. Most recently in *Economic Journal*, no. 459. (Nov, 1999.) pp. F652–F691.

Second feature was that the chain reaction has *not originated in any of the G 7 economies*, still the waves of disturbances have not left the major OECD economies untouched. The 'one world' symptom was felt more than ever.

As a *second economic disturbance* shock oil prices skyrocketed. In 1998 oil prices fluctuated between 9–11 \$ per barrel, they climbed to 32 \$ per barrel by March, 2000. Recall that in 1973 the quadrupling of oil prices induced recession and balance of payments crises. New terms, as 'stagflation' and 'epochal changes in the world economy' were introduced in the economic vocabulary. When in 1979 a second oil price hike restored the 1973 price relatives, economists talked of a 'new price revolution'. Many analyses were produced to elaborate on the limits to growth and expand ways to change technologies to make production less energy-intensive. The second adjustment recession could also not be saved. In 1998–2000 nothing similar happened. While oil prices tripled, EU growth accelerated to 2.5 per cent, with inflation in the euro zone remaining at 1.3 per cent, well below the ECB target of 2 per cent. Also in the United States growth reached 4 per cent, inflation remained barely above 1 per cent, and unemployment fell to 4 per cent to a historic low. Also a series of small countries managed to survive these shocks in good shape, as the contribution of Magas on Hungary and Gottlieb on Israel demonstrates in this volume.

As a *third economic shock* to small countries a series of mergers and *mega-mergers* have been going on in the period under scrutiny. While the first wave of mergers may have been attributed to forward-looking strategies making use of the euro, cementing and deepening the single market of the EU, the US wave of mega-mergers is hard to attribute to this factor. The concentration in the banking and financial sector exemplified most recently by the (unsuccessful) merger of two archrivals in the German landscape, Deutsche Bank and Dresdner Bank, or the mega-mergers of Japanese banks may be indicative of the increasing importance of scale economies. Other contested mergers, as the failed Volvo–Scania project, or the Vodafone–Mannesmann deal seem to be indicative of this feature.

However, it is important to avoid the conventional *post hoc, ergo propter hoc* argumentation, Fröliche... [1998]. This is surely not the first merger wave. Experiences with former such actions often have shown mere fashion, rather than good business economics, behind this trend. Following the acquisition of Bankers Trust Deutsche Bank concluded its financial year with a loss, for the first time in many years. Also in many other examples, it seems managerial megalomania, rather than enhancing shareholder value that lies behind the merger craze. The new trends in industrial organisation, highlighted by Kocsis, Szabó, Dallago and Szalavetz as well as the limits to transferability in the area of management and industrial organisation, as exemplified by the contribution of Lukács to this volume, all are indicative of strong counteracting tendencies.

In a way, these countervailing forces represent nothing else but the *enhancement of the boundaries of the firm. Ceteris paribus* the enhanced boundaries of multinationals, having contributed significantly to adjustment in small countries and other small economies, as elaborated by Šereghyová in this book, imply the same for the macrolevel. The parallel ongoing process of rendering both macro- and micro-boundaries fluid, may have held the key to explaining, why small countries have not suffered *more* from all-the-world shocks.

Last but not all least, as the *fourth* shock, the *fragmentation of international security* on the ruins of cold war era should be mentioned. Analysing a multifaceted issue goes beyond the scope of the present chapter. Still, it is worth mentioning that the migration wave is often triggered by bloody civil wars and ethnic strifes, from Kurdistan to Ethiopia and Kosovo. Besides, the unbridled and in many ways unprofessional, armament race of large developing countries may pose an immediate threat to their smaller neighbours and the world (Mangelnde.. [1999]). The clash in Kashmir, that has been close to a full-scale nuclear conflict between India and Pakistan, is just one of the many examples of the grave conflict potential. Obviously, these trends challenge the integrity and stability of small nations, in a manner that seem to have been overcome by the second world war, or by the post-cold-war era at large. Instability prompts larger defence and peace-keeping expenditures, also in small states. In more extreme cases, it may call into question their mere economic viability, as in the case of Macedonia, Albania, Sri Lanka and the recent years Congo/Zaire could be observed.

Coming back to economics, how do we conceptualise instability? This is when growth and other activity indicators show extreme volatility, if the stability function of prices get blurred, that leads to depressive signs, moral hazard and adverse selection in financial intermediation (Mishkin [1999]). If these pathologies remain uncovered, the distortions cumulate, devaluations become inevitable, that depreciate assets of banks. Thus even good macrodata do not wouch warranty against financial collapse. This has been compounded by lax financial reporting, making book-keeping largely irrelevant, owing a large extent to off-record activities, that may have gone up to 40 per cent of turnover in some. The contribution of *Benczes* elaborates, how these practices have lead to the onset of contagion in east Asian small countries.

How does contagion spread? *Fratzscher* [1998, 644–645] names three main channels: unsustainable fundamentals, contagion due to herd behaviour of financial investors, finally contagion due to close trade and financial integration. Investigating the importance of each factor he finds the third to be more important than misaligned fundamentals, but unforeseen reversals of capital flows to be

more important than anything else, (*ibid* p. 688). This means the limited ability of small country authorities to do much more than conduct sound policies that enhance credibility in the respective countries, like avoidance of much too heavy reliance on short-term finance, and enhancing transparency across the board. However, this may not be entirely sufficient to prevent the spillover effect. This is exactly what *Keren's* model and discussion implies in this volume.

These all sound like serious *warnings for small countries*, where open door policies have played a major role in catching up and modernisation, as the previously quoted literature in general and the contributions of Šereghyová, Boltho and *Benczes* in particular in this volume highlighted. *Should they continue open door policies?* Or should they be more restrained, heeding the suggestions for 'throwing sand among the wheels of capital markets', a call originating with *James Callaghan*? There is no simple answer. On the one hand, countries, having conducted outward-oriented policies and having integrated themselves to international flows, could reasonably withstand attacks. This holds for Greece, Portugal (cf. *Braga de Macedo* in this volume), Poland and Hungary, but also for Singapore, Switzerland and Austria. On the other hand, closer scrutiny of the Hungarian success story is indicative of the high intervention costs (*Darvas and Szapáry* [2000]), as well as of the crucial role of the still existing limitations on short-term portfolio operations in the efficacy of crisis management.

Does it imply that *capital controls*, at least on short-term flows, are to be seen as the *principal answer* to the problem of contagion? The answer is clearly no. Countries where contagion has triggered lasting troubles, like in Indonesia or Brazil or Ukraine, had been facing more or less *covered structural and policy ills* for quite some time before the crisis erupted. Controls alone, lacking sound fundamentals and solid financial structures, have not been particularly helpful in any of the problem cases. Controls alone are no substitute to sound finances and credible policies, since they have a tendency to cement themselves as lasting policy elements, further they do allow for postponing overdue reforms (*Edwards* [1999]). This danger is imminent not only in Latin America, where *Sebastian Edwards* draws his policy examples from, but has clearly been observable in Malaysia, Russia, Ukraine, Rumania, and Croatia, just to list some other recent cases.

Recent semi-official and quite radical proposals (*Fischer* [1999]) to overhaul international lending and reporting practices conspicuously miss any *old-fashioned statist measures*, controls and prohibitions. Instead they aim at *bailing* the private sector in, at making *transparency*, both at the level of corporate finances and general government finances, *enforceable* and uniform in standards, so as to make signals *comparable* and *cross-checking* practicable. Furthermore they aim at more *information sharing* among creditors and more publicity *vis-à-vis* governmental and corporate malpractices. Requiring non-banks to *publish reports* on their

activities, public information notes on the performance on government flexibility in reserve-building practices tailored to debtor specificity, and of Code of Good Practices on Fiscal Transparency, elaborated by the Committee, all go in the right direction, without instituting new controls.

This is all the more important, since capital controls are constraining of foreign savings, one of the preconditions for accelerated growth of economies. They further act as efficiency constraints, limiting the most intertemporal and international combination of factors. Furthermore controls substitute sound financial institutions and transparency, which may by risks in due time, act as *pre-emptive before crises*, and so is the rearrangement of portfolios and asset values therein, as a consequence of and/or exchange rate risk.

This finding is quite in tune with a broad analysis of the consequences of contagion for transition economies, see (Fries et al, [1999]). Having studied country experiences, they conclude that deep reforms make financial systems crisis-resistant. Sound financial systems retain, or quickly regain, access to international capital markets, thus *the suffering associated with the drop of indicators was likely to be much shorter and recovery more rapid*. Notwithstanding these general conclusions the small country vulnerability to cyclical effects is unlikely to disappear.

This is quite important an insight for transition countries. On the one hand, oft-voiced criticism, levelled against their overzealous radicalism in the reserve building, especially in the early transition years, seems retroactively even misguided than it sounded in contemporary times. Output and job losses, suffered in the 1990-1993 period, have to be measured against cumulative output and employment losses in the control groups of CIS and southeast Europe. Furthermore *one-time losses must be weighted against cumulative and dynamic losses, including those incurred from contagion in the 1997-1999 period*. On the other hand, the advancement of transformation and broadening the scope of capital markets, *reliance on portfolio investment is gaining importance as a means to diversify risks*. Also enhancing the liquidity of capital markets and better access to a large pool of foreign saving is becoming important, as well as the opportunity for newly created private pension funds to find safe and lucrative investments, probably abroad (Buch et al, [1999, 212-213]). The more a country transits to the second and even the third (pre-EU) maturity stage of systemic change, the less likely to afford a regression to capital controls and other statist policies.

These are all important theoretical and also policy relevant insights. Although countries with no alternatives but striving for EU-accession, as Hungary portrayed in the contribution of Práger to this volume, have to face the limitations known also from the Mundell-Flemming model, i.e. that full (capital account)

convertibility, exchange rate stability and endogenous monetary policy can not be attained at the same time. If *open capital markets* weigh so heavily in terms of *development strategies*, as seems to be the case on the base of above cited theoretical insights and country evidence, it is not that surprising to find that banking specialists caution from premature pegging of candidate countries' currencies to the euro, from premature joining the ERM, due to the overdose of rigidity this option would entail (Backé [1999, p. 60]).

This finding is in line with other insights gained from transition-specific research. While the rate of exchange serves, by and large, inevitably as a nominal anchor in the first stage of stabilisation, this is but a short-term, temporary option (Csaba [1997, 105]) and (Desai [1998, 640]). Fixing the exchange rate is a poor substitute for disciplining fiscal policies or for reforming the system of financial intermediation and regulating it properly in terms of soundness and transparency. Therefore too early and too long a fixing may actually backfire, as the Czech and Russian cases evidenced. The resulting enforced devaluation undermine the entire hard-earned creditability of economic policies of the previous periods. This implies not more and not less than the candidate countries *can simply not meet the EMU accession criteria* as defined in Maastricht i. e. including two years of membership in ERM before joining EMU. They have to be waived either from the inflation criterion, which seems politically next to impossible or from two years of membership in ERM before joining EMU, which has already two precedents with Italy and Finland. In fact, this waiver would *not equal to softening up the Copenhagen criteria*, but adapting them to the needs of chatching up small open economies, though *not in their capacity of postcommunist transition régimes*.

Perspectives of small economies

Small economies have positively been refuting the 'big is beautiful' ideology of the industrial period, and the related integrationist school all across the last half of a century. Eight out of the ten richest economies are small. Many of the lasting success stories, from Finland to Singapore, have been written by small nations. From the ruins of the Soviet and Yugoslav empires *only small*, previously subordinate, *nations* have been emerging *victoriously* in economic terms: Estonia and Slovenia, respectively. The great east Asian contagion has not shaken small economies, as such, and success or failure *has not been related to country size*. Switzerland has not suffered more than Germany, and Greece or Israel proved positively more successful than Russia or Japan.

The underlying causes for this apparent paradox have been investigated at the political economy level by *Brada and Boltho*, and at the corporate level by *Sereghyová, Dallago, Szabó and Szalavetz*. Country experiences, varied as they might be, all point to the same direction: towards the *viability of small economies*. We have found some new insights:

1. The *new economy* does not seem to be confined to the United States. The countries' resistance to new oil shocks seems to have proven.
2. Good *institutions* and good *policies* seem to work across countries, irrespective of history and country size. The relatively quick recovery from contagion in Israel (cf. Gottlieb in this volume), Hungary, Estonia, Poland, Greece, the resilience of the Singaporean and an Austrian economy, have been taken as empirical evidence for this thesis.
3. Earlier and more global insights seem to have gained new support, highlighting: being small calls for even more *going global*, not only in the real economy, also in finance. Small economies should not be conceptualised as *shrinking economies*, as small business is not the mirror copy of *large economies* either. Quite analogously, small economies are pushed to specialise in niches, to be more innovative and flexible than larger ones.
4. But does not globalisation, i.e. the rendering the borders of both for territorial nation-states permeable and fluid lead to the abolition of small economies, their full *absorption* by a larger group or integration? Does the merger wave itself prove this tendency? As we tried to show, as our findings, the institutions ensuring the maximisation of shareholder value, very inherent features of capitalist order already *trigger countervailing forces*. Similarly to the industrial era, but this time supported by the *decentralisation* trends in modern technology and organisation, it is naive to hold: the *large firms* are better. Megafirms are often inefficient, or are internally decentralised. A network of relations actually may explain *how* could small national economies function so *crisis-resistant* in the 1990s.
5. Our finding is in line with a broader review of literature and related economic testing of popular assumptions, (*Schulze and Ursprung* [1999, esp. pp. 347]). They claim that countries and activities are integrated in a rather *integrated* manner, thus there is *no empirically testable sign of homogenisation*. If *small economies* seem to have remained fairly independent, moreover if and when welfare spending, it could mostly be accommodated.

Partisan politics are still important in determining the *level and pattern of welfare spending*, as well as the modes and structures of collecting *public dues* and their levels. No overall retrenchment of the welfare state could be empirically observed, only its continuous expansion, once termed Wagner's Law, seem to have been invalidated by the neoliberal counterrevolution of the last quarter of a century. The overall tax burden has not shrunk either. In sum, in line with our *fifth finding*, *globalisation is not about the extermination of the nation state*.

Another interesting and reassuring finding is our *sixth* one, i.e. how much transition economies and their problems are becoming *truly akin to non-transition economies of similar size and similar level of complexity*. The latter may sufficiently explain why picking winner strategies and statist export promotion policies do not work any longer in east Asian small economies either. Likewise, what transition economics has delivered in terms of the importance of *financial institutions* and the focal role of transparent and well *regulated capital markets* can no longer be contested with a *shere* reference to east Asian successes (*Park* [1991]) where high growth rates sustain without such devices. On the contrary, with their *maturing* economies, east Asians had to *similarly reform* their corporate, disclosure and public finance *practices*, much in the same way as transition countries have done, or else choose to stagnate, as Japan has been doing all across the 1990s.

Having said that, we do not subscribe to the bureaucratic view seeing primarily the EU or WTO as a forum for cross-border standardisation, and measure success purely in terms of meeting their respective criteria. On the contrary, the strength of the EU lays in the balance it strikes between common rules of the game and regulatory competition, which ensures *freedom* and *efficiency*. The existence of such small safe heavens as Luxembourg and Liechtenstein, that are not subject to populist pressures of the politicians of large and heavily taxing countries, contribute to the sustained *competitiveness* of west European countries. They do so as they countervail the otherwise hardly constrained 'heavy hand of the taxman', as the Finnish minister of finances called it recently. Such complex structures as the Swiss wouch warranty against what is traditionally called the dictatorship by the majority. This may count as our *seventh* finding on the future role of small economies.

We tried to underscore the ongoing *devolution* and *decentralisation* process, which is observable from Belgium to Russia. This process is made possible by the very same technological, organisational and motivational changes as we discussed primarily in the context of postcommunist transition. The finding, in both cases, points towards the limitations of purely economic generalisation.

We too have fallen short of establishing how exactly a community is being constituted, and how far secession may be basically issues *beyond the competence of the economics discipline*. We take certain factors as exogenous, the same way we do not need to do research to the psychology of the Schumpeterian entrepreneur, nor afford assuming his presence, and distill his qualities through abstraction.

8. Having reached the external limits of our approach we may assume that the viable size of a nation or an economy is determined by its *culturally and technologically* constituted. As such it may be different in time. It must certainly be different by the historic era, since the possible exchanges and the scope of the extended order varies. Thus, our *eighth* thesis goes as follows: *globalisation enhances the viability of making a relatively small nation viable, with the chances having become better than they used to be, say, in Antiquity or even in the middle ages. Small nations are economically all the more viable, the more they engage in various exchanges, the more they find their niches.* The Reggion of Emilia, a region specialising exclusively on traditional handicrafts earning a very good living, is probably the best example how small nations may be, the further examples going from Silicon Valley to the USA.

This finding is in line with all what we know about the nature and dynamics of the market economy, based on *diversity, competition and natural selection* processes. Therefore, being small is not a predetermination. Nor is it, however, a recipe for prosperity, as the fate of Sub-Saharan Africa may more than sufficiently demonstrate.

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