A "Eurocentric" Perspective on Global Governance[1]

Jorge Braga de Macedo
jbmacedo@oecd.org

Draft prepared for presentation at:

IEEI/IEE-UCP

Com o Alto Patrocínio de S. E. o Presidente da República

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[1] First draft. Based on *Globalisation and Institutional Change: a development perspective*, in **Globalisation, Ethical and Institutional Concerns**, edited by Edmond Malinvaud and Louis Sabourin, Vatican City: Pontifical Academy of Social Science, 2001, pp. 223-268.

A "Eurocentric" perspective on global governance[2]

Globalisation has emphasised the need for good governance and institutional change. When globalisation and governance interact positively, reform can be sustained The European experience is only one example of direct ways in which national governance may be improved, namely belonging to regional arrangements based on peer pressure.

1. Peer pressure and yardstick competition

Even in the days of the Washington consensus, most economists and policymakers would count on effective states as well as on efficient markets to be crucial ingredients for development. When markets become more efficient states need to become more effective. This is especially important because world financial markets, by themselves, were not capable of promoting rules of good conduct among sovereign states.
The IMF and the World Bank did play a role in spreading 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 stabilised, liberalised and privatised the economy in part because they saw other policymakers do the same. Within the EU, in particular, this peer pressure led to the 1992 Treaty mentioned at the outset, which has included a multilateral surveillance framework (MSF) designed to support the introduction of a single currency. The MSF has been progressively reinforced in the two revisions of the treaty.
The issue of whether peer pressure bring about improved performance has been addressed by Tim Besley and Anne Case (1995) in the context of "yardstick competition", a term coming from industrial organisation which suggests comparing similar regulated firms with each other (Schleifer, 1985). For any given firm, the regulator uses the costs of comparable firms to infer a firm's attainable cost level. This may not fully overcome moral hazard problems, but it is certainly preferable to the traditional procedure of comparing current and future costs to past performance. The peer pressure scheme is thus susceptible to manipulation by participating firms but the difficulty in co-operating to impose collusive behaviour makes this perverse outcome less likely. Note also that in the case where heterogeneity is observable and can therefore be corrected for, Andrei Schleifer (1985) shows that a regulatory scheme based on peer pressure should lead to a superior performance.
This implies that the regulator can credibly threaten to make inefficient firms lose money and cost reduction can therefore be enforced. When national objectives are at stake, best practices can thus be achieved, rather than allowing a convergence towards the mean. Conversely, when peer pressure is used to stall reforms, rather than to promote them, the outcome is equivalent to the collusive equilibrium and an alternative yardstick must be devised.
Therefore, adapting the same reasoning, when there is peer pressure among national policymakers to follow best practices, these are likely to become more and more accepted. Peer reviews have enhanced competition for better macroeconomic and trade policies among OECD members. Similar benchmarking has begun with respect to structural

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policies, especially those relating to the regulatory framework. The greater complexity of such policies makes them more susceptible to procrastination, and the same problem has been observed in the EU, as discussed in section 4 below. This hinders institutional change and makes corporate and political governance more difficult.

Among the G-7, only the four European states have attempted to deal explicitly with their regional architecture, so that the presidents of the European commission (EC), central bank (ECB) and council (especially the EcoFin) attend the meetings. There is no sovereign national centre equivalent to that of the United States, Japan or Canada (let alone Russia, set to become the 8th member), even though the complexity of the current EU institutional framework leaves substantial room for manoeuvre to the United Kingdom and to the three large members of the eurosystem.

The question of external representation of the EU has been a source of controversy at least since its creation. Due to the fact that the EC participates in the discussions of the G-7 since 1977, the four EU (three eurozone) members tend to ignore their eleven (eight) "peers" when global affairs are on the agenda. The same applies to the OECD, where the EC also participates. At the IMF, like in the G-7, a representative of the ECB addresses all matters directly pertaining to monetary policy.

The ambiguity of the solutions reflects, once again, the complexity of the EU institutional framework. Nevertheless, the strengths of the perspective can be put to good use in the global arena, as long as the European identity is understood as a flexible partnership portable to other groups of nations. The creation of a single currency among most members based on a MSF supported by all, helps to make the case for flexible integration in section 3. below.

The MSF developed among EU nation-states can be adapted to build a global financial architecture resilient to financial crises. To begin with, its intercontinental domain reflects longstanding cultural and commercial ties. Moreover, the EU probes into budgetary procedures and corporate governance standards, in ways that may offend national sovereignty if applied to Washington or Tokyo. 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 role of the Commission as regulator and that of the Court of Justice help bring procedures closer to a regulatory framework allowing for yardstick competition.

The EU MSF does not focus on balance of payments adjustment, but rather attempt to bring together principles of good government commonly accepted and which indeed are jointly transferred to Community institutions. 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 creation of the eurosystem in January 1999 was followed by a difficult institutional period, which has also delayed the accession calendar. The delay reflects the propensity to procrastinate on structural reforms, rather than the recurrent European debate about whether multiple-speed convergence towards union objectives is possible and desirable.

2. Convergence and cohesion as common good

The current international system calls for a more effective regional and global response to threats of contagion of national crises. American national interest in preserving world stability is one such response. Co-ordination mechanisms among monetary and fiscal authorities like the ones found in the EU and in the eurozone rely on economic and societal values shared among sovereign states are another response.

The American and European interests have been complementary on many occasions and indeed originated fifty years ago in the process of allocating Marshall aid through the European Payments Union and the Organisation of European Economic Co-operation, which later became the OECD. The current relevance of these distant origins is described by Barry Eichengreen and Macedo (2001). Fred Bergsten (2000) provides a list of similarities and differences between European and Asian integration, and concludes that the former are beginning to outweigh the latter.

Under globalisation, a single country, no matter how dominant, cannot provide the "common global good" (No.58 of *Centesimus Annus*). The global applicability of the European experience to the search for the "common good" suggests itself because it hinges on the "centre" in Europe not being a nation-state, but rather a community thereof. Note that, in spite of a similar emphasis on co-operation and development, Smith and Naím 2000 hardly mention the European experience. Even in the European context, external pressure remains powerful. This is another way of underscoring the result in Bonaglia et al (2001) that globalisation improves governance.

The lessons from the crises in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) may be helpful in emerging markets. Basically, the largely unwritten ERM code of conduct implied a more effective co-ordination mechanisms among monetary and fiscal authorities than expected. Non-compliance with the ERM code of conduct played a major role in the development of the currency turmoil, but after August 2, 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. The option to float in order to fix, a kind of financial "cruel to be kind" (Macedo, 2001a) shows that the set of principles, rules and code of conduct which underlie the monetary union in stage two have proven correct for the euro as well.

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, as long as they manage to enforce financial stability. This applies to the Financial Stability Forum and to the G-20, for example.

Enforcing financial stability can lead to a virtuous cycle, whereby currency stability delivered by monetary union feeds back to a more employment-friendly economic environment. Conversely, when terminal conditions lack credibility, a "stop-go" convergence process that hinders change may appear. Temporary, unaccountable shifts in sentiment in financial markets thus may disrupt the convergence process permanently. A government can only protect itself from this threat by acquiring a reputation for subordinating other goals of economic policy to the pursuit of convergence.

The MSF can play a role in providing timely information on national economic policies in a way that enhances the reputations of deserving governments. The same is true of the adoption of appropriate budgetary procedures at national and union levels.

Thanks to its code of conduct, the ERM acted as an instrument of convergence towards the single currency. The code was partly unwritten, but it encompassed instruments specified in the 1992 EU Treaty. These were essentially a timetable with three stages, the convergence programmes and the specific procedures included in the MSF, especially the ones dealing with excessive deficits. In addition, progress towards independence of national central banks was impressive during stage two of monetary union, as was the fact that the public sector could 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 monetary union in order to contribute to the realisation of the conditions necessary for the transition to stage three. The fact that it 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 103 of the Rome Treaty (in its 1999 version). The approval in 1996 of the Stability and Growth Pact (SGP) also contributed to allay such fears because it actually tightened the excessive deficit procedure included in the 1992 EU Treaty. The creation of the ECB at the end of stage two of monetary union proceeded on schedule, in spite of a political dispute about the term of the initial governor.

Once again, an effective MSF, supported by all member states, was decisive for medium term policy credibility at national and union level. Indeed, all of these instruments and procedures effectively delivered convergence and cohesion. Together with political stability or social consensus and national cohesion, the MSF delivered 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 2 of the EU Treaty in its 1999 version 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. As this should not be a pretext for creating an additional burden on enterprises, the structural funds directed to member states have been made conditional on appropriate policies.

Such conditionality turned out to be difficult to agree upon at the Maastricht European Council, and accordingly cohesion countries were reluctant about the proposals for flexible integration made during the preparation for the 1996 revision of the treaty. This reluctance has been overcome, as discussed next. But it reinforces the perception that poorer member countries are more favourable than richer ones towards political integration along sheer income redistribution lines. Such perception is not only detrimental to cohesion, it also feeds the fears of a future European "superstate" where taxation would be excessive because of international redistribution, an extremely unlikely scenario.

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.

A converging country is 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. One reason why the instruments and procedures underlying the ERM code of conduct delivered convergence and cohesion certainly is the "new politics of credibility" of Keohane and Nye (1999) but another is the quest for the "common European good". The notion of medium term policy credibility emerges as essential in the evaluation of the EU MSF. Both the credible MSF and this form of inclusive globalisation on a European scale are consistent with flexible integration schemes, described in the next section.

Now the European System of Central Banks (ESCB) provides price stability in the eurozone by means of a single monetary policy but the institutional framework of the eurosystem draws on the functioning of the EMS based on a common (now single) monetary policy and on national fiscal policies. The single monetary policy is conducted by the ESCB led by the ECB and independent of national governments and of the EC. The national fiscal policies are co-ordinated by multilateral surveillance procedures. These include the SGP; they are monitored by the Euro Group (which gathers the Ecofin Council members from the eurosystem) and by the EcoFin Council itself.

Yet the ESCB, the Euro Group and the SGP together do not quite match the "rules of good housekeeping" of the gold standard because some features of the articulation between the single monetary policy and national fiscal policies remain ambiguous. Is the ESCB accountable to the European parliament, national parliaments, both or neither? Who is responsible for exchange rate policy? No matter how crucial, these aspects are not alone responsible for the observed weakness of the euro relative to the dollar and the yen. Difficulties in making the institutional architecture more flexible and the (related) propensity of governments to procrastinate on unpopular reforms are also to blame. They are taken in turn in sections 3 and 4.

3. The case for flexible integration

The recurrent European debate about multiple-speed convergence helps illustrate the complementarity between global and regional common good. One extreme position in the European debate draws on the view of a unified constitutional state, for which variable geometry is impossible. The other extreme position calls for a set of contractual arrangements, where common institutions are undesirable.

From the beginning, the European Community attempted to transcend the rigid intergovernmental nature of the OECD or of the G-7 (which does not even have a permanent secretariat) in the direction of supranational institutions like the EC. But the convergence stopped far short of establishing Community-wide democratic legitimacy. As a consequence, the institutional framework became more and more complex, especially after a Union with three pillars (the Community and two intergovernmental ones) was created in the 1992 EU Treaty. In the process, flexibility was lost and this is why the debate about multiple-speed convergence towards union objectives has resurfaced. Another reason is, of course, the imminent enlargement.

For any given number of member states, there is a trade-off between the freedom to enter into contractual agreements which include some members and exclude others and the ultimate requirement of "one man, one vote" which would be associated with a new state emerging from the integration of all members. In Figure 1, adapted from CEPR (1996, p. 47), the vertical axis measures flexibility and the horizontal axis measures depth of integration. The origin represents purely intergovernmental co-operation among the same member states. The vertical axis represents economic efficiency and executive performance, or the forces of competition, while the horizontal axis represents legal status

and legislative activity, or the forces of co-operation. Each point in the quadrant can therefore be seen as a combination between competition and co-operation.
The highest point on the vertical axis, labelled "a la carte", would be equivalent to a purely contractual institutional design where any combination of subgroups of member states is acceptable, so that the basic intergovernmental principle of equality of member states applies and unanimity in decision making is preserved. During the revisions of the Union treaty in 1996 and 2000, intergovernmental schemes of "reinforced co-operation" have been called for among some member states, as their creation still requires unanimity of all member states and their membership is open to all of the member states who qualify.
These manifestations of flexible integration are consistent with the operation of the principle of proximity (or subsidiarity) mentioned at the outset, according to which further decentralisation is acceptable and desirable. Indeed, CEPR (1986, p. 65) mentions a generalised subsidiarity principle, where decentralisation can go towards groups of states, rather than local and regional bodies within each state.
The horizontal axis would go to the extreme where majority voting applies to the voting population without regard to its national location, labelled "superstate". There co-operation among the (former) member states would cease to be relevant politically, economically or socially. Quite clearly, even in areas where single policies have existed for a long time, such as tariffs, and the EC has an undisputed mandate, the relevance of the member states is always there. The same can be said about monetary policy, administered by the eurosystem.
With respect to the objective of a free movement of persons, it was achieved properly for the first time on 19 March 1995 by the seven member states (Belgium, France, Germany, Luxembourg, the Netherlands, Portugal and Spain) that are parties to the Schengen convention. When the EU Treaty modified at the Amsterdam European Council came into force on 1 May, 1999, the freedom of movement was extended to all others, with the exception of the United Kingdom and Ireland.
Not all combinations of flexibility and integration defined by the two axes are possible, let alone desirable. In effect, for each specific issue-area, when integration becomes deeper, purely contractual arrangements are constrained and when the principle of equality between members is sacrificed to the democratic deficit, flexibility is constrained. Therefore a downward sloping line can be defined between the point of maximum flexibility and no common institutions and the point to the right of which deeper integration would prevent any flexibility in the co-operation among member states. The intersection should be to the left of the point labelled "superstate".
It is assumed that along the 45 degree line, there is a balance between integration and flexibility. This means that flexible integration schemes along this line will balance the contractual commitment and the deeper integration, as called for by schemes of "reinforced co-operation" mentioned above. If the combinations of a common base and open partnerships defined in functional rather than geographical terms (CEPR, 1996, p. 59) were along this line, they would balance integration and flexibility in the best possible way, given the number of states involved.
The creation of the EU called for new institutions such as the ESCB while the excessive deficit procedure regulated the surveillance in the area of budgetary policy required for a sustained operation of the eurosystem. Increased intergovernmental co-operation common foreign and security policy (CFSP) and justice home affairs (JHA), the latter in conjunction with the free movement of people and the creation of a common asylum and immigration policy. These institutional procedures have been put in place gradually but this has not overcome the fact that the architecture resulted from last-minute negotiations at the

European Council in Maastricht rather than from an explicit commitment to flexible integration.
As shown in Figure 1, the array of open partnerships provided by the two pillars complements the Community, as a very significant base including all members, but the areas of interaction are limited. In the economic and financial area, on the contrary, the ECB and the Euro Group are complemented by the SGP. In all three set-ups, but especially in the SGP, countries not in the eurosystem follow the rules anyway. Moreover Denmark continues to follow the ERM code of conduct.
In any event, the resulting institutional framework is extremely complex with areas of duplication and inefficiency alongside areas where resources are insufficient. This applies to the various secretariats but also to the Commission itself which has been involved over some years in a difficult internal restructuring. Whatever the place of the entire Community architecture in Figure 1, the combination of the three pillars is unlikely to be along the diagonal. Probably a legalistic approach would place the union architecture more towards the Community than towards the intergovernmental pillars. While the common base remains difficult to distinguish from open partnerships nearly ten years after the EU Treaty was negotiated, with the revisions agreed at the European Councils in Amsterdam and Nice, there is a suspicion that the balance has tilted towards the vertical axis, but so far without noticeable improvements in executive performance.
Since all member states have met the entry criteria for monetary union (independently of the willingness to join for Sweden and the United Kingdom, and the membership of Denmark in the ERM), the case for flexible integration has been strengthened by the euro and there is greater acceptance that variable geometry was inevitable in the case of a single currency. Jacquet and Pisani-Ferry (2000) note in closing that the Nice Treaty provides the possibility of making use of "reinforced co-operation" in the field of economic and monetary union.
In sum, the flexibility approach to European integration stresses the portability of the European experience to countries in different stages of economic and financial development. As such it may facilitate enlargement. But it also helps improving the EU institutional framework, especially its financial architecture, now that the stability culture prevails among its 15 members.

4. The danger of procrastination

The notion of medium term policy credibility emerged as essential in the evaluation of how the regime in the EU Treaty combined convergence and cohesion. This credibility hinged on the functioning of the SME. It now depends on the institutional framework of the eurosystem, which is based on a single monetary policy and on national fiscal policies.
The lack of credibility of the "common European good" in world financial markets reflects the absence of reforms in member states. If the propensity to procrastinate is reversed, a European identity might appear even in areas of reinforced co-operation among some member states, such as money and finance, let alone development and even migration. This combination of global unity with regional and national diversity would certainly increase the portability of EU procedures in transition and emerging markets.
Unfortunately, national governments have used the euro as an excuse for procrastinating on unpopular but essential structural reforms. Yet, even if the euro-based MSF is effective, it cannot replace reform in labour markets, social security, education and training etc. Only if reforms take place will medium term credibility be ensured so that replacing national currencies with the euro will have effects according to the credit ratings of nations, cities

and firms rather than their geographical location. Indeed if countries use monetary union to procrastinate on their unpopular reforms, the benefits of the stability culture may vanish both at the core and at the peripheries. The "hold up" problem in the industrial organisation literature suggests the similar danger of a "euro hold up" (Macedo, 1999).

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 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. As there is no dominant player in the EU, procedures relying on an agreed MSF, had to be devised and implemented.

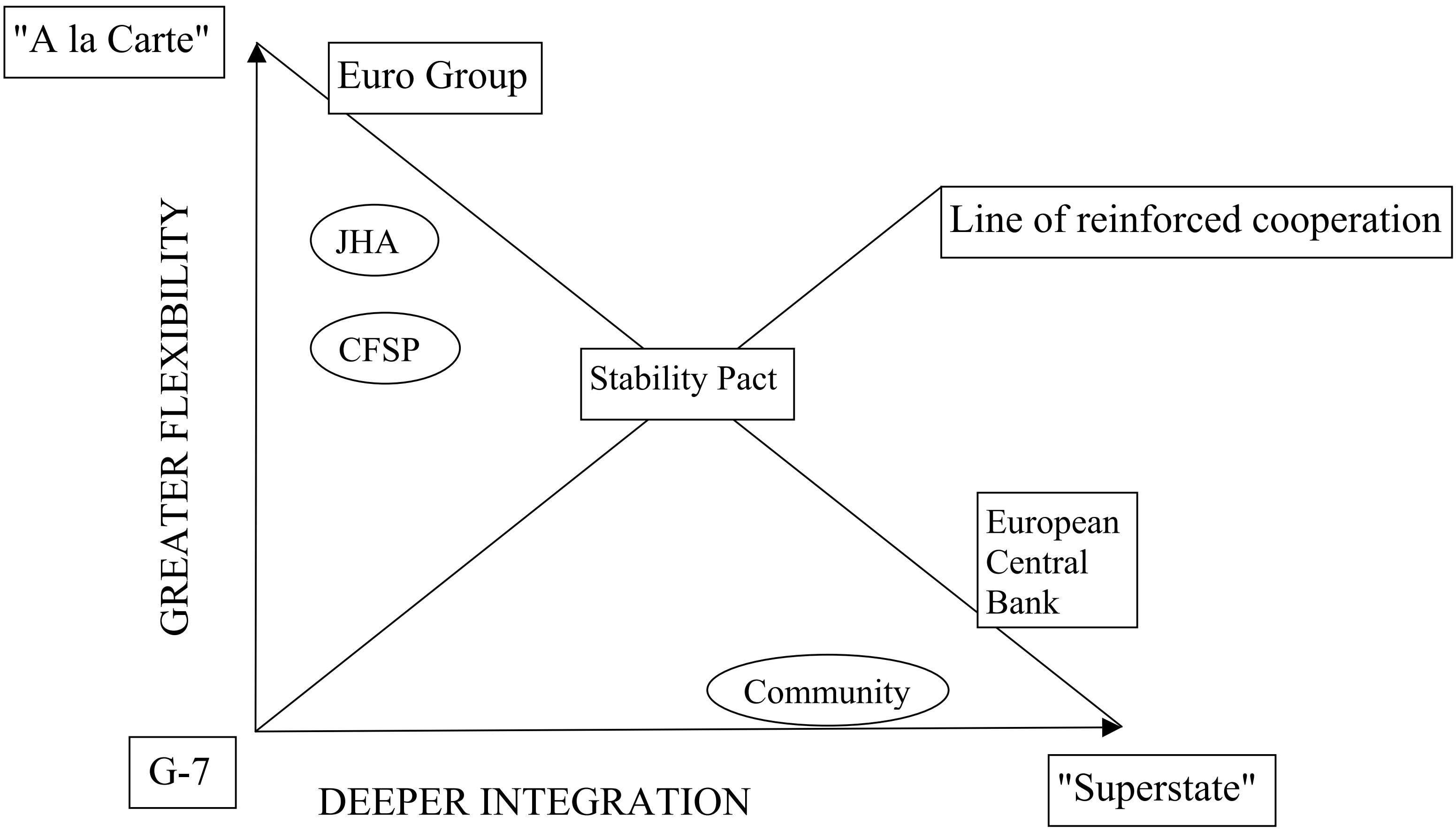
The incentive to free ride on the public good is indeed greater for the small countries but without a decision to join which can be domestically supported, the benefits of convertibility and stability are also less apparent.

The public good element of the euro 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 world-wide.

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.

The role of the EU notwithstanding, 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 spectacular interruption of the Millennium Round of the WTO launched in Seattle in late 1999 and of subsequent protests at meetings of the Bretton-Woods institutions. While it is essential to empower people to face the challenges of globalisation, the changes in governance that are called for cannot become protectionist without threaten the basic benefits of open trade in goods, services and assets and of the free movement of people.

Figure 1: European institutional architecture



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