correlation exists between a country’s inability to borrow in own currency and degree of exchange rate flexibility.

In chapter 3, Barry Eichengreen and Carlos Arteta in “Banking Crisis in Emerging Markets: Presumptions and Evidence,” identify three contributory factors to the instability of the banking system as a major disruption in the EMs: the rapid growth of domestic credit; the large size of bank liabilities; and financial liberalization. The authors find no stable relationship between the exchange rate regime and banking crises (if anything it is banking crises that cause currency crises), nor do they find evidence that the quality of institutions, or deposit insurance arrangements, matter. Ultimately, though, the authors conclude that, as far as the causes of banking crises in EMs are concerned, “it is fair to say that the jury remains out” (p. 55).

J. Onno de Beaufort Avijnholds and Arend Kapteyn in chapter 4, entitled “International Financial Crisis: The Role of Reserves and SDR Allocations,” argue that while a stable macroeconomic environment and a sound financial system might be important prerequisites to avoid a crisis, EM countries would be strongly advised to hold an adequate level of international reserves. It is, of course, recognized that holding reserves entails costs and benefits. EM countries with relatively high reserves are able to manage to withstand financial crises better than those with relatively low reserves. A considerable cost is identified in the case of countries that hold excessive reserves. It could lead to macroeconomic laxity since the external constraint is thereby removed. An adequacy benchmark is, therefore, proposed.

Jacek Rostowski in chapter 5, “The Eastern Enlargement of the EU and the Case for Unilateral Euroization,” examines the issue of the choice of an appropriate exchange rate regime by the “eastern applicant” EM countries that aspire to EU membership. For these countries, the question is the exchange rate regime that optimizes their path to the EMU. EM countries should adopt the euro unilaterally as the best way to achieving convergence. Chapter 6 by D. Mario Nuti in “The Costs and Benefits of Euroization in Central and Eastern Europe Before or Instead of EMU Membership” deals with a similar theme. The costs and benefits of euroization are extensively discussed to conclude that ultimately the net balance is an empirical question. Early euroization may have clear advantages but the costs cannot be ignored.

In chapter 7, entitled “Currency Substitution, Unofficial Dollarization, and Estimates of Foreign Currency Hel Abroad: The Case of Croatia,” Edgar L. Feige, Michael Faulend, Velimir Šonje, and Vedran Šočić attempt to measure the amount of foreign currency in circulation in a country, knowledge of which is important to economic policymakers in their choice of exchange rate regime. Despite this there is no reliable evidence on the extent of unofficial dollarization. This measurement is attempted in the case of a number of countries, and Croatia in particular, in the case of dollar and DM holdings. It is argued that, when the euro replaces national currencies, the results of exercises of the type proposed in this contribution should be very helpful.

Although one may very well quibble about a number of aspects of the theoretical and empirical parts of the book, especially the variables utilized in the estimations and techniques utilized, this is no doubt a topical book, dealing with relevant issues concerning EMs and their place in the world economy. There are, however, three aspects that are sadly downplayed in the book: the role of institutions (legal and political economy factors in particular); the importance of governance; and more quantitative analysis of a number of issues raised in the book should have been forthcoming (e.g., cost and benefits referred to in a number of instances in the book). These are key aspects to the problems faced by EMs, especially so in view of the conclusion reached by the editors that EMs “must look within their own respective countries and find specific answers to specific problems for a better future. There is no alternative to a home-grown development” (p. 14).

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The book analyzes Russia’s transition from a command economy to the market, with particular
emphasis on the role of Russia’s industrial and behavioral heritage in slowing the pace of transition. The “virtual economy” is an environment in which large loss-making enterprises were able to survive without restructuring by using informal and highly personalized networks that allowed value-subtracting goods to be produced and exchanged; the oil and gas industry was the ultimate source of value infusion.

Russia’s transition to a market democracy is far from being complete, and any analysis is bound to be interim. Reality played a cruel joke on the authors: the book, which was begun in 1997 with the aim of explaining the disappointing results of economic reforms, was out of print by 2003, the fifth consecutive year of high growth rates. Yet what might be concealed by these rates fueled primarily by high oil prices and dramatic ruble devaluation in 1998 is that the overall economic structure remains largely intact. Recent estimates by the World Bank show that transfer of value from extractive industries to the rest of the economy remains a pervasive feature of the Russian economy.

For a book aimed at a general economics readership, Russia’s Virtual Economy is a little bit too systematic. To provide a comprehensive picture, the authors invoke a lot of peculiar features of the Russian economy and attempt to put them into a general perspective by contrasting them with the Economics 101 wisdom. While the authors’ command of Russian details is indeed impressive, the number of issues tackled and the number of explanations suggested seem overwhelming. Still, despite doing a poor job of drawing interest to Russian transition, the book provides a superb analysis to those who are really interested. Starting from a case study of a medium-size provincial firm, the book explores the basic mechanism that allows “industrial dinosaurs” to survive in the era of rapidly changing market conditions. Instead of investing money and efforts into transition toward the efficiency frontier, firms maintain nonmarket relations with one another and accumulate relationship capital which is crucially important in dealing with state authorities. The whole economy is then stuck in a bad equilibrium, where those firms that try to do business in a standard market mode are relatively penalized, while those who play by the “virtual economy” rules are rewarded. The symptoms of the economy’s disease include widespread barter, in-kind taxes, and other nonmonetary transactions.

In part, the Russian virtual economy was a reaction to a particular strategy of exchange-rate based macroeconomic stabilization pursued by the Russian government in 1995–96 rather than the legacy of the Soviet past. The same “virtual economy” symptoms were observed lately in Argentina between the Brazilian devaluation and the Argentine default. Still, one of the truly valuable points raised by the book is the extent to which enterprises inherited from the Soviet era have been unable rather than unwilling to restructure. Early students of Russian reforms put a lot of emphasis on incentives. Though there is no doubt that proper incentive design is of crucial importance, the authors are right to point out that the constraints due to initial conditions have been binding for large industrial enterprises. This is in contrast with the empirical evidence on newly created firms, which are shown to respond to changes in the rules of the game, e.g., an improvement of property rights protection, in a market way. The authors are right to argue that Russia’s unique features by no means imply that a market system cannot ever work properly in Russia. All the available evidence demonstrates that transition economies are inhabited by agents who are genuinely interested in enjoying fruits of their own efforts.

One aspect, mysteriously missed in the book, is politics. Russia is a federal country, and governors who are elected in contested elections have played a crucially important role in regional economies. Without taking governors’ incentives into account, it is hard to understand why it is so important for the directors of large enterprises to maintain employment far above the efficiency level, and why close relations with large regional business lead to governor’s unfriendliness toward small and new business development. In the book, the “missing politics” phenomenon is more of a linguistic nature. With an apparent aim to widen the readership, the authors sometimes choose to introduce new concepts rather than to stick to more traditional academic language. For example, once investment in relational capital—be it a bribe to a police officer or putting a senator’s wife on the payroll—is understood as a private protection of property rights, the picture starts to look more familiar to students of capitalist economy.
The whole phenomenon of the “virtual economy” was probably no less characteristic of the late decades of the Soviet Union than of post-Soviet Russia. In the 1990s, while official Russian GDP may have been overestimated as a result of “virtual economy” accounting, as the authors claim, the same estimates might also have failed to account for the informal economy, and thus the net effect may be that GDP was understated. In the Soviet Union, where prices had been set by a central planning body, value was transferred from extracting to manufacturing industries through artificially low energy prices.

To those readers who reach chapter 9, there is an analysis that is a model of clarity and precision, which are sometimes lacking in earlier chapters. The authors outline the “impossible trinity” of the Russian state: to simultaneously achieve economic growth, democracy, and security. The current trend of cutting down still-young democratic institutions in the name of sustaining high growth rates and maintaining security fits very well into this paradigm. In the final analysis, it might be a bit of overstatement to say that the book is a must-read for anyone who is interested in the economics of transition. But the “virtual economy,” the main mechanism that Gaddy and Ickes were first to identify, describe, and analyze, is surely something that must be understood.

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Junko Kato, a political scientist, tells a historical political story of the relationship between the adoption of regressive taxation—value-added taxes (VAT)—and the growth of the welfare state—social security expenditures—across various industrialized and newly developed or developing nations during the twentieth century. Kato’s interest is in examining the funding base of the welfare state. She begins with a look at evidence on the cross-national patterns in welfare expenditures for 1960–1996 in eight industrialized nations, concluding that there was little convergence among high-spending and low-spending welfare states. The explanation: there was in fact little retrenchment among the high-spending states during the 1980s welfare retrenchment era. Kato argues that a greater funding capacity within a nation in the 1980s blunted any movement toward welfare retrenchment, while in nations with financial problems retrenchment was inevitable. She further contends that “The divergent funding capacity of the welfare state is path-dependent upon the institutionalization of regressive taxes” (p. 1). If the regressive (VAT) taxes were institutionalized during periods of high economic growth, they created greater funding capacity and welfare spending; if during periods of low growth, they caused less funding capacity and spending.

The book does not have an introductory chapter; instead, chapter 1 is organized similarly to a journal article. It serves as an introduction to the topic, places it in the context of the (principally) political science literature, discusses various hypotheses and propositions, analyzes data, discusses findings, and draws conclusions. The chapter examines the cross-national patterns in tax revenues, tax composition, and welfare expenditures for 1965–2000 for eighteen OECD countries, which are labeled according to various political classifications that may seem odd to economists. Thus, the high-spending, high-tax Denmark, Finland, Norway, Sweden, Austria, and Belgium are labeled “nonright hegemony” welfare states while the low-tax, low-spending Canada, France, Ireland, Japan, Switzerland, and the United States are labeled “liberal” welfare states. The high-tax, low-spending Australia, New Zealand, and the United Kingdom are labeled “radical” while the low-tax, high-spending Germany (West), Italy, and Netherlands are labeled “conservative” (p. 7). Detailed data on tax composition and tax revenues for the eighteen countries is presented next, indicating a large cross-national variation that increased between 1965 and 1980. But while total taxes generally increased, the relative positions of countries remained the same in 1995 and 2000. The later years still indicate a large, but unexpected, cross-national variation in both the composition and level of tax revenues. The continuing variation in the postwar period is unexpected, according to Kato, because of the widespread diffusion of the progressive income tax during the 1940s and 1950s and the “worldwide tax reform in the