

**SCOTLAND AND EUROPEAN MONETARY UNION:
CONSTRAINTS ON POLICY DISCRETION IN A
GLOBALISED ECONOMY**

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1. INTRODUCTION

In this paper we consider the implications of membership within a monetary union for local economic policies. We start from the position that specific economic policy instruments increasingly are unavailable to policy-makers as a consequence of a process of 'globalisation'. Here we define globalisation as the tendency for national economies to become increasingly integrated through the dismantling of the barriers to the movement of goods, services, capital and persons – what in EU parlance tends to be described as the 'four freedoms', or the progressive integration of product and factor markets. In that sense, European monetary union (EMU) has been rationalised as a further step towards the creation of a truly single market in that exchange rate movements constituted an obstacle to the four freedoms – especially with regard to trade in (financial) services and the readiness for capital mobility to reflect genuine market opportunities. At the same time, the shift to a monetary union between 12 of the 15 EU member states carried with it significant implications for the conduct of national fiscal policy and this resulted in the Stability and Growth Pact (SGP) being established. The consequence of EMU and the SGP is that national economic policy-makers have either wholly or partially lost independent autonomy (sovereignty) over the two levers of macroeconomic policy. Here we consider the underlying dynamics of the resulting situation, and consider how national and sub-national governments most appropriately might respond to these

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developments. The relevance of this work to Scotland's probable future as a region participating in the euro-zone (either as a part of the UK or independent from the UK) is, we would argue, readily apparent. The principal focus of this paper is to assess how best local economic policy activism might make good the economic policy shortfall that will accompany this transition.

2. THE MONETARY UNION QUESTION

Participation in a currency union has significant economic implications both for national and for sub-national (regional) economies. Typically, these are assessed using the standard tools of optimal currency area theory (Mundell 1961; McKinnon 1963; Kenen 1969). The literature on the UK position with respect to EMU reflects this – for instance, see the recently published UK Treasury report on the five tests. Typically the analysis concerning UK participation in EMU begins from the perspective of optimal currency area theory with a view to assessing the 'goodness-of-fit' between the UK economy and the euro-zone as a whole and the extent to which the one-size-fits-all euro-zone monetary policy is 'right' for the UK. However, this test alone is a necessary but not sufficient condition for membership of EMU. Additionally, policy-makers are interested in domestic adjustment problems which might arise should an external economic disturbance 'shock' the currency union in an uneven – or asymmetric – manner. In that event, the 'shocked' country is unlikely to be able to persuade the central bank to adjust monetary policy to assist domestic policy-makers restore local equilibrium conditions. This is, of course, precisely the type of problem that regions (such as Scotland) presently face as discrete economic entities susceptible to local economic disturbances within extant national monetary unions. However, in that scenario, national authorities respond (or at least have the potential to respond) to local shocks through both automatic and discretionary fiscal policy transfers.

As is well known, a potentially problematic feature of the current arrangements of EMU is that both types of fiscal transfer (structural funds notwithstanding) at the level of the EU are virtually non-existent, and most probably will remain so, with the result that adjustment to asymmetric economic shocks will be the responsibility of national authorities (assuming no monetary policy response on the part of the European Central Bank

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(ECB)). Moreover, national authorities are constrained in the extent to which they can assist domestic adjustment through fiscal transfers where this produces a situation in which the resulting budget deficit threatens to breach the 3%-of-GDP ceiling imposed by the SGP. In that event, attention is switched to the degree of 'flexibility' of the economy as the principal mechanism for restoring domestic equilibrium in the face of an asymmetric shock. Flexibility in this context principally refers to labour market flexibility and, given the relative international immobility of labour (at least in the short-term), the policy instruments involve a combination of wage flexibility and occupational mobility. And as the latter realistically is available only over the medium-to-long term, the burden of adjustment can be expected to fall on wage flexibility. In the UK analysis, this element arguably has become the 'deal-breaker' with regard to sterling's membership of EMU.

If we now turn to Scotland, then arguably we might wish to modify the standard optimal currency area theory perspective. Orthodox currency area approaches tend to ignore the relative size of the economy as a variable in the analysis. The proposition that large, closed economies can more or less ignore movements in the exchange rate of their currency follows from the fact that currency movements have little discernible impact on domestic economic targets – inflation, employment, output, etc. For small, open economies the opposite is true. The degree of economic inter-dependence with others through integration is high, and is a significant factor affecting their ability to achieve domestic policy objectives. Under any economic criteria, Scotland (and, post-EMU, arguably the UK as well) constitutes a small, open economy with respect to its principal trading neighbours inside the EU's monetary union. This raises additional considerations for Scotland in the choice of exchange rate regime:

1. The high degree of integration of product and factor markets weakens considerably the effective degree of monetary policy autonomy the country will have – or may choose to exercise – under flexible exchange rates. The option of setting monetary policy solely by reference to domestic economic conditions remains, but if pursued may produce a disturbing combination of exchange rate volatility and high interest rates. Consequently, a small open economy lying outside a larger monetary union may opt to shadow the monetary policy decisions of its larger neighbour, leaving fiscal policy to be assigned to domestic objectives – Denmark in the 1970s, Ireland in the 1980s and Sweden

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presently are cases in point. This implies that a small, open economy may benefit proportionately more (or lose proportionately less) by operating inside an exchange rate arrangement than remaining outside. Of course, small economies inside a larger monetary union will have little influence on the common monetary policy. Under the EU variant of monetary union, member states are represented by the head of the national Central Bank who is responsible for reporting on economic conditions in their own economy. Monetary policy is then set for the single currency area as a whole according to the objective of price stability. As the ECB policy process is not transparent, it is impossible to know the respective influence that specific participants have in that debate – but monetary policy is not supposed to be decided on national grounds in any case.

2. Exchange rate volatility matters disproportionately more for a small, open economy than for a large, closed economy. This is because the burden of maintaining exchange rate stability would then fall entirely on the small economy, rather than be shared by international policy coordination and multiple intervention. If the domestic costs of stabilising the exchange rate become excessive (e.g. depletion of foreign currency reserves or high domestic interest rates), and the currency is floated, a given level of volatility may be disproportionately damaging to a smaller, more open economy with less industrial diversification and a smaller access to credit to absorb the shocks. Consequently, small economies may benefit relatively more from external policy coordination (e.g. through membership of a monetary union) than large countries whose currencies – by virtue of the scale of their underlying economic base – are inherently less volatile.
3. A small economy may have little effective control over its own fiscal policies because its own cycle is more influenced by the boom or slump in external cycles. That could have a big effect on its welfare expenditure programme and on the state of its tax revenues. Similarly a mobile tax base is likely to mean revenues are harder to raise, and some of the impact of extra expenditures will be lost abroad.
4. The small economy exchange rate may be disproportionately susceptible to external perceptions about domestic fiscal policy in comparison to larger economies (e.g. the sustainability of cumulative fiscal deficits). If

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so, this will constrain effective autonomy over the targeting of fiscal policy solely to domestic objectives.

5. Foreign direct inward investment (FDI) flows to a small, open economy may be disrupted if its exchange rate is volatile. This reflects the fact that FDI is intended to produce goods and services which are then exported to other foreign markets. Local suppliers servicing FDI may also suffer a decline in demand because of the uncertainty which exchange rate volatility imparts to the production costs of the inward investors, and thus the selling prices that they have to charge in other markets.
6. Forming a union with others helps diversify risks from external shocks. But that also means small countries can often make small policy adjustments (e.g. cuts in business taxes) which have a large effect at home but a small effect on their (larger) neighbours. Paradoxically, that means small countries may well be able to handle regional stabilisation issues and structural reform better within a union, where things are more stable and negotiation formalised, when larger economies would find it easier to do so outside.

The issues that we have raised here suggest that the calculation which a small, open economy will make with respect to the choice of exchange rate regime will be influenced significantly by considerations beyond those raised by the 'pure' theory of optimal currency areas. A summary of what is implied by these additional considerations is that a small, open economy faces a constrained set of options regarding the exchange rate regime that is likely to benefit it most, or to harm it least. And, as economic integration (or globalisation) intensifies and international interdependence increases, further constraints will appear reflecting an increase in the potential welfare costs of external policy non-coordination. These considerations cannot lead to a decisive conclusion favouring one exchange rate regime over another. However, they do suggest that the risk of exchange rate volatility coupled with the restricted scope for genuine economic policy independence combine to tilt the balance in favour of a small, open economy joining a currency union compared to larger economies doing the same.

3. MONETARY UNION, POLICY ASSIGNMENT AND POLICY COORDINATION

Our discussion thus far has followed fairly orthodox economic lines. The standard critique of this argument is that it ignores the problems of asymmetric economic shocks. In such an event, adjustment in the shocked country will not be assisted by changes to union-wide monetary policy, and the burden of adjustment will be thrown onto a combination of domestic fiscal policy and internal price changes.

We would suggest that focusing solely on the formal institutionalisation of EMU as the point at which the questions over macroeconomic policy autonomy and response to asymmetric economic shocks become important is to underestimate the extent to which developments in the global economy have effectively undermined – and continue so to do – the scope that the relevant economic policy authority in actual fact has to achieve domestic policy objectives even where they enjoy formal autonomy over macroeconomic policy levers. It has long been accepted that some macroeconomic policy levers no longer can be deployed with the same force as previously because of the increasing interconnectedness of the world's economies, for example that the domestic aims of monetary and fiscal policy changes can be readily offset by movements in a country's currency in global markets as international capital responds to the policy shift. The trend of globalisation through the removal of barriers to international movement of goods, services, capital and labour has significantly undermined the notion of discrete and autonomous economic policy jurisdictions (countries). Clearly the EU is an example in which 'globalisation' in this sense has proceeded farthest – and has been institutionalised by international treaties that are enforced by an independent judiciary and judicial procedure – but it is not unique at least in terms of the implications of heightened global economic integration on the effective (as opposed to constitutional) autonomy of national economic policy levers. The implications of this type of globalisation for national economic policy authorities is quite clear. No longer can national economic policy authorities be confident in achieving domestic economic targets by the application of domestic economic policy instruments. The direct link between domestic targets and instruments has instead become diffuse, reflecting the progressive erosion of the economic barriers which, hitherto, defined discrete policy jurisdictions.

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What we end up with, therefore, is a general proposition regarding the increasing loss of effectiveness of macroeconomic policy levers in the context of globalisation, and the question of how best to achieve local economic objectives or respond to local (asymmetric) economic shocks? In practice this is the question that confronts Scotland's economic policy-makers. In effect, both as a constituent part of the UK and the EU, Scotland has opted voluntarily to restrict its degree of discretion over macro-economic policy in order to achieve a higher level of welfare. This reflects the impact that globalisation has had on the efficacy of domestic macro-economic policy to deliver welfare improving outcomes, as it greatly intensifies economic interdependencies and policy spillover. Enhanced coordination of economic policies is required if welfare for all participants is to be maximized. As a consequence of the internal market (1992) programme and the liberalization of intra-EU capital flows, this issue is of considerable relevance to all EU member states. Here, we suggest that a greater degree of 'localisation' in these ancillary policy instruments is a necessary counterpoint to the 'globalisation' of macro-economic policies generally, and under EMU specifically. However, such localization should occur within a framework of a wider policy coordination. The core of the argument is that the costs and benefits of EMU are not static. Instead, these will depend on the extent to which other policy instruments are available to respond to unanticipated economic developments – such as asymmetric shocks – in the absence of, or weakening of, national control over domestic macro-economic (especially monetary) policy. A greater degree of policy localisation will permit a country, or a region, to respond to external economic developments by changes to non-macro-economic policy instruments in a manner suited to the specific characteristics of that area.

Orthodox, closed-economy theories of macro-economic policy argue that monetary policy should be targeted at achieving price stability and fiscal policy to stabilising the level of output. However, policy interventions under this rule have to be consistent – there has to be internal coordination between the interventions. In short, the policy-mix has to be right. Open economy models do not alter the assignment rule. However they do point to the need to incorporate policy decisions being made in economies closely integrated with the domestic economy within the domestic policy calculations themselves. In

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that case, external policy coordination becomes important.¹ The explanation (Cooper 1969) is that ignoring interdependence within or between economies leads to oscillations and overshooting (in targets and instruments) because the implied assignments (country by country) will ignore the international side-effects of decisions made in the domestic interest until after they have appeared. Corrections have then to be applied. These are the costs of imposing policy assignments on an exclusively national basis (i.e. domestic policy instruments to domestic targets).² As globalisation intensifies following the elimination of barriers to trade and factor movement, so these costs of external non-coordination increase.

Typically one would expect internal coordination to be more important than the coordination of policies or regimes between countries, since any changes or shocks go directly through the domestic goods and financial markets in the former case. In the latter case, policy changes (or shocks) have to go through the markets for traded goods or capital movements before they get to the domestic markets. However, with globalisation, international policy spillover will assume much greater force both in speed of transmission and magnitude of effect. Hence countries that are particularly sensitive to trade flows, exchange rate movements or capital flows (driven by interest rate differentials, expected devaluations, or by the threat of debt, insolvency, or liquidity problems) may find that their domestic stability is also particularly sensitive to international (or external) coordination. From this we derive that coordination – external as well as internal – is important:

1. when trade contributes a large share of national income;
2. where capital or national imports are a key component of domestic production, or exports a key element in the development strategy;
3. where the exchange rate can be significantly affected by changes in the policy mix in the major trading partners;

¹ *A result which appears in almost every study is that coordination of economic performance seems to generate more stability in the targets and more continuity in the policy interventions (Hughes Hallett 1986a).*

² *These are analogous to the costs imposed by creating one-to-one policy assignments internally: e.g. monetary policy to inflation and fiscal policy to output stabilisation, as commonly happens when the central bank is granted independence.*

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4. and, where the domestic financial and capital markets are incomplete or too small so that domestic investment and production have to be financed by foreign capital inflows.

These conditions are exactly the same as in analyses of the determinants of the net costs and benefits of membership of monetary unions. However, the argument goes beyond the need to coordinate monetary policy, and extends to fiscal policy as well because spillover and feedback linkages will also operate through fiscal policy instruments as well as through monetary policy instruments. The type of co-ordination described here, that is, between different countries in a monetary union, is called 'horizontal policy co-ordination'. Horizontal coordination is directed at securing a better overall performance for each participant through a better global, or European, performance. It is absolute coordination and it will produce a combination of national macro-economic policy measures which is optimal in terms of maximizing the welfare of all participants. No participant would then be able to improve its welfare by adjusting its macro-economic policy stance.

But there is a second type of coordination that is necessary in a context of globalisation – that is 'vertical' coordination. This involves coordination between the policies being set at the 'global' level (to secure a better performance in overall terms – e.g. as part of the European or international economies) and those being set at the local level in order to improve the local performance relative to that global average and to iron out any local difficulties caused by the fact that your economy isn't always in the same state as the others. Global policies will seldom be entirely appropriate for domestic conditions. Vertical coordination is important because it is designed to secure a better performance for the local economy, given the global situation. It is relative coordination – and exploits the (local) policies which may be brought into play to make the internal situation support and benefit from the external (global) policy environment most effectively. Hence vertical coordination can be just as important for the final outcomes and their stability as the global (European Union) policies involved in a currency union.

It is worth reflecting on the intuition behind these observations. Essentially the message is that assignments, whether internal or external, render domestic policies ineffective to the extent that policy makers have to correct past 'mistakes' and counter the undesired impacts of policies introduced by others for the benefit of others. Moreover, because the strength of these

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spillovers increases with the degree of interdependence and globalisation, the effectiveness of domestic policy in decentralised economies characterized by ineffective internal policy coordination declines along with it. Decreasing policy effectiveness shows up in the size of the policy interventions needed to restore targets to their desired levels, and in the speed with which the targets approach their desired levels after a shock. For a small country such as Scotland, that makes it all the more important to preserve and strengthen whatever policy instruments are available at the local level.

The key point is that all of this is an unavoidable consequence of increasing globalisation. It can only be partly fixed by policy making at a global level. It also requires an increasing coordination and flexibility among policy makers at the local level; that is within countries, or within particular markets. Indeed, without the latter, coordination between countries or blocs of countries will become much more difficult – or will fail entirely.

We can now distinguish between the following cases:

1. *No coordination*: domestic instruments are assigned to domestic targets on a one-to-one basis (as in Mundell's assignment of fiscal policy to achieving internal targets, and monetary for achieving external or monetary balance).
2. *Internal Coordination*: domestic instruments are used simultaneously to achieve domestic targets, but they take no account of foreign targets.
3. *Full Coordination*: domestic and foreign instruments are used together to achieve the set of all domestic and foreign targets.

The first case represents decentralisation both internally and externally, whereas the other two cases represent policy arrangements which are, respectively, non-cooperative and cooperative externally. Studies have shown:

- Target overshooting and oscillations are removed by internal coordination, which no longer ignores side-effects until after they have happened. The same happens if the assignments of national instruments to national targets are eliminated.

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- Increasing degrees of coordination (for a fixed degree of interdependence) damp out the transitory effects of shocks more rapidly. On the other hand increasing degrees of interdependence (with policies fixed) extends the size and duration of the target disturbances. Thus coordination increases the power of policy interventions, while interdependence reduces the effectiveness of policy.

One example of the increased costs of local intervention in an open economy is that interdependence slows the correction of trade imbalances (because other countries take countermeasures such as competitive tight money, competitive depreciations, etc., in order to protect their own targets) so that a higher level of reserves is required to last out the slower adjustments. The required level of reserves is lower with coordination both because the domestic adjustment processes are stronger (policy effectiveness) and because smaller interventions mean that the side-effects (externalities) of national policies are reduced.

In the wider context of greater integration within and between economies, policy assignments can only survive in the form of policy specialisations between or within interdependent economies. That means 'comparative policy advantage' will remain the key to the successful use of policy in economies which are interdependent.

4. 'VERTICAL' COORDINATION: COMPETITION POLICY AND THE MARKET FLEXIBILITY ISSUE

Globalisation reduces the extent to which it is safe for a country to let its economic performance deviate significantly from its trading and financial partners. That makes careful coordination more necessary. But it also means that countries must make sure that their policies are effective as possible, for if their economies do not respond easily it will not be possible for policy makers to put those countries on the required track.

The globalisation of markets and investment will tend to reduce prices and increase output through increased competition, scale economies and a better use of comparative advantage. Where the markets are already fully competitive and offer free access, there will be relatively little gain to be made. However, where the markets are imperfectly competitive or fail to offer free access, the potential gains will be much larger. As the pressures for

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globalisation build up, prices will tend to fall further. The pressure will therefore be to divert trade and investment from inefficient firms/countries, while creating it for the efficient ones. Regional or national differences in performance will become more pronounced. So if countries wish to protect themselves (or profit from) these changes, they need a strong internal competition policy to keep prices and quantities flexible; and to allow other policies the scope and effectiveness appropriate to external conditions. In this sense a strong pro-competition policy is a necessary condition for dealing with globalisation and international shocks.

Trade restrictions – be they tariff barriers, quantity restrictions, non-tariff barriers or restrictions on market access (including restrictions in the markets for corporate control or investment) – will likewise have exactly the same effect. It won't help much if an internally pro-competitive policy is matched by external restrictions. Countries and blocs of countries must remain 'open' rather than 'closed' if they are to remain flexible enough to coordinate their internal affairs properly and reduce their vulnerability to the effects of globalisation.³ So we need a 'deepening' of the number and type of relationships that can be used for policy purposes, rather than a 'widening' of the scope of existing relationships. A small economy such as Scotland would therefore benefit by extending her own relationships rather than by relying on indirect benefits through someone else's relationships.

The place where it is most difficult, and politically controversial, to create the effects of flexibility and free access is in national labour markets. And flexible markets are not without their opponents. Apart from offending rent seekers and special interests groups, they afford only a minimal scope for social protection and the redistribution of income. Some argue that this drawback is necessary since lost output and investment and the pressures on competitiveness would otherwise be too high. But others argue that the goals of social and political protection are simply too important, and too vulnerable to be left to unregulated markets; and that the output losses generated by limited flexibility are only small. In fact it is possible to argue that structural or market regulation and interventions on the supply side are really a substitute form of social insurance – albeit one that has the unfortunate consequence of larger fluctuations in economic performance (Agell et al

³ See Hughes Hallett and Primo Braga (1994) for a more detailed discussion.

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1999; Blanchard 2000, 2002). In practice this argument seems to have been overdone. In Europe the distribution of earnings between wages and profits shifted towards labour in the 1970s, as this analysis would predict. But then the wage share started to fall; and it has continued to fall to a point where it is now lower than in the more flexible US or Canadian markets. This is not what you would expect in a market well known to be regulated to improve job security and shield wages from excessive competition. In fact, over time, market regulation has produced greater unemployment as employers have substituted capital for labour in order to avoid the costs and restrictions associated with this type of inflexible labour market. It may also be that productivity growth slowed in Europe but the growth in real wages and employment costs did not. But in either case, increased flexibility in the labour markets would not solve structural problems if their roots lie elsewhere.

Thus the last point to make is that we need flexibility in all markets – including price flexibility in the goods markets. Inflexibility in one set of markets (e.g. for goods) will cause inflexibility in others (e.g. labour) which, if left to themselves, could have adjusted flexibly and easily.

5. STRUCTURAL REFORM

Market flexibility therefore seems to be a necessary part of the localisation response, in the face of the restrictions imposed by increasing globalisation. Part and parcel of the idea that markets need to be more flexible is the idea of structural reforms – especially in the labour market. It is also possible to intervene directly in the labour markets in order to steer them towards the responses that flexibility would have provided, but which their own rigidities (or high employment costs) prevent.

Under the latter heading we may have limits on wage increases to the average of one's trading partners/competitors. We also might have to reduce the measures that are designed to boost job security – hiring and firing costs for example, or extensive redundancy regulations and payments. We might also have to consider reducing the non-wage costs on employment – corporation taxes, employer contributions to social security and pensions systems etc. By doing that we won't have to require wages to fluctuate so much to get the appropriate adjustments in employment and growth. On the other hand, any mechanism that makes wage bargains more sensitive to market conditions

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would also be helpful. But that may require significant changes in the wage bargaining process (and institutions thereof) to ensure real wages are not too rigid.

Among more general structural reforms are the removal of industrial subsidies, market deregulation (especially in utilities, transport communications), restrictions on market access or on employment etc. Possibly more important is to have a streamlined system of permissions and regulations on who can do what and where – transparent and on a 'one stop shop' basis. Finally investment in efficient infrastructure and good education and training can do a lot in promoting structural reform and the flexibility for a 'local' response to global policies. All of these things need to be in the hands of a national or regional government in EMU.

6. CONCLUSION

The basic argument set out in this paper is that membership of a monetary union (especially EMU) will constrain the room for national economic policy autonomy – self-evidently in the case of monetary policy but additionally with regard to fiscal policy. However, it is useful to view the resulting policy-constrained outcome as an extreme case of the more general phenomenon of 'globalisation'. This produces a situation where international policy spillover is acute, thereby explaining the need for international policy coordination. The implication is that specific policies lose their potency within national (or local) jurisdictions, and that a deepening of 'local' policy flexibility through 'local' policy instruments is required if 'local' welfare is to be maximised – both by attaining local aims and by offsetting the local effects of asymmetric economic shocks. To date, insufficient attention has been given to this counteracting 'localisation' dimension to the 'globalisation' process.

Both the problems we have outlined here, and the approach to tackling these which we advance, imply that an institutional response is required if the policy deepening (localisation) process is to be successful. Perhaps the best illustration of the underlying logic of this point can be drawn from the economic transition experience of the central and eastern European countries (CEECs) about to join the EU. In those cases, domestic economic policy reforms were driven by what has come to be referred to as the 'Washington consensus'. The conventional wisdom underpinning the Washington consensus was that the speedier was this reform process, the more rapidly

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would the transition process be completed. In the event, however, the onset of the reform process was accompanied initially by a deep recession in each of the transition economies. The precise causes of the recessions in the CEECs remains a matter of dispute, although most debates revolve around questions concerning the sequencing and timing of the reforms that were implemented. At one end of the spectrum was a policy of 'shock therapy', or 'big bang', which emphasised the need for rapid and radical economic reforms to be introduced immediately and thereby to lay the foundations for accelerated economic growth⁴. At the other end of the transition policy spectrum was a 'gradualist' approach which stressed the importance of the institutional and social aspects of the transition process as prerequisites for the successful and less painful implementation of the economic reforms (Fischer et al 1996; Stiglitz 1999; World Bank 2000). In the main it was the 'shock therapy' school (some would describe it as 'blitzkrieg') which prevailed, with most of the CEECs speedily adopting macroeconomic stabilisation programmes designed to lower inflation and secure progress towards fiscal stability, while simultaneously liberating price controls and removing currency and trade restrictions.⁵ Perhaps the best depiction of the economic dislocations of the early transition years is that, in the words of Janos Kornai, it constituted a 'transformational recession' which captures the necessarily painful and evolutionary nature of the economic transition process, a process that almost certainly could not have been accomplished without considerable economic dislocations (Kornai 1993, 2000). But the core problem that perhaps is now more readily accepted was that local conditions and institutions were not sufficiently taken into account at the moment when global economic policy changes were implemented, and certainly it is arguably the case that this failure made the transformational recession deeper than otherwise could be expected.

⁴ Catured in Jeffery Sachs' famous dictum that 'you do not leap a chasm in two steps'.

⁵ Stiglitz (1999) describes this as the 'Washington consensus' meaning that the introduction of stabilisation programmes in the CEECs was a condition imposed by the international agencies (e.g. IMF, EU) if they were to receive financial assistance. For instance, the IMF established a new lending facility called the Systemic Transformation Facility for the period 1993-95 which had lower conditionality conditions than the norm.

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It is the presence of a dominant (e.g. 'Washington') consensus which might be inappropriate to 'local' conditions, aspirations or capacities. This reinforces our case for 'vertical coordination' and localisation of policy responses. The problem is that globalisation, and policies designed to deal with global events, run the risk of creating market and information failures at the local level. If misguided market responses and imperfect coordination are then the outcomes, local policy will be needed to counter them. The problem is not so much misguided policies, but that these policies have been recommended on the basis of the wrong framework for understanding how most economies work. That means the problem is market and information failures, leading to misguided market reactions, and a lack of coordination between different sectors of the economy.

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