

# Controlling Inflation in Transition Economies: The Relevance of Central Bank Independence and the Right Nominal Anchor

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*Controlling inflation is a central problem in transition economies. This paper asks under what conditions or even whether central bank independence helps in this task. The conclusion shows that merely imposing legal independence on the central bank may be ineffective or even counterproductive. It is necessary to make a monetary strategy and the responsibilities and restrictions of central bank policy transparent to the public. In addition, it is important that the right nominal anchor is selected—one that is, or is believed to be, effective and sustainable. Both monetary targeting and inflation targeting are assumed to be unsuitable for most transition countries. Instead, some kind of dynamic exchange rate targeting appears to be the most reasonable choice. (JEL E5, P2)*

## Introduction

Controlling inflation has proved to be a central problem in transition economies (Aslund et al. [1996, p. 217] even speak of "the" central problem). Above a certain level, inflation can be regarded as a hindrance to economic growth and development [Fischer et al., 1996; Bruno and Easterly, 1998]. Central bank independence appears to have been a cornerstone for controlling inflation in many countries as shown by empirical experiences with it in Western market economies [Kißmer and Wagner, 1998].

Transferring recommendations and justifications for central bank independence to transition economies, however, is open to question because in transition countries, inflation is more or less a fiscal phenomenon. It also takes quite a while (in principal, the entire transition period) until the necessary conditions for successfully controlling inflation through monetary policy are implemented. This paper poses the questions: Is the employment of statutory or legal central bank independence reasonable under such conditions? Which institutional preconditions are required to enable successful control of inflation by an independent central bank in a transition economy? This paper argues that the choice of nominal anchors plays a decisive role.

The second section investigates the relevance of central bank independence for controlling inflation in transition countries. The third section analyzes the choice of the right nominal anchor for successful inflation control by an independent central bank in transition economies. The fourth section presents the conclusion.

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## **The Relevance of Central Bank Independence for Inflation Control in Transition Economies**

The main problem with controlling inflation in transition economies is that during the transition process, inflation is more or less a fiscal phenomenon. This means that fiscal policy has some influence on monetary policy in that it can exert strong political pressure on the central bank. In the extreme, there is fiscal dominance. That is, inflation is determined by the dominance of fiscal policy over monetary policy [Sargent and Wallace, 1981]. The main argument here is that the central bank cannot influence the size of the government's budget deficit. Eventually, it is forced to finance the deficit by creating money (seignorage). This dominance of fiscal authority can supposedly be influenced by imposing independence on the central bank. However, the extent to which legal central bank independence is an adequate solution to this problem in transition economies is an open question.

### *The Existence of an Inflation Bias*

Today, central bank independence is usually favored and regarded as the optimal solution against the so-called inflation bias problem. The fundamental reason for an inflation bias is seen in the fact that policy makers operate in a discretionary regime. That is, monetary policy decisions are taken sequentially over time in a second-best world. Therefore, a socially desirable monetary policy may suffer from a lack of credibility caused by time inconsistency [Persson and Tabellini, 1997]. The consequence of the time inconsistency of the (*ex ante*) optimal but not enforceable monetary policy consists in realizing a credible policy that leads to a suboptimally high rate of inflation (inflation bias).

### *Resolving the Inflation Bias*

One possible way to deal with this credibility problem consists in removing all discretionary power from the government. However, studies on the employment motive for monetary expansion show that when stochastic shocks are taken into account, the optimal monetary policy does not conform to a simple rule but also includes an optimal shock absorption [King, 1996]. By following a simple rule, the government might be able to eliminate the inflation bias but would produce suboptimally high output fluctuations. On the other hand, statutory entrenchment of the optimal state-contingent rule appears to be extremely difficult because it is hard to imagine how all contingencies might be described *ex ante* and verified *ex post* [King, 1996]. What remains is the choice between simple rules, which are inflexible, and discretionary policies that display an inflation bias.

This trade-off between credibility and flexibility has led to a game-theoretic foundation of central bank independence. Here, two approaches can be differentiated: Rogoff's [1985] proposal to delegate monetary policy to an independent "conservative" central banker and the contracting or targeting approach [Walsh, 1995; Svensson, 1997]. It has been shown in many studies that by implementing one of these two forms of central bank independence, the inflation bias can be reduced if not eliminated.

This theoretical substantiation of central bank independence is supplemented by empirical evidences from many studies that have mostly investigated industrial economies<sup>1</sup>

and that see a "free lunch" in the existence of an independent central bank. On one hand, there is a significant and negative correlation between central bank independence and inflation. On the other hand, there is no significant correlation between central bank independence and real effects such as economic growth or output volatility.<sup>2</sup>

### *Lessons for the Transition Countries*

Against the background of the theoretical and empirical studies referred to above, which are mainly from the early 1990s, it is sometimes concluded that central bank independence is a general and sufficient requirement for controlling inflation. In fact, by 1996, all transition economies had created completely new central bank laws or reformed existing laws, sometimes even twice, that embodied substantially higher levels of independence than was the case in the prereform period. Additional reasons for this include:

- 1) transferring Western institutions made it easier for a transition country government or authority to build up a reputation and signal its competence to its own population;
- 2) central bank independence was viewed as a kind of entrance ticket to the international financial markets and to IMF credits; and
- 3) for transition economies wanting membership in the European Union, establishing central bank independence is an institutional precondition for this entrance.

However, apart from recent methodological objections with respect to the consistency of the various indicators for central bank independence, the robustness of the statistical associations, and causality [Kißmer and Wagner, 1999], the specific conditions in transition countries call for caution in following the above conclusion. Unless adequate institutional and strategic conditions are installed, such as those found in most industrial or developed countries but not yet in many transition countries, then implementing legal central bank independence may be ineffective if not counterproductive.

### *The Difference Between Legal and Actual Independence*

Measuring central bank independence for developed industrial countries is mainly based on the interpretation of central bank laws and, therefore, relates to legal independence only. Actual central bank independence, however, can differ from legal independence to a large extent. Even when the law is relatively explicit, factors such as tradition, personalities, and power may affect actual central bank independence. In addition, in spite of a wide legal independence from the government, there may in fact be political dependence on national parliaments if central bank laws can be amended, abrogated, or suspended by simple majorities.<sup>3</sup>

It should not be overestimated that some central banks in transition countries are considered even more statutorily independent than the Deutsche Bundesbank in some recent rankings [Cukierman et al., 1998; Healey and Levine, 1999]. It is actual independence that matters. A reasonably high legal independence of the central bank can be viewed as a useful first step for building up the institutional climate needed for actual independence. However, legal independence is merely a necessary but not sufficient condition for a truly independent central bank.

*The Danger of Ineffectiveness and Even Counterproductiveness*

There are enough signs indicating that legal independence of the central bank in transition countries, particularly in the Commonwealth of Independent States (CIS), is substantially less effective as a commitment to price stability than in industrialized economies. For example, Cukierman et al. [1998] show that inflation and legal independence are negatively related but only above a sufficiently high threshold level of sustained liberalization. As long as legal central bank independence is not anchored on institutional adjustments necessary for successful transformation to a (social) market economy, then establishing solely legal central bank independence may be meaningless or ineffective.

It may even be counterproductive if the government can shift blame for unpopular policies and responsibility for inflationary policies or outcomes onto the legally independent central bank. Since the central bank lacks actual independence, it may be powerless to prevent or restrict the inflationary course. This means that the government will probably try to pressure the central bankers to finance public goods, other investments, or election gifts by printing money and lending to state enterprises on noncommercial terms. Without a high standing or reputation, the central bank will be unable to resist this pressure over time and will be forced to capitulate. Government will have an incentive to shift responsibility for the inflation outcome of this seigniorage financing onto the central bank, which is easier if the central bank is legally independent.<sup>4</sup>

*Preconditions for the Effectiveness of Central Bank Independence in Transition Economies*

What lessons can be learned from this? One alternative reaction could be to renounce implementing central bank independence in such transition economies. However, there is no doubt that a reasonably high level of legal independence of the central bank in principal is a useful first step for building up the institutional climate needed for actual independence [Cukierman, 1998]. The problem, though, is how to overcome the gap between actual and legal independence, that is, between actual practice and the letter of the law. In other words, what institutional climate or environment must be installed to allow legal independence to become a good proxy for actual independence, hence, to become effective as a commitment to price stability? Wagner [1998] argues in more detail that it should include an adequate market infrastructure (including an effective legal framework), sound and competitive financial institutions, and macroeconomic stability. This, however, takes time. It also includes a new definition of the role of monetary policy itself, which implies main structural changes with respect to institutional, strategic, and instrumental aspects. Besides the transition to a two-tier banking system, which is the technical precondition for transition toward a market-oriented monetary policy, the banking system itself must be restructured. A main precondition for an efficient conduct of monetary policy is a well-functioning market-based banking system. It is not enough to commercialize specialized state-owned banks and assign them new tasks, letting a number of new private banks emerge as has been done in all transition countries. To enable commercial banks to function effectively under market conditions, practically the entire institutional and operational framework must be overhauled or changed. In many

CIS countries as well as some central and eastern European countries, the shortcomings in legislation, prudential norms and accounting frameworks, and a general lack of adequate supervisory capacity is still acute [Sundararajan et al., 1997; IMF, 1997; European Bank for Reconstruction and Development (EBRD), 1998].

In addition, many banks have accumulated significant amounts of nonperforming loans in the early years of transition. This bad loan problem, however, distorts credit allocation, thus impeding structural adjustment (see, for example, Begg [1996, p. 24]). In addition, it complicates the task of the central bank in fighting inflation and, simultaneously, in promoting the stability of the financial system by supervising banks and serving as lender of last resort. The bad loan problem may then weaken the credibility of a central bank's commitment to fight inflation even during financial instability crises.

Another important aspect is the transition to indirect instruments in monetary control. Indirect instruments such as reserve requirements, refinance or discount facilities, and government and central bank paper in open market operations are more flexible and promote competition and efficiency and depoliticize the allocation of credit to borrowers. Indirect instruments, however, are most effective only when certain institutional preconditions exist, which are usually not yet completely implemented in transition countries. These include an adequate market infrastructure (including an effective legal framework), sound and competitive financial institutions, and macroeconomic stability. Prematurely adopting and using indirect instruments in the transition process might have proved ineffective since it implies a risk of uncertain or perverse transmission and the dangers of adverse selection and moral hazard. This was probably the reason why several CIS countries still partly rely on direct instruments in monetary control [EBRD, 1998].

Implementing institutional requirements such as these can take several years. In many transition countries, particularly CIS countries, implementing these steps has not yet gone far enough, and there is still substantial need for reforms in this area [EBRD, 1998]. What should be done in such a situation? Renouncing the implementation of central bank independence is not the best strategy, as emphasized above, because a reasonably high level of legal independence of the central bank is a useful first step for building up the institutional climate needed for actual independence. However, actual independence is a necessary element of efficient inflation control in each country. Therefore, a better solution would be to look for additional institutional precautions that might alleviate the task of a legally independent central bank.

## **The Relevance of Choosing the Right Nominal Anchor**

### *The Role of Transparency and a Credible Nominal Anchor*

It has been argued that the main problem with controlling inflation in transition economies is that inflation is a fiscal phenomenon there. Institutional measures are needed to restrict the pressure of fiscal policy on the monetary authority. Imposing legal independence on the central bank is not enough. However, it would take many years to drastically change the mechanisms of both the political and the economic systems, which

would be needed for this. In the meantime, it is important to create transparency about the political responsibilities and the strategies of monetary and fiscal policies.

### *Transparency*

The role of transparency protects the central bank from an undermining of its authority through pressure from the government. For this purpose, transparency (transmitted by the public information media) is necessary regarding allocation of tasks and disclosure of the actual distribution of responsibilities and dependencies between individual government agencies. Otherwise, there is a danger that, in spite of legal independence, the central bank will come under increasing political pressure. In certain circumstances, it may even be forced to give in to this pressure, which would mean that the central bank's independence would only exist on paper. On the other hand, with transparency, the central bank can defend itself more easily against government pressure or patronage in that it attempts to win over the public as its allies.

However, transparency creates public interest and understanding for monetary policy and its legal responsibilities. Therefore, an opportunity is created to monitor this policy by means of greater visibility (through disclosure) of the central bank's strategic and operative procedures. This in itself forces the central bank to greater accountability before the public and, in the end, to a much stronger compliance with commitments. This will prevent the central bank from abusing its given authority or its decision-making independence.

### *Credible Nominal Anchor*

Transparency includes preannouncing nominal anchors. A preannounced nominal anchor serves to reduce the government's exertion of influence on monetary policy. A preannouncement means, in fact, a clear stipulation of a defined monetary policy target. This nominal target is supposed to help stimulate and coordinate the anti-inflationary forces in society around a specific numerical value, thus strengthening the commitment to disinflation or price stability. The preannouncement makes it less easy for the central bank (and the government) to alter or water down the target subsequently at its discretion from the aspect of other political targets (which is easier with a generally unspecified disinflation or price stability promise). The central bank can defend itself more easily because with transparent anchors, the government itself is constantly subject to public controls or the central bank can appeal to the public and even the courts (if the target is stipulated in a statute).

Transparency and a credible nominal anchor make it easier for a central bank to build up its reputation. In fact, this reputation can already be established through an adequate external institutional environment and a good record based on this (a good example is the Deutsche Bundesbank). However, this is not the case in countries with unstable political systems or insufficient institutional climates. If the market economy institutions are only imperfectly developed and the confidence of the citizens in their institutions is insufficiently developed, then a central bank can only gain credibility for its monetary policy course in the light of transparency and with the protection of a nominal anchor.<sup>5</sup> Here, just any anchor is not sufficient. It must be a suitable anchor because the credibility of the promise that a monetary policy target will be achieved can only be developed on

the expectancy that this anchor is realizable and efficient. For this reason, it is necessary to take a closer look at choosing the right anchor in transition countries.

### *Which Nominal Anchor?*

There are various options a country can choose from when selecting a nominal anchor. The best-known alternatives, and those already practiced by various transition countries, are monetary targeting, inflation targeting, and exchange rate targeting.

### *Monetary Targeting*

Despite some apparent successes with money-based stabilization (in countries as diverse as Albania, Croatia, Slovenia, Latvia, and Lithuania), most economists doubt the adequacy of monetary targeting in transition countries. These doubts are mainly based on two arguments:

- 1) the inevitable instability of money demand during transition (particularly as a result of the ongoing processes of financial market deregulation and financial innovations in transition countries as well as common dollarization); and
- 2) the possibility of the exchange rate overshooting during money-based stabilization. Moreover, given that transparency and credibility are the most important conditions for the success of any stabilization program [Bruno, 1993], money-based stabilizations do not provide good chances for rapid disinflation. Targets for the net domestic assets and the money stock suffer under a lack of transparency because monetary targets, even if published, do not provide an easily understood message to the public about what monetary authorities intend to do and which inflation outcome can be expected. In particular, base targeting is less visible than either an exchange rate target or an inflation target. Therefore, its effect on inflationary expectations is limited. On the other hand, controllability is likely to be smaller the wider the monetary stock that is being targeted. Furthermore, restrictive monetary targets usually cause high costs [Calvo and Végh, 1992] as shown by related experience from developing countries [Sahay and Végh, 1995].

### *Inflation Targeting*

Inflation targeting has become known as a new monetary policy strategy that, in one form or another, was adopted in the first half of the 1990s by several industrial countries such as New Zealand, Canada, United Kingdom, Sweden, Finland, Australia, and Spain. The most important characteristic of inflation targeting is the public announcement of an official quantitative (low) inflation target over a specified time horizon and the primacy of this inflation target, based on the hypothesis that monetary policy has no enduring real effects but only affects the price level and the inflation rate in the long term. An inflation-targeting central bank uses its internal conditional inflation forecast as an intermediate target and as an indicator variable, and sets its instruments so that deviations in its conditional inflation forecast from the inflation target are eliminated or diminished.

Inflation targeting is expected to provide a nominal anchor for monetary policy and inflation expectations (supported by good visibility and the allegedly easy controllability of both inflation targets and the inflation forecast). Furthermore, inflation targeting is supposed to increase the transparency of the policy procedure and the accountability of monetary authorities. So far, inflation targeting seems to be a suitable solution to the

problem of controlling inflation with an independent central bank in transition economies. Therefore, some transition countries such as the Czech Republic and Poland have recently decided to adopt this new framework for monetary policy [Čihák and Holub 1998; National Bank of Poland, 1998].

However, the most important objection against inflation targeting for transition countries lies in the specific problem of implementation. In general, it seems to make sense to consider the adoption of inflation targeting only if the following institutional requirements [Masson et al., 1997] are satisfied:

- 1) the central bank must be capable of conducting an independent monetary policy. That is, a country should not show any symptoms of fiscal dominance. As argued, this is not the case in the present transition countries, that is, at their present stages of development or transition;
- 2) the central bank must have a clear inflation target precept and must not be committed to simultaneously maintaining the nominal exchange rate at any prespecified level or range; and
- 3) the monetary authorities must possess the technical and institutional capacity to model and forecast domestic inflation. Moreover, they need some knowledge or estimate of the time lags and the transmission mechanism of monetary policy. It is doubtful whether the infrastructural conditions for this are available in all industrial or developed countries or even in the present inflation-targeting countries [Almeida and Goodhart, 1998]. It is even more doubtful that they are already in place in the present transition countries of central and eastern Europe.

### *Exchange Rate Targeting*

If monetary targeting and inflation targeting are seemingly not appropriate for (most) transition countries, then they are left with the alternative choice of some kind of exchange rate targeting. Exchange rate pegging is usually practiced in small, relatively open economies. It is also used during and following the stabilization of inflation when credibility is relatively low. The respective countries often peg to the currency of a major trading partner, provided this currency is relatively stable.

The announcement of a nominal exchange rate target for the domestic currency is expected to provide the private sector with very transparent information about the future inflation rate, at least in the short run [Agenor, 1993]. It reflects a strong commitment to macroeconomic stabilization since it can be controlled by the public daily and without any delay. Moreover, fixed exchange rates are expected to exert a disciplinary effect on both monetary and fiscal policies [Obstfeld, 1985]. So far, exchange rate pegging appears to be a reasonable choice for a nominal anchor of monetary policy in transition economies.

Theory and evidence, however, indicate that exchange rate pegging tends to create increasingly undesirable effects as transition goes on [Begg, 1996]. During the later stages of transition, productivity growth and emerging investment opportunities render adherence to a narrow exchange rate target that is not only inappropriate but also unsustainable. A powerful argument against the credibility and sustainability of fixed exchange rate systems is the fact that structural changes in an economy require real



exchange rate changes. In other words, robust regimes require more exchange rate flexibility.

The most plausible solution to this problem seems to be crawling exchange rate bands. As a dynamic version of exchange rate pegging, these had become popular during the 1980s and 1990s in moderate-inflation middle-income countries such as Chile, Colombia, Israel, and Mexico, as well as in some transition countries such as Hungary, Poland, and Russia. These countries, especially those opting for a forward-looking, crawling parity, are trying to combine some nominal anchoring with sufficient flexibility to rule out enduring appreciation of the real exchange rate. If disinflation and structural adjustment continue, the rate of announced crawl is intended to be reduced.

Note that the band width should not be too narrow because uncertainties remain high, the scope for fiscal responses to shocks is usually small, and capital inflows may happen. Those countries having adopted crawling bands have typically chosen to widen the band over time partly in response to such pressures. In addition, a band requires efforts to defend its edges. This may evoke sterilization, changes in interest rates (by changes in fiscal policy or unsterilized intervention), or tightening of controls on capital flows. Though bands must be supported by appropriate fiscal policies, reliance cannot be placed on fiscal policy changes being quick enough. Inconsistencies between announced bands and fiscal stance, however, are likely to induce exchange market crises.

## Conclusion

This paper has argued that controlling inflation in transition economies is a very complex task that cannot be solved by merely imposing legal independence on the central bank. The main problem is that as long as central bank independence is only legal, that is, existing only on paper, there is a danger that it will not only be ineffective but even counterproductive. Legal central bank independence may be used as a cover for a fiscal authority, which tends to dominate.

An independent central bank can only be successful in controlling inflation in a transition economy if it keeps its strategy, responsibilities, and restrictions transparent to the public and announces beforehand a nominal anchor that is transparent and credible (that is, realizable and effective). Monetary targeting and inflation targeting are shown to imply significant problems in transition economies. Therefore, transition economies are left with the alternative of some kind of exchange rate pegging (in the later stages of transition, preferably in the form of exchange rate bands) with all the above-mentioned inadequacies.

## Footnotes

1. There are also several studies on the macroeconomic effects of central bank independence on developing countries. They conclude that there is no correlation between legal measures of central bank independence and inflation. However, alternative indices of actual central bank independence used in these studies are rather controversial [Kißmer and Wagner, 1998].

2. For a survey of these studies see, for example, Eijffinger and De Haan [1996] or Kißmer and Wagner [1998].
3. See Cukierman [1998] and regarding the Baltic countries, see Äimä [1998].
4. The game-theoretic basis of this argumentation is worked out in Wagner [1999].
5. See also Cottarelli and Giannini [1998] who emphasize the credibility-increasing role of IMF programs.

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