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FINANCIAL CRISES AND INTERNATIONAL ARCHITECTURE: A "EUROCENTRIC" PERSPECTIVE

by

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PREFACE

The recent past has demonstrated that the most apparently dynamic regions can fall victim to financial crisis and instability and that the patterns of contagion go beyond geographic proximity. This suggests that there are lessons for the international financial architecture to be learned from the crisis in the European Monetary System (EMS) in the early 1990s. In effect, the system relied on a code of conduct which became a powerful convergence instrument among very different economies, some of which had no strong constituencies for price stability. For such regional solutions to be adopted universally, however, institutions of global governance must exist, so as to encourage competition on the quality of policies.

The word "region", however, hides a series of differences and divergence between nations and makes policy co-ordination difficult in the absence of shared values. Such a volatile policy environment lends itself to financial crises. The experience of the EMS demonstrates that codes of conduct accepted on a sovereign basis by participating states receptive to peer pressure will both reduce the danger of crises and expedite their resolution.

While it is clear that global institutions will continue managing the international financial architecture, the regional dimension cannot be ignored. The European Union's experience has shown that sovereign nations will benefit from regional co-ordination between monetary and fiscal authorities to the extent that they subject themselves to peer pressure. The experience provides a useful precedent for EU applicants from central Europe and, more broadly, for Asian economies and Mercosul.

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RÉSUMÉ

Est-il possible de coordonner les dévaluations et les mesures de contrôle des changes au niveau régional ou mondial, afin de limiter leur aspect de concurrence entre pays ? Vraisemblablement non en l'absence de mécanismes de régulation entre les autorités monétaires et budgétaires, comparables à ceux mis en œuvre au sein de l'Union européenne. Il reste toutefois à étudier de près la manière dont de tels mécanismes pourraient être transposés au CEFTA, à l'ANSEA ou au Mercosur. Ce Document propose une approche qui est peut-être la meilleure.

Par-delà les parallèles possibles entre la crise des marchés émergents de 1997-99 et la dévaluation mexicaine de décembre 1994, il peut être utile de tirer les leçons des crises qui ont touché le système monétaire européen, dans la perspective de l'élaboration d'une nouvelle architecture financière internationale. En effet, les crises ont pu être surmontées grâce au code de conduite du mécanisme de change européen. L'expérience acquise au cours de la première année d'existence de l'euro pourrait permettre de définir un nouveau code de conduite, tenant compte de l'importance d'une supervision bancaire internationale et notamment d'une meilleure gestion des risques cohérente avec les lignes directrices proposées par la BRI. Imaginer que l'on pourrait éviter la contagion des crises par un retour au protectionnisme commercial et financier pourrait bien s'avérer une politique aussi stérile aujourd'hui qu'elle l'a été au début des années 30.

Des systèmes comme le mécanisme de change européen reposent sur des valeurs économiques et sociales communes. Leur adaptation à la grande diversité des marchés émergents dans le système mondial actuel peut se révéler difficile. Ils sont toutefois indispensables lorsque le champ des accords régionaux dépasse les aspects commerciaux pour couvrir l'investissement ce qui, pour des raisons diverses, est le cas du CEFTA, de l'ANSEA et du Mercosur.

SUMMARY

Can devaluations and exchange controls be co-ordinated at the regional or global level, to lessen their beggar-thy-neighbour character? Probably not without co-ordination mechanisms among monetary and fiscal authorities like the ones found in the EU. How precisely the mechanisms may apply to CEFTA, ASEAN or Mercosul remains to be thoroughly investigated. The claim of this paper is that there does not seem to be a better perspective that the one defended here.

Over and above the parallels between the 1997-99 emerging markets crisis and the Mexican devaluation of December 1994, the lessons from the crises in the ERM may thus be helpful in designing a new international financial architecture. In effect, the crises were overcome by the ERM code of conduct. With the experience gathered during the first year of the euro, a new code of conduct may be developing, which acknowledges the importance of international banking supervision, including better risk management along the lines proposed by the BIS. Avoiding contagion by reverting into trade and financial protectionism could well prove as ultimately futile a beggar-thy-neighbour policy now as it was in the early 1930s.

Systems like the ERM relied on shared economic and societal values. They may be difficult to adapt to the variety of emerging markets in the current world system, but they are certainly required when regional arrangements are spreading from trade to investment, as is the case, for different reasons, with CEFTA, ASEAN and Mercosul.

I. INTRODUCTION[1]

Recent financial crises in emerging markets strongly affected thinking about international architecture. There has been reluctance in planning global reform and rather little has been done to enhance surveillance on a regional scale. The rapidity of American response to Russia's 1998 financial crisis, Japan's recurrent difficulties and an apparent European indifference to emerging markets made perceptions in major economies more diverse than they have been in decades.

As global integration advances, greater prosperity will result — as long as governance improves and people do not feel excluded from the reforms. Similarly, the new financial architecture should combine global unity with regional and national diversity. The euro-zone experience and the strength of the dollar over the last year both suggest that markets doubt this combination can be achieved in practice.

Yet the current international system goes beyond American national interest in preserving world stability and it calls for a more effective regional and global response to threats of contagion of national crises. Co-ordination mechanisms among monetary and fiscal authorities like the ones found in the European Union (EU) and in the euro-zone rely on economic and societal values shared among sovereign states and are one such response[2].

Could the Central European Free Trade Area (CEFTA), the Association of South East Asian Nations (ASEAN) and the South American Common Market (Mercosul) adopt them?. Bill Branson *et al.* (1998) suggested that CEFTA members use EU surveillance methods and Barry Eichengreen (1998) quoted a series of articles advocating the same approach towards Mercosul[3]. Indeed, on 9 June 2000, Mercosul's four full members, and associates Chile and Bolivia, "began a joint effort in the macroeconomic and financial services areas and proposed to move forward towards common objectives"[4].

Without calling his proposal "Eurocentric", Fred Bergsten (2000) advocates a tripartite currency world whereby the European experience is applied to ASEAN plus Japan, Korea and China. The same argument could be made with respect to the North American Free Trade Association (NAFTA) or to the Southern African Development Community (SADEC), even though the existence of a dominant player might strain the multilateral perspective taken here.

Over and above the parallels between the 1997/99 emerging markets crises and the Mexican devaluation of December 1994, the lessons from the crises in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) may be helpful in emerging markets. In effect, the crises were overcome by more effective co-ordination mechanisms among monetary and fiscal authorities, the ERM code of conduct[5].

The importance of international banking supervision, including better risk management along the lines proposed by the Bank of International Settlements (BIS) would now be more explicitly acknowledged than it was in the management of the EMS crisis. The adaptation of the ERM code of conduct to improving international financial architecture would also support the creation of new networks including major emerging markets, such as the BIS itself[6].

The experience with codes of conduct has great potential impact on development because such codes can only be supported by multilateral commitment. In the case of aid governance, possible codes of conduct involve more elaborate forms of peer pressure among donors and recipients alike. The partnership strategies agreed upon in the OECD, for example, were not sufficient to create a commitment to the untying of aid to the least developed countries. Other multilateral initiatives have also been plagued with execution difficulties well beyond those encountered in both the euro-zone and the EU.

The text is divided into six sections. Section II defines the "Eurocentric" perspective. Updating my work with Hervé Carré (1994), section III describes how the ERM code of conduct became a powerful convergence instrument. This is followed by an overview of financial crises in emerging markets[7]. The implications for the international financial architecture are in section V. Section VI concludes that regional co-ordination mechanisms among monetary and fiscal authorities are consistent with global plans for the reform of the international monetary system, as long as the institutions of global governance are capable of preventing reversions into trade or financial protectionism.

II. THE "EUROCENTRIC" PERSPECTIVE DEFINED

The respect of property rights and open markets for goods, services and assets have become widely accepted principles for the organisation of economic activity everywhere, including mature democracies as well as emerging markets[8]. These two principles, which may be described respectively as governance and globalisation (G&G for short), became accepted through a complex process of peer pressure which began with the collapse of the Soviet Union.

The existence of institutions of global economic and financial governance, such as the IMF, the World Bank or the WTO also helped spread the results of alternative policy paths among their member states, thereby reinforcing the notion that some paths worked better than others. The wide acceptance observed suggests that national policymakers follow these two principles in part because they see other policymakers do the same.

Under what conditions does peer pressure bring about improved performance? The issue has been addressed in the context of "yardstick competition", a term coming from industrial organisation which has been applied to the political economy of state taxation in the United States by Tim Besley and Anne Case (1995). Yardstick competition was originally proposed as a means to address the inefficiency of "cost-of-service" regulation of franchised monopolies. The welfare inefficiency derives from the fact that the regulator adjusts the firm's prices to equal the costs it incurs in providing service to consumers at each point in time. If prices track costs, the monopoly has no profit incentive to minimise costs.

What the regulator needs is some relatively simple benchmark, other than the firm's present or past performance, against which to evaluate the firm's potential[9]. Andrei Shleifer (1985) suggested comparing similar regulated firms with each other. For any given firm, the regulator uses the costs of comparable firms to infer a firm's attainable cost level.

This does not fully overcome moral hazard problems and the scheme is susceptible to collusive manipulation by participating firms. Yet both the punishment strategy of the regulator and the difficulty in co-operating to impose collusive behaviour make collusion unlikely in the example of health care chosen to illustrate the approach[10].

Therefore, adapting the same reasoning, when there is peer pressure among national policy makers to respect property rights and to open markets for goods, services and assets, the two principles are likely to become more and more accepted, as they have been. But the reward from globalisation in terms of higher standard of living cannot be reaped without substantial improvements in policy, including both corporate and democratic governance.

Indeed, risk increases with the reward. If a financial crisis destroys a fragile civil society, then the combination of political and financial freedom found in mature democracies may seem unattainable even to some of the members of the OECD. Peer reviews have traditionally enhanced competition for better policies among OECD members, but benchmarking may take some time to spread to new members.

Financial crises have affected emerging markets much more than aid-dependent countries. The reason is that an economy heavily dependent on official development assistance is typically unable to borrow in international financial markets. In this way, exclusion has a paradoxical insulating property. The paradox comes from the fact that the

apparent risk reduction comes at the expense of the rewards foreign savings may bring to the national economy[11]. Nevertheless, this threat is perceived to be more pronounced in the least advanced countries than in emerging markets, leading to calls for "inclusive globalisation"[12].

Most OECD countries are gathered around the seven richest economies (G-7), whose leaders have regularly met over the last quarter of a century, suggesting a response to international interdependence rooted on sovereign nation states[13]. The perspective taken here is called "Eurocentric" to stress that, among them, only the four European G-7 states have attempted to deal explicitly with their regional architecture, so that the presidents of the European commission and central bank attend the meetings. The fact that there is no sovereign national centre equivalent to that of the United States, Japan or Canada overcomes the weakness of the current EU institutional framework[14].

Certainly, the institutions of global economic and financial governance have, in one way or another, helped prevent the 1997-99 financial crisis in emerging markets from becoming a 1930's style global depression. This is true in spite of the widespread criticism of the Bretton-Woods institutions and of the spectacular interruption of the Millennium Round of the WTO launched in Seattle in late 1999.

Parallels between free trade in goods and services and free mobility of capital (or labour) are analytically dangerous to make. In any event, the stability of the global trade architecture which led to the creation of the WTO should caution against purely regional solutions to financial globalisation, including European ones, lest they revert into protectionism.

The "Eurocentric" perspective claims that the multilateral surveillance mechanisms developed among EU nation states can be adapted to build a global financial architecture resilient to financial crises. To begin with, its intercontinental domain and its bridges to the former Soviet bloc, Africa and Latin America reflect longstanding cultural and commercial ties. Moreover, such "Eurocentric" perspective of the international financial architecture probes into budgetary procedures and corporate governance standards, in ways that may offend national sovereignty if applied to Washington or Tokyo[15]. In the OECD peer reviews and in the standards agreed upon at the BIS, unanimity is required so that national sovereignty is entirely preserved. The procedures of the EU are closer to the regulatory framework just outlined, because of the role of the Commission as regulator and that of the Court of Justice.

The "Eurocentric" perspective does not focus on balance of payments adjustment, but rather attempts to bring together principles of good government commonly accepted in Berlin, London, Paris and Rome and indeed jointly transferred to Brussels and elsewhere. In particular, as mentioned in subsection III.4, the European System of Central Banks (ESCB) provides price stability as an international public good.

This "Eurocentric" perspective has weaknesses, however. The degrees of commitment to the EU and to each one of its main institutions have been changing in various issue areas, as a partial response to a more turbulent global and regional environment. The euro was created in January 1999 among most of the fifteen member states but it was followed by a difficult institutional period, which has also delayed the accession calendar. Albeit conjunctural, the reasons for the delay underscore one weakness of the "Eurocentric" perspective: peer pressure is sometimes used to stall reforms, rather than to promote them[16].

The other weakness, which is even more serious in times of global financial turbulence, is that the four European members of the G-7 often forget their eleven “peers” in the Union when discussing global affairs at the level of the G-7, of the OECD, or of the Bretton Woods institutions. The two weaknesses may be related and they explain the bewildering complexity of the EU institutions at the moment. Nevertheless, the strengths of the perspective can be put to good use in the global arena, as long as “Eurocentric” is understood as a partnership open to other nations, in Europe and elsewhere. Within those principles, some of them are taken further on the continent, along the lines of “flexible integration”[17].

To make the temptation offered by regional solutions worse, the crisis and its aftermath have also uncovered an unusual amount of disagreement within the Bretton Woods institutions. Even if they do even appear to agree with each other, the IMF and the World Bank may not be capable of influencing the architecture of the international economy. If they appear to disagree, then clearly their advice on co-ordination will be less credible[18].

III. LESSONS FROM THE EMS

III.1. The Code of Conduct

After the demise of the Bretton Woods system of fixed but adjustable exchange rates in 1973, various continental arrangements to stabilise exchange rates were tried, the last of which was the EMS, created in 1978 by a Resolution of the Council of Finance Ministers of the Union (EcoFin) and supported by an agreement among participating central banks.

The primary objective of the 1986 Single European Act was achieving free trade in goods and services and assets, as well as free movements of people among twelve nation states. In turn the abolition of internal borders created market pressure for stable exchange rates in terms of the European Currency Union (ECU) basket. Accordingly, the EMS functioned without any realignments after January 1987.

The progress towards the single currency accelerated in the late 1980s. At the Madrid European Council in 1989, the report of a Committee of Central Bank Governors chaired by the President of the European Commission was accepted as a basis for Economic and Monetary Union (EMU). The single currency was to be achieved in three stages, beginning 1 July 1990. Rather than relying on national reserve currencies, a new currency was chosen, the ECU. It was renamed euro at the Madrid European Council of 1995.

Over the years, a code of conduct built up as the ERM developed from a mere exchange rate arrangement into a powerful convergence instrument. In addition to compulsory intervention, for unlimited amounts, at the agreed bilateral limits and to the need to reach a consensus for modifying a parity; the Basle-Nyborg Agreement called for convergence to establish and maintain stable exchanges rates. The rules also refer to the creation of ecus through swap operations, to the provision of currencies for intervention purposes, to the settlement of claims arisen from intervention, and so on. The ERM code of conduct implied the acceptance the deutschmark as the anchor of the system and thus the recognition of the leadership of the Bundesbank. It gave a prominent role to co-ordinated interest rate changes in the management of the system and also involved a consensus on crisis management.

Shortly after the first stage of EMU began, Britain joined the ERM. Sterling appeared to trade its past allegiance to the broad Atlantic standard for a narrower continental bloc. This first experience lasted less than two years but it involved Britain in the design of multilateral surveillance procedures which turned out to be decisive for the sustainability of the system. In that dimension, the rules of the game changed for all the twelve states who signed the Union Treaty.

The plans for the single currency were agreed upon at the Maastricht European Council in late 1991. They were conditional upon convergence and cohesion, as explained in subsection III.4 below. The second stage of EMU was set to begin on 1 January 1994. The third and final stage of EMU was to begin after the 1996 revision of the Treaty signed at Maastricht if convergence was sufficiently high, and in 1999 if not[19].

In the spring of 1992, all Community currencies except the Greek drachma were in the ECU parity grid, but the Atlantic dimension was very weak. Even in the presence of sterling, the continental bloc continued based on the deutschmark. Indeed, it included currencies of countries in the European Free Trade Association which were to become members of the union, like Finland and Sweden. In September 1992, sterling and the Italian lira left the ERM. Until August 1993, political instability and speculative attacks on the grid interacted with the most severe recession and with the highest unemployment the Community ever witnessed.

The single market for financial services, established in 1993, built on the operation of the ERM code of conduct, which, at one time or another, all of the EU member states followed[20]. The gradual acceptance of stability oriented policies by means of peer pressure is at the heart of the ERM code of conduct. The code remained valid after the widening of the bands, even though the obligation of compulsory intervention for unlimited amounts at the agreed bilateral limits was unlikely to be applied.

The need to reach a consensus for modifying a central rate remained, as the parity grid was not changed by the decision to widen the fluctuation bands. It is also noteworthy that the economic priorities of the Treaty (low inflation, sound public finance, medium-term stability framework) remained undisputed among member states and Community institutions, stressing the need for convergence to establish and maintain stable exchange rates.

During the second stage of EMU, multilateral surveillance procedures designed to ensure convergence of national economies towards price stability and sound public finances became binding. The excessive deficit procedure, in particular, determined whether or not a member state could adhere to the single currency. Since convergence was not achieved in a majority of national economies, the EcoFin Council set 1999 as the beginning of the third stage of EMU when exchange rates become irrevocably fixed and the euro becomes the single currency.

III.2. Managing the Crisis

This transition to the single currency included both the first and the second stage of EMU, during which convergence must be achieved under stable exchange rates called "normal fluctuation margins" in the Union Treaty. With high capital mobility, this requires a speedy convergence process, especially as reflected in the indicators of budgetary discipline, which have become signals of sustained regime change.

Given that financial markets tend to exaggerate rather than to dampen such signals, apparent reversions during a relatively rapid convergence are also more liable to misinterpretation. The cohesion objective involves a degree of social awareness that may not be required with respect to the convergence of fiscal variables. In any event, whatever the credibility of national policies, it became apparent during the first stage that fast convergence was more difficult with slower growth. Moreover, during the transition, the main macroeconomic costs arise before the main microeconomic benefits are felt.

The Treaty convergence criterion relating to exchange rate stability requires the observance of the "normal fluctuation margins" during two years, and not having been involved in any realignment during the same period (or at least not having initiated one).

Maintaining the currencies within the parity grid is the result of more than intervention by participating central banks. It reflects the credibility of national policies especially in Germany, and also that of the entire EMS relative to major currencies such as the dollar or the yen.

If, in the final analysis, the exchange rate reflects the credibility of national policies over the medium term, it may do so with considerable noise if the entire parity grid is under attack. This is why little indication about the credibility of national policy can be gathered from the realignments which occurred during this period, which were a direct consequence of systemic turmoil.

Speculative attacks on more vulnerable currency parities will have more negative effects on the system if parities are already locked than if they continue to be flexible. Flexibility within a sufficiently wide band allows speculation not to be a one-way bet. That lesson was learned in the twelve months preceding 2 August 1993 when very wide bands of 15 per cent replaced the normal fluctuation margins. The temporary nature of the move notwithstanding, these new "normal fluctuation margins" eliminate the need for exceptional measures, such as exchange controls, designed to deal with a protracted second stage of EMU. At least, the experience until the fall of the dollar in early 1995 suggests that the widening of the bands stabilised expectations of exchange rate changes.

In particular, foreign exchange market turbulence began in late August, early September 1992 when dollar interest rates fell substantially. In the meantime, German short-term interest rates remained high. Pressures for wage increases deepened the reluctance of the Bundesbank to acknowledge that a Europe-wide recession was imminent. The policy conflict led to the exit of some currencies from the ERM and to speculative attacks against others. The attack of July 1993 was so massive that an emergency meeting of the EcoFin Council including Central Bank Governors was convened and exchange rate fluctuation margins were broadened to 15 per cent on each side of the parity.

The 15 per cent wide band was not used by any participating central bank and margins of 2.25 per cent were observed between the deutschmark and the Dutch guilder. The basic difference, relative to the previously normal fluctuation margin, was the absence of one-way bets on parities. The external discipline provided by the grid no longer obtained and each central bank decided whether or not to intervene within the old fluctuation bands. Most decided to do just that, so that the convergence process was not hurt by the decision to widen the band.

It has been argued that the ERM was intrinsically unstable since fixed exchange rates, independent national monetary policies and free capital movements are inconsistent. After full liberalisation of capital controls, the ERM was in danger of falling into the inconsistent triad, but instead EMS countries chose to give up their own independent monetary policies. The role of the deutschmark as the anchor of the system became undisputed and the maintenance of policies aimed at exchange rate stability, even after the widening of the bands, added to the credibility of the commitment to EMU. In that sense, the widening of the bands was a positive step towards the euro.

Indeed, except for the deutschmark, most of the former national currencies ("legacy") could neither float nor credibly fix without a well-defined institutional framework for yardstick competition such as the ESCB and the 1996 Stability and Growth Pact, designed to supplement the excessive deficit procedure contained in the 1992 EU Treaty. The pound sterling and the Swedish krona follow an inflation targeting monetary rule which allows the exchange rate to float, but in fact the latter has been fairly stable against the euro[21].

III.3. Geography

During the EMS crises, therefore, speculative attacks had less to do with the credibility of national policies and the medium-term resolve of national authorities, than with the reflections of the overall turbulence. It threatened the reputation for financial stability in a small national market, to the extent that national policies become less relevant than the proximity to a turbulent large market.

Examples of this effect of "geographic" rather than "economic" fundamentals on the value of currencies were provided by Portugal and Ireland, which suffered currency attacks based on what was happening to the Spanish and British currencies. The attacks were short-lived but they nevertheless led Ireland to request a realignment in January 1993 and Portugal had partly to follow several realignments of the peseta[22].

One possible reason is that the financial reputation of these countries was not fully established as their regime change was quite recent (1987 for Ireland, 1989 for Spain and 1992 for Portugal). A related reason is that testing the ERM parity made sense when the real appreciation was perceived as excessive by export-oriented firms and the government may have been sensitive to their pressure. The bet proved to be correct for Spain, which initiated two realignments during the ERM turmoil. The Portuguese response was to follow in part, so as to reinforce its own credibility without suffering the direct consequences of a competitive depreciation[23].

The reason why the convergence process was not hurt by the decision to widen the band was that external credibility, while necessary for medium-term policy credibility of any nation state, is never sufficient. This was again apparent in the turbulence in early March 1995, which led Spain to ask for a new realignment in spite of fairly sound fundamentals. The lack of political stability was undermining the confidence in the currency[24].

III.4. Convergence and Cohesion as a Public Good

The ERM was therefore an instrument of convergence towards the single currency, to the extent that it was flanked by other instruments, specified in the Maastricht Treaty and in subsequent resolutions like the Stability Pact. These are essentially a timetable, the specific procedures of multilateral surveillance, the convergence programmes, the excessive deficit procedure. In addition, progress towards independence of national central banks was impressive during stage two of EMU, as was the fact that the public sector can no longer be financed by central banks or by privileged access to financial institutions.

The European Monetary Institute was established at the end of stage one of EMU in order to contribute to the realisation of the conditions necessary for the transition to stage three and the creation of the European Central Bank also proceeded on schedule at the end of stage two of EMU. The fact that stage three was delayed from 1997 until 1999 may actually have helped prevent an excessively fast politicisation of monetary policy. The politicisation would increase the temptation to soften the excessive deficit procedure, raising fears that some governments will expect to be bailed out by the union, in contradiction to Article 104b of the Treaty.

Once again, an effective multilateral surveillance is required, supported by all member states. The effectiveness of multilateral surveillance is decisive for medium-term policy credibility at national and union level. Indeed properly used, all of these instruments and procedures effectively delivered convergence and cohesion.

Non-compliance with this code of conduct played a major role in the development of the currency turmoil, but after 2 August 1993 the EMS regained stability, thanks to the widening of the fluctuation bands, which limited speculative pressure by eliminating one-way bets and reintroducing two-way risks. While the euro remains sensitive to sudden changes in the value of world currencies such as the dollar or the yen, the set of principles, rules and code of conduct which underlies the EMU in stage two proved correct.

In addition, political stability or social consensus and national cohesion were decisive in achieving convergence. Social consensus implies, first and foremost, that social partners and public opinion understand and accept the medium-term stance of economic policy. In particular, trade unions must recognise the perverse interaction between price and wage increases, which hurts the poor and unemployed disproportionately. With the feedback of wages into prices in operation, price stability will not be durable without wage moderation. The social acceptance of these norms can be turned into a factor of national cohesion if the government takes the leadership in wage negotiations for the public sector employees.

A single market with a single currency reflects a particular combination of private and public goods, determined by the mobility of the tax base and the availability of inter-regional or inter-national transfers. Article B of the Treaty refers to “the strengthening of economic and social cohesion” as instruments of “economic and social progress which is balanced and sustainable”. Therefore, some income redistribution among nation states is supposed to correct the economic geography that market integration brought about.

There is a recurrent European debate about whether multiple-speed convergence towards union objectives is possible and desirable. It is probably inevitable in the case of a single currency as divergences existed among the 15 EU members, and are not likely to disappear. Since it turns out that all member states have met the entry criteria for EMU (independently of the willingness to join for Denmark, Sweden and the United Kingdom), the case for flexible integration has been strengthened by the euro[25].

The hierarchy of financial markets is linked to the geography of the single European currency. Where local financial monopolies exist, differences between interest rates at the core and at the periphery may endure, even in the presence of full currency convertibility and perfect capital mobility among core markets. Belonging to the convertibility and stability club is nevertheless useful to the extent it signals to market participants that the country is keen on achieving external credibility without relying only on instruments it could control — and might therefore manipulate.

In this sense therefore a converging country is also attempting to buy domestic credibility for its efforts. This is the only way in which the national authorities could escape the adverse selection bias from which new participants in the international capital market have been shown to suffer. The notion of medium term policy credibility emerges as essential in the evaluation of how the regime in the Treaty combines convergence and cohesion. This credibility hinges on the functioning of the EMS and on the institutional framework of EMU. To the extent that they allow for yardstick competition, the euro becomes a public good[26].

Traditionally, system stability has been provided by the largest national economy. The provision of the international public good is made in ways that are often determined by national traditions and institutions. The role of treasuries and central banks from America, Britain, Germany and Japan have a lot to do with some of the features of the IMF[27]. The provision of the international public good is also in the national interest, which in this case is often represented by institutions sensitive to the needs of the taxpayer and therefore

more prone to understand and fight against the incentive of each one of the member countries to free ride. In the “Eurocentric” perspective, there is no dominant player, so that procedures relying on peer pressure, or yardstick competition, had to be devised and implemented.

The incentive to free ride on the public good is indeed greater for the small countries but without a decision to join which can be domestically supported, the benefits of convertibility and stability are also less apparent.

The public good element of the European single currency cannot be achieved against market sentiment, but policy credibility can overcome hierarchy. Any solution not based on the national cohesion of the member states would be unstable. No member state is likely to remain in a slower speed of convergence against its national interest, expressed by majority vote. National and union cohesion thus became requirements for the competitiveness of European business worldwide.

In other words, the euro is largely an enabling reform that requires additional structural adjustment. If carried out by the EU states, structural reforms would not only enhance the potential of the euro as a world currency but also the competitiveness of European firms. This is another way of saying that the institutional framework allows for yardstick competition.

IV. FINANCIAL CRISES IN EMERGING MARKETS

IV.1. Chronology

As more and more currencies became fully convertible into each other during the second half of the 1990s, financial interdependence was no longer confined to a few mature democracies. Across the global economy, national financial policies came under increased scrutiny from international investors and rating agencies. Interest rate spreads of emerging markets over established borrowers fell. But there were also sudden reversals in investor sentiment, which led to massive capital outflows and dramatically increased these same spreads.

The role of "news" in generating sudden changes in beliefs is such that crises can hardly be forecast: the success rate at predicting them is less than one third (25-30 per cent). The reason is that two types of errors must be balanced against each other: not to predict crises that do occur and to predict crises that do not occur. Detecting vulnerability is very different from predicting the timing of a crisis.

This is why perceptions on the part of investors and opinion makers matter so much. Depending on the perception, a crisis can become self-fulfilling instead of being countered by effective management. Information about future market perceptions can help national and international policy makers develop and implement appropriate responses, that is to say responses which re-establish confidence. But better information alone does not succeed in predicting, let alone in preventing, financial crises.

Shortly after the EMS crisis was overcome, the attack on the Mexican peso in December 1994 had ripple effects in 1995 in both South America and Central Europe. A plausible explanation of the "tequila" crisis, insufficient savings, was readily found. There were no significant contagion effects and soon international investors were accepting larger emerging market debts[28]. That is until the third and most serious wave began.

It lasted two years, ended shortly after the launch of the euro and led to calls for a reform of the international financial architecture, which would make it more resilient to crises. This is also why the architecture advocated in the next section applies the ERM code of conduct to groups of emerging markets willing and able to follow it. Before dealing with architecture, a brief chronology of the third wave of crises helps focus on the problems of emerging markets and the contrast with the EMS crises described above.

The successive crises in emerging markets began in spring 1997 when a minor attack on the Czech koruna resulted in its devaluation. However, the Thai baht floated in the summer of 1997, reversing an implicit dollar peg which had been pervasive in the fast growing economies of the ASEAN, and Malaysia, Indonesia and Philippines also experienced attacks on their currencies.

Currency and banking crises spread to other Asian economies in the autumn of 1997, appearing to threaten the role of Hong Kong as a financial centre ruled by, but separate from, China. The Republic of Korea, like the Czech Republic a recent member of the OECD, suffered a combined currency, banking and debt crisis. Japan, a mature democracy and a prominent member of the G-7, was seen as part of the problem. Only China, whose transition to market and to democracy had yet to begin, was seen as capable of keeping financial stability in the region.

The prevailing perception was of an emerging markets crisis which hurt the borrowing capacity of Asian, Latin American and Central European debtors. The continued weakness of the Japanese currency exacerbated the negative impact of the financial turmoil on Asian growth throughout the spring of 1998. South Africa followed while Russia floated the rouble and defaulted on its domestic debt in late August. Brazil succeeded in keeping its dollar peg in spite of several attacks in September, on the eve of a crucial presidential election.

Long Term Capital Management, a hedge fund which bet aggressively on declining spreads for emerging markets and which was thought to be "too smart to fail" had to be rescued from bankruptcy by some of its clients, the major global players. The operation, arranged by the New York Fed, was followed by the lowering of interest rates in the United States in September, on the eve of the meetings of the IMF and the World Bank. Both measures suggested that the emerging markets crisis had spread to the North Atlantic and was hurting growth prospects in the EU and the United States. There were also threats of further contagion to Latin America, let alone to Hong Kong and China. Brazil did devalue the real in January 1999, but the rapid adaptation to a more flexible regime and reforms on the fiscal front improved the financial situation. Accordingly, the fear that the emerging markets crises would become global subsided.

One specific lesson from the Brazilian crisis is the need to involve the private sector in a solution, as the IMF cannot make private portfolio decisions for banks. The attempts of the Brazilian government to keep banks rolling over their credits were successful, as creditors realise the importance of not moving when others stay in.

These developments and the continued strength of the US economy, moved the spring meetings of the IMF and the World Bank to signal the end of the emerging markets crises. World growth prospects in 1999 were subdued largely because of the lasting negative effects of the previous two years of financial turbulence spreading from the Pacific to the Atlantic, but once again the US economy showed resilience and global prospects remain very positive.

IV.2. Causes and Responses

IV.2.1. Definitions and Caveats

The notion of emerging market hides a lot of different national and regional circumstances. If the notion of emerging market encompasses too many varieties, that of financial crisis is often misused. The term applies best to a combination of currency, banking and sovereign debt crisis with strong negative effect on the national economy.

The definitions of emerging markets and financial crisis help understand that the appropriate level of policy response may no longer be national, but instead become regional or global, depending both on contagion mechanism and on the availability of instruments and institutions.

IV.2.2. Fundamentals vs. Financial Panic

The main source of debate hinges on the role given to fundamentals vs. financial panic. Both are probably at work, so interpretations often depend on a balancing of each factor. If structural problems and policy inconsistencies make it inevitable that a combination of currency, banking and debt crises will lead to a financial crisis with severe real

consequences for the national economy, then the root causes must be addressed, at the risk of encouraging moral hazard behaviour[29]. Crises are cumulative processes, which have a self-fulfilling character, therefore their costs end up being much greater than called for by the fundamentals. Then prevention efforts make sense almost always.

IV.2.3. List of Causes

One way to solve the debate between the two camps is to look for areas of agreement in what are causes of a financial crisis. The list of favourite causes still leaves a great deal of room for interpretation but it helps focus on the disagreement[30]. That bad shocks and policy mistakes make things worse is uncontroversial but the practical question is rather how the severity and duration of the bad shock and the irreversibility of the policy mistake make a difference to the perception of crisis. The attack on the Czech koruna, for example, was short-lived because devaluation was coupled with a temporary import deposit and measures to deal with the fragility of some of the financial institutions[31].

There is again consensus on the statement that large and free foreign exchange reserves, and/or a flexible exchange regime reduce the probability of a crisis. Yet it may not be possible to agree on what finite level of free foreign exchange reserves and exchange rate flexibility averts a crisis. The existence of an international lender of last resort would help if it does not exacerbate moral hazard. For fundamentalists this is a bigger “if” than for those who hold that crises are self-fulfilling. Of course, both sides agree that a crisis always has a combination of causes.

On the economic doctrine, keynesianism seems to have made a comeback. The view that fiscal contraction may turn out to be expansionary due to strong positive confidence effects, is no longer held[32].

IV.2.4. Anatomy of Crises

A financial crisis comes in many forms — because it combines a currency collapse, with or without resort to exchange controls, a bank run or the threat thereof and a debt default or moratorium. Its anatomy often includes the expected bailout of private debts by the state, or by international institutions. Such expectations are easier to form in the presence of cronyism and with weak corporate governance[33].

Even in countries with high savings ratios, investment booms brought about by expected bailouts generate large current account deficits and real appreciation. If these deficits are financed by short term foreign currency unhedged liabilities and by the ever greening of bad loans, it is tantamount to making private debt into an implicit public debt.

IV.2.5. Indicators

When crises loom, there is a great deal of interest in advance warning systems. Nevertheless there has been little progress in developing practical crisis indicators. Foreign exchange reserves, for example, are still compared to imports with reference to the so-called “3-month IMF rule”, without taking into account the exchange rate regime. A better candidate for normalisation, especially for inconvertible currencies, would be external debt. Under a fixed rate and free capital mobility, reserves should instead be compared to the broad money stock (M2). While reserve adequacy depends on the exchange rate regime, none of these average measures is satisfactory under uncertainty. Reserves should ideally be related to the volatility of the current account or of short term capital flows.

A high ratio of bad loans to total loans is another indicator which has been used in looking for evidence of a lending boom. The increase in real lending to private sector and state owned enterprises is in turn how a lending boom is identified. The usual criterion for internal balance, namely a sustainable fiscal position, was absent in the Asian economies but it remains a serious problem in transition economies and especially in the Russian crisis[34].

Real appreciation in terms of effective rates is another early warning indicator. There again, care must be taken to net out the equilibrium component of real appreciation which has accompanied any successful development experience.

IV.2.6. Financial Fragility

Financial fragility is seen as decisive in the combination of currency, banking and debt crisis. In that context, the maturity of capital inflows matters more than their size, because financial fragility comes from failures in the maturity transformation of short-term assets into the long-term liabilities banks are suppose to provide.

Another uncontroversial point is that financial liberalisation and banking deregulation require improved prudential supervision, the question being how to achieve this supervision in global markets. In particular, does this require a new institution? Instead, can the BIS and the IMF substitute for the role of an international lender of last resort?[35]

The converse of the previous (uncontroversial) point is that capital account liberalisation without improved banking supervision is also found in most crises. Over-investment is the mechanism through which the combination of financial liberalisation and banking deregulation results in banking and currency crises.

IV.2.7. Responses

Once a crisis erupts, it is difficult to take action. Indeed, if the IMF goes public about an impending crisis, it becomes even more difficult to act. Despite the advantages of multilateralism, moreover, bilateral action can still help a lot. In the cases of Russia and Ukraine, for example, if the IMF helps, it is bad; if the IMF does not help, it is also bad! Then political reasons could dictate bilateral help not constrained by the charter of the IMF. Even if action is taken on time, results from action may be modest relative to expectations, feeding into the perceptions of recurrent crises. These thoughts are sobering and they caution against plans for global governance.

National policy responses to a large capital outflow may be a combination of allowing reserves to drop, increasing interest rates, and depreciating the currency. These responses include several different measures, with different effects. In particular, depreciation may be achieved through controls, which lead to multiple exchange rates, one or several of which may remain unchanged at the pre-response level. Moreover, they tend to be combined and the relative importance of each one depends on the particular circumstances of each country. Perhaps outright depreciation is ruled out by an exchange-rate arrangement, as in a currency board. Or it may appear to be very costly in terms of financial reputation, as was the case in Mexico and Korea, which had just joined the OECD[36].

There may be constraints on the rise in interest rates that is politically or socially viable, and increased interest rates are more costly, the weaker the banking system. Allowing reserves to drop, on the other hand, is less likely, the lower the ratio of reserves to liquid liabilities. If reserves are low, and cannot drop further, one of the other options, no matter how unpalatable, must be contemplated.

The exchange-rate option will be more likely to be chosen the greater the real appreciation observed, but devaluation is a beggar-thy-neighbour policy to the extent that it attempts to restore competitiveness at the expense of trading partners and may elicit retaliation. It therefore needs to be co-ordinated.

As in the case of the exchange rate regime, exchange controls need to be co-ordinated: they involve almost always a devaluation in disguise. Even when they seek to prevent excessive inflows, they are often not matched by free outflows, or even by a relaxation of existing controls. This was true in Portugal in the early 1990s but can also be found in the Chilean experience, where the decision to relax its controls on inflows has been especially controversial since these controls were seen as very effective[37]. Exchange controls were also reinstated in Malaysia in 1998/99, but their contribution to recovery is likely to have been minor.

V. INTERNATIONAL FINANCIAL ARCHITECTURE

V.1. The Exchange Rate Regime

The chronology of crises presented above suggests that during 1997-99 few opportunities for testing the credibility of exchange rate parities were missed by market operators. This made the exchange rate regime as crucial a determinant of macroeconomic stability as fiscal, debt management and banking policy. The market tests of the credibility of exchange rate parities were often successful in triggering a currency devaluation, so there seemed to be fewer and fewer alternatives to a hard peg, or even a single currency[38]. This perception rationalised direct policy responses such as exchange controls, perhaps along the lines of the so-called Tobin tax on short-term capital movements[39].

The widespread mobility of financial capital has reduced the attractiveness of exchange rates as policy instruments, thereby lowering the costs of a fully credible peg.

It turns out, however, that floating is not necessarily a viable alternative for many of the world's small open economies, unless they chose to keep the currency fully inconvertible and thereby withdraw from globalisation. In this regard, there seems to be less scope for adjustable pegs and independent floating. As described in section III, you may need to float in order to fix. Another way of saying this, due to Jeffrey Frankel and Andrew Rose (1996), is that optimum currency areas are endogenous.

With global financial markets, exchange rate systems involving fixed but adjustable rates or crawling pegs are crisis prone. If South Africa, Turkey or Mexico had some kind of a peg, there would have been more severe crises there. Otherwise, an extreme commitment is called for, like the Hong Kong or Argentine peg to the dollar. In other words, emerging markets should float or peg hard[40].

Floating alone is no good solution as there have been wild swings in bilateral rates such as dollar-yen. The lesson of widening the ERM bands shows that multilateral surveillance beyond exchange rates is needed[41]. It is of course by allowing responses that would not obtain in calm periods that financial crises serve as co-ordinating devices. In effect, co-ordinated systems like the one implied by the ERM code of conduct are difficult to adapt to a world system without shared values, even when they refer to what is essentially a *shared* variable, the exchange rate.

The exchange rate regime is just one instance of needed improvements in financial architecture. Nevertheless, it plays a central role in the debate on the reform of the system of international relations and its main institutions, which for the most part were established in the aftermath of World War II. This is a caveat to the application of "Eurocentric" mechanisms on a broader scale: they presume that the exchange regime is well defined.

V.2. Surveillance Mechanisms: Global vs. Regional?

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

a role, with some evidence pointing to the role of trade and to listings of country potentials that owe more to marketing than to fundamentals. Reuven Glick and Andrew Rose (1998) have a trade explanation which might account for the “geographic fundamentals” described in subsection III.3. above. Another hypothesis might be hegemony, in the sense of “winner takes all”. For example, in the competition among potential locations for international investment, the result may be that some markets are crowded and others deserted[42].

Both geography and hegemony are at work when it comes to the economic policy autonomy of Hong Kong, relative to China during the attacks on the currency board. The fragility of the Asian recovery in 2000 also involves both geography and hegemony, to the extent that the recovery in Japan also remains fragile.

The turmoil in Russia in the summer of 1998 had a strong domestic component which threatened to reverse the transition process. In spite of recent improvements in the credibility of policy (and in Russia’s participation as an equal in the G-7 discussions), the sequels of a debt moratorium and of currency inconvertibility, let alone a bank run, remain economically and politically hazardous.

Given the importance of contagion, useful inputs into crisis management come from investigating its regional patterns. Emphasis was given to the European exposure to multilateral surveillance mechanisms. This is not to say that peer pressure mechanisms are absent from international financial institutions. It simply reflects the widely acknowledged fact that there are often four or more European voices in the face of the United States and Japan. That being said, geography is sometimes cast in a trilateral fashion, which rather suggests an architecture based on three hegemonic blocs.

The informal apportionment of responses to financial crises emerging markets to the major mature democracy in the same continent suggests a pattern of contagion reminiscent of “the Monroe doctrine” and probably inadequate in today’s global markets. There have been proposals to revive regional arrangements along the same lines, so as to facilitate a new financial architecture[43]. Effects in Brazil, or in Latin America, are already seen as primarily calling for a US response. Instead, given Russia’s status as former hegemon in Europe and parts of Asia, perceptions of crisis elicit stronger responses by the United States and by the EU. Central Europe is seen as a European problem but the Balkans war was of course led by NATO, rather than the EU or the UN[44].

Over the last decades, the financial discussions of the G-7 have remained the crucial conduit for US influence on European and Japanese policy formulations, quite aside from the OECD peer reviews. Moreover, the IMF has a well established role in backing these financial deliberations[45].

V.3. Crises as Co-ordination Devices

The financial crises caused hardship in individual countries but they also served as co-ordination devices and therefore did not threaten globalisation. The cases of withdrawal from world financial markets, most notably Malaysia, were isolated and temporary. In spring 1998, Chile lowered its barriers to short term capital inflows (a tax called *encaje*) so as to revive the domestic stock market, and set the tax rate to zero in the autumn. Even a country endowed with a relatively well functioning administration found it difficult to keep an exchange control geared to a long-term objective when the environment became turbulent.

The long-term objective in Chile was an improvement in the composition of capital inflows towards long-term instruments and especially foreign direct investment relative to short-term flows which were considered more volatile. In any event, the rationale for the *encaje* was clear during the boom of the mid-1990s but it ceased to apply afterwards, reinforcing the idea that such measures work temporarily, and only if they are introduced in good times.

The output declines in several countries hit by financial crises were a definite cost against which some of the positive sides can be evaluated. In particular, improvements in banking supervision and even in corporate governance might not have occurred without a crisis. Nevertheless, there are many reforms in that area remaining to be done, and not only in emerging markets but in the OECD area as well.

The reflection of regional co-operation arrangements such as the EU is one of the issues in the debate where the geographic/hegemonic pattern of contagion matters. The role of Japan acquires special salience because it was seen as the major player in Southeast Asia, where the current crisis originated.

Grandiose reforms of the international system have been resisted by the G-7 and by its members in the EU but concrete steps have been taken because markets' resistance to change is lower in times of crisis[46]. Both the Financial Stability Forum, created by the G-7 and currently chaired by the BIS, and the G-20 (including large emerging markets) examine closely the market behaviour of highly leveraged institutions, offshore centres and short-term capital flows[47].

These various entities have made recommendations on how to improve capital-flow statistics and prudential standards in both lending and borrowing countries aimed at stabilising financial markets. In parallel, progress in risk management techniques is required, as many global players have not yet exploited the potential of their own auditing services[48]. If this is true of global players, central banks and regulators might be even less prepared to carry out let alone being prepared to carry out mandatory *value at risk* reviews as called for by the Basel committee of the BIS[49].

Following widespread agreement between academics and market organisations such as the group of thirty that some improvements in orderly workouts were desirable and easy to achieve, the IMF has been authorised to lend in arrears[50]. Nevertheless, the traditional difference remains between national action on private debt and international action on sovereign debt. In the absence of international enforcement, the "pre-nuptial agreement problem" makes these improvements less likely to be accepted outside of a broader set of changes in the international system. An IMF Contingent Credit Facility for pre-defined liquidity support has also been implemented and the debt reduction by private creditors that the Paris Club requires to grant public concessions on debt principal and debt service payments has been broadened.

In short, the crises allowed bank restructuring to take place on a much broader scale than otherwise and debt structures are now in better shape than if countries had postponed reforms. As a consequence, there may be a lesson about exchange controls that echoes the one on the escalation of tariff to non-tariff barriers during the inter-war period.

Liberalisation and globalisation must be better managed to prevent protectionist pressures from taking over. Managing the emerging markets crisis means therefore avoiding a relapse of protectionism while fostering reform in the international system to allow for a more effective regional and global response to threats of contagion of national crises.

VI. CONCLUSION

Can devaluations and exchange controls be co-ordinated at the regional or global level, to lessen their beggar-thy-neighbour character? Probably not without co-ordination mechanisms among monetary and fiscal authorities like the ones found in the EU. How precisely the mechanisms may apply to CEFTA, ASEAN or Mercosul remains to be thoroughly investigated. The claim of this paper was that there does not seem to be a better perspective than the one defended here.

Over and above the parallels between the 1997-99 emerging markets crisis and the Mexican devaluation of December 1994, the lessons from the crises in the ERM may thus be helpful in designing a new international financial architecture. In effect, the crises were overcome by the ERM code of conduct. With the experience gathered during the first year of the euro, a new code of conduct may be developing, which acknowledges the importance of international banking supervision, including better risk management along the lines proposed by the BIS. Avoiding contagion by reverting into trade and financial protectionism could well prove as ultimately futile a beggar-thy-neighbour policy now as it was in the early 1930s.

A significant amount of tax resources has been devoted to crisis resolution, not just through higher transfers to the international financial institutions, but also through loan-loss reserves by banks which lower their taxable profits. Bailing in the private sector into higher burden sharing is thus hoped to reduce the degree of moral hazard in global financial markets implied by public bailouts. On the other hand, the modifications to the international financial architecture might restrain private flows to the emerging markets, hence making these flows less liquid and more volatile.

The potential costs, stability and magnitude of private capital flows to developing countries are an important criterion to assess current proposals to reform the functioning of the international financial system. In this regard, there have been proposals for regional fora, which could help the IMF improve its performance when exchange rate and banking issues are difficult to disentangle, as is more and more frequently the case. While this is certainly true, institutions of global governance have been essential in preventing the 1997/99 financial crises in emerging markets from becoming a 1930s style global depression and they continue to be needed in the future.

Suspicions about “fortress Europe”, even limited to the continental EU, are no longer so fashionable. This is why the role of the IMF, but also of OECD and BIS, become essential to the usefulness of a “Eurocentric” architecture based on peer pressure.

Systems like the ERM relied on shared economic and societal values. They may be difficult to adapt to the variety of emerging markets in the current world system, but they are certainly required when regional arrangements are spreading from trade to investment, as is the case, for different reasons, with CEFTA, ASEAN and Mercosul.

NOTES

1. The expression in the subtitle was first used during a panel on *Are We in a Global Economic Crisis?* held at a Yale Economics Reunion, 17 April 1999 during which I evoked the memory of my former teacher Robert Triffin. The material was also presented at panels on *Multilateral Surveillance* (meeting of the Portuguese presidency of the Ecofin on 6 May 2000 at *Centro Cultural de Belém*), on *European Identity and Development* (meeting of Development Ministers held by the Portuguese and French EU presidencies on 30 June 1999, at *Centre de Conférences Internationales*) and on *The Future of Mercosur* (meeting at the Central Bank of Argentina, Buenos Aires, on 24 August 2000). Guillermo Calvo was present in the first and last panels. I am grateful to him and to other participants for comments, but the views expressed remain personal.
2. In spite of a similar emphasis on co-operation, Smith and Naím (2000) only mention the European experience in their opening paragraph: “Jacques Delors looked dumbfounded ... when he was invited to identify Quebec's separatists with the progress of history” and they go on to speak of “the turbulence of a world tensed between globalism and localism”. I leave the word “Eurocentric” in quotation marks (with thanks to Colm Foy for the suggestion to drop it entirely) because the wider applicability of the European experiences hinges on the “centre” in Europe not being a nation-state, but rather a community thereof, as argued in the text.
3. Last April, Argentina and Brazil “set a timetable for ... a set of economic convergence targets similar to those ... that led to the euro” Economist (2000). This is an example of the flexible integration mentioned below in note 25.
4. This is the language used in the communiqué of the meeting of ministers of finance and central bank governors held in Buenos Aires, kindly provided to me by Alexandre Tombini of the Brazilian Central Bank, which then lists 12 points. It stresses the role of macroeconomic co-ordination to attain fiscal discipline and financial integration. In point 11, a macroeconomic monitoring group (GMM) is established to evaluate progress. Eichengreen (1998, page 24, note 27), referred to unpublished work at the Brazilian Development Bank (BNDES) suggesting a co-ordinated convergence of macroeconomic policies in Mercosul. Goldstein (1998) concludes that “contrary to the recent experience of Europe, regional integration *per se* cannot constitute an incentive to macroeconomic prowess, since there are no virtuous criteria to which Mercosur countries are obliged to converge” (p. 377). See also Goldstein (2000).
5. The ERM code of conduct is described in Macedo and Carré (1994). The analysis is updated in section III.
6. In drawing up the *Users' Guide* of the OECD Development Centre, the author emphasised the role of the G-20. See section V.2. in the text, note 47 below and www.oecd.org/dev.
7. Section IV adapts Macedo (1999).
8. The empirical basis for this claim is discussed in Macedo (2000), where the relevant literature is cited. The conjecture that better policies be emulated across sovereign jurisdictions is central to the “Eurocentric” perspective. I am grateful to Tim Besley for making me aware of the concept of “yardstick competition” discussed in section II.
9. One obvious available benchmark is a state-owned firm engaged in the same line of business as the regulated firm. Unfortunately, state-run utilities are often too different from private firms to serve as useful benchmarks, and they are not necessarily efficient.
10. Medicare´s prospective reimbursement system compensates hospitals on the basis of average costs incurred by comparable hospitals in treating patients in the same diagnostically related group. Shleifer (1985) also cites some US Defense Department contracts and relevant literature.
11. The effects of foreign savings on growth have been disputed. New evidence on a positive link is contained in Reisen and Soto (2000).
12. The expression is contained in the OECD Development Centre programme of work for 2001-2002. See note 6 above.

13. Russia has been participating in some G-7 deliberations for almost ten years and after the July 2000 summit in Okinawa, seems close to becoming a full 8th member. Given that the Russian territory spans Europe and Asia, such G-8 enlargement is especially interesting for the perspective taken in the text.

14. Indeed, it has done so in ways that include bridges towards the former Soviet bloc, Africa and Latin America. Each of these bridges is of interest for the "Eurocentric" perspective, to the point that the expression itself may become inadequate. There should, of course, be no implication of imperialism stemming from this word. I am indebted to colleagues at the OECD Development Centre for bringing up the possible negative reaction of some groups to the word. As implied by note 1 above, though, neither the Centre nor its member states are taking institutional positions on this matter.

15. The absence of a EU military capability outside NATO suggests that the "Eurocentric" perspective would have a different domain in times of war but this other domain would certainly be compatible with flexible integration as discussed in Macedo (2000).

16. This would be the equivalent of a collusive equilibrium in the regulatory mechanism outlined above. Similarly in the tax setting model, there is no presumption about the welfare effects of government expenditure (level and composition), even though evidence that state spending may respond to spending decisions in neighbouring states is quoted in Besley and Case (1995).

17. The argument is made and the literature is reviewed in Macedo (2000).

18. Some claim that the tension between the two sister institutions (with staff about 10 000 at the World Bank and 2 700 at the IMF) actually helps. In spite of the Meltzer report, it looks as though the IMF is here to stay, unmerged.

19. As mentioned below in the text, the convergence rules are made explicit in criteria referring to certain nominal and fiscal variables aside from observing the rules of the ERM.

20. Greece joined the ERM in spring 1998, Austria joined with accession in 1995 and Finland in October 1996. They are now all part of the Eurozone. As mentioned in the text, even Sweden which, unlike the UK and Denmark, does not have an opt-out clause, shadowed the ERM before the 1991 banking crisis.

21. Calvo (2000) discusses the similarities between hard pegs and inflation targeting in emerging markets. The question of credibility is different in EMS members because they are more used to peer pressure mechanisms as mentioned in section II above. The argument in the text that you have to float in order to fix ("you have to be cruel to be kind", as the song goes) also reflects the credibility of co-ordination. For example, how credible is the decision by the equivalent of EcoFin in the Mercosul (plus Bolivia and Chile) to set targets for macroeconomic convergence?

22. As Finance Minister of Portugal responsible for the escudo's entry into the ERM in April 1992, I followed this crisis and the responses that were found by the Ecofin. The tests about how the escudo fared under the attacks is discussed in Macedo, Nunes and Covas (1999) confirm that financial reputation was achieved in 1993 with the rating upgrade. Lessons for transition can be found in Macedo (2000).

23. The account by *Diario de Notícias* of 26 May 1994 is worth quoting: "The forex and capital markets were in crisis yesterday after rumours, originating abroad, of a coup d'état in Portugal. At the end of the day, the market operators laughed about the rumours. But, earlier in the day, the Bank of Portugal had to intervene to protect the escudo....The rumours seemed to have arisen from the interpretation of a story published by the US based news agency Bloomberg about the resignation of the Director General of SIS *Serviço de Informações e Segurança* (Information and Security Services) on Monday...The rumours first reached Lisbon daily *Diario de Noticias* when stock market operators telephoned the paper in panic asking about the political and financial scandal they believed was breaking in Portugal. They had heard that SIS was to announce the results of its phone tapping, revealing a major scandal. They also said the escudo was going to leave the ERM and that the EU monetary committee had already set up a meeting. The rumour also said a bank was going bankrupt, the Governor of the central bank was to resign and the treasury and central bank had contradictory interest rates. The rumours were far fetched but affected the market." One month later, a major reshuffle of the central bank board due to the sequels of the Totta-Banesto case did involve the Governor. Further references in Macedo *et al.* (1999).

24. This is, of course, another manifestation of policy credibility at the level of democratic governance, social cohesion or both.

25. See references on flexible integration in Macedo (2000).

26. The same argument is made with respect to the gold standard in Macedo, Eichengreen and Reis (1996).

27. This is another reason why the EU procedures may provide a model for the global surveillance performed by the IMF.

28. No effect on Portugal could be detected in a regime-switching model of weekly changes in the escudo-deutschmark rate from 1987 to 1998, as documented in Macedo, Nunes and Covas (1999). See, however, note 23 above.

29. Eichengreen and Hausmann (1999) and Goldstein (1999).

30. The distinction between areas of agreement and disagreement is taken up in Ocampo (1999).

31. Drabek and Brada 1998 claim that the Czech peg lasted too long and led to an unstable trade policy. They also point out that before the crisis most economists viewed the currency experience favourably. Another cost of this policy was that capital account liberalisation was conducted to alleviate exchange rate pressure even when it aggravated problems of corporate governance. This pattern is reminiscent of the relaxation of the import deposits in Chile in 1998.

32. The two cases that are often mentioned (Denmark in 1982 and Ireland in 1987) involved successful changes in economic regime which introduced a stability culture. The latter was mentioned in subsection III.3. above.

33. This is another example of the need to combine G&G, emphasised above in the text. See also Macedo (2000).

34. Criteria for policy sustainability in the context of transition economies are described in Branson *et al.* (1998).

35. Calvo (2000) discusses the limitations of the lender of last resort function in emerging markets.

36. The same could be said for Russia, which was increasingly being accepted into the G-7. See note 13 above.

37. See Reisen (1999) and Macedo *et al.* (1999) respectively.

38. Calvo (2000) and references therein argue that pure floating seems beyond most emerging markets.

39. Bartolini and Drazen (1997) stress the credibility effect of capital account liberalisation. See also Dornbusch (1998*a*). A more cautious stance can be found in Eichengreen (1999).

40. See the previous note. The conclusions of the ABCDE panel on exchange rate regimes in developing countries qualify this dichotomy by emphasising the role of institution building and multilateral surveillance, which are crucial in emerging markets. This is, of course, the characteristic of the "Eurocentric" perspective described in section II above. The various positions can be found in the OECD Development Centre Newsletter (available on the website): Guillermo Calvo presented the case for a hard peg based on the effective dollarisation in much of Latin America and on the inflationary and limited role of the lender of last resort in floating currency regimes. Brigitte Granville collected evidence from transition economies in Eastern Europe and the Commonwealth of Independent States, to confirm that no exchange-rate regime was right for all countries at all times. Daniel Cohen stressed the importance of actual convertibility in hard peg regimes and argued that the devaluation of the CFA franc had not hurt the African countries participating, on the contrary. He concluded that the choice of the anchor currency was an essential determinant for the performance of monetary unions in developing countries. Helmut Reisen explored the alternatives for the financially integrated emerging markets, calling for flexibility in the underlying regulatory and institutional framework. Participants brought other experiences to the debate, from the Balkans to Pakistan.

41. The launch of the euro also underscores that with global financial markets there must be fewer currencies. This has also helped dollarisation in Mexico and Argentina to become a media issue.

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

43. This is especially visible in Ocampo (1999). See also Griffith-Jones and Ocampo (1999) and Kaul *et al.*, (1999).

44. See note 15 above.

45. The internal governance of the IMF implies that all actions are supported by shareholders. There are 182 members countries and 24 members of board. The eight largest countries have their own director (US=17½ per cent), and the G-7 has a share of 85 per cent.

46. The list presented in Hausmann and Hiemenz (2000) includes global codes of conduct, such as the Basle Core Principles for Bank Supervision, the IMF Data Dissemination Standards and the OECD Principles of Corporate Governance. They are attempts to increase transparency so that the misevaluation of assets due to misinformation can be kept to a minimum.

47. The members are South Africa, Saudi Arabia, Argentina, Australia, Brazil, China, Korea, India, Indonesia, Mexico, Russia, Turkey. There are eight members of OECD (or of its Development Centre), Russia (G-8), three Asian giants and powers from Africa and the Gulf. The G-20 met for the first time at ministerial level at end 1999 in Berlin. The managing director of the IMF and the president of the World Bank participate fully in the sessions. See note 3 above.

48. The financial press states for example that only Chase Manhattan Bank took notice of the results of the stress tests carried out in connection with the August 1998 Russian crisis.

49. Dornbusch (1998*b*) suggests mandatory value at risk reviews as called for by the Basel committee of the BIS. See also Blejer and Schumacher (1998) and Braz (2000). While developments in the technology may allow this, the concepts are still foreign to many financial institutions and the methods are not without dangers, as described in Reisen (2000).

50. See Goldstein (1999) and Eichengreen (1999).

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