

**Fixity of Exchange Rates and Efficiency of Monetary Policy in the European
Transition Economics. The Experience of the late 1990's**

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Introduction

With the beginning of the decade of the 1990's, the transition economies, among other things, had to choose the "appropriate" exchange rate regime which would be consistent with the other components of their general economic policy framework. Given the importance of the exchange rate for the efficiency of economic policy, consistency is of critical importance. Firm commitment to the exchange rate regime provides the basis for foreigners to form reliable expectations about the response of government economic policy to changing conditions. Unexpected shifts or adjustments to accommodate specific economic situations that may arise especially in an environment of economic uncertainty are likely to undermine the credibility of economic policies and their effectiveness.

On the other hand, the choice and adherence to an exchange rate regime acts in many ways as a constraint to the conduct of economic policy. In this sense, there is a price to be paid for the maintenance of a specific exchange rate regime without deviations. The price takes usually the form of a sacrifice by policy makers in their efforts to attain other objectives. This alternative cost is especially high in the case of commitment by the government to retain a pegged exchange rate. To do so it will have to adjust its fiscal and monetary policy to this end. In fact, consistently pegged exchange rates have very little room for monetary policy to pursue other objectives while at the same time impose discipline on fiscal authorities.

In the final analysis, the problem faced is one of frequency and extent of movements of the exchange rates. The spectrum of choice ranges between the extreme cases of irrevocably fixed exchange rates in the case of a currency union with a common central bank and a "pure" float with no intervention. The latter remains a purely theoretical case that might appeal only to the large industrial countries. In

between the two extremes we have regimes of different degrees of fixity and/or variability despite the fact that in the literature the discussion is carried on in terms of fixing and floating in general.

Fixity includes the three variations of a) **currency board** (very firm commitment to fixity of the value of domestic money to that of foreign currency and strict relationship between the domestic monetary base and foreign exchange reserves). b) **adjustable peg** (with variations on the degree of exchange rate stability as determined by the bands of fluctuation and the frequency and size of adjustments of the central rates) and c) **crawling peg with fluctuation bands** (where the possibility of change in the rate of crawl allows potentially greater variation and less fixity).

Floating refers to different degrees of flexibility of parities depending on the degree of intervention. A **managed float** with heavy intervention could prove more rigid than a "loose" adjustable peg. The intervention points, if predetermined and adhered to, could be viewed as equivalent to the bands of the adjustable peg.

In recent years, with the increase in capital mobility and the globalization of economic life, we have observed a shift by many countries from fixed to more flexible exchange rate regimes in order to defend the competitiveness of their economies and protect them from domestic and foreign shocks. Transition economies, for the most part, due to their inflation vulnerability have insisted on fixity of their exchange rates throughout the 90's. Pegged exchange rates are usually associated with lower inflation and imply a deliberate or de facto tightening of monetary policy since money supply is treated as an endogenous variable.

This paper examines the above proposition for the case of the European transition economies in the light of their experience in the 1990's. The findings of the paper point to the fact that fixed exchange rate regimes did not operate as an effective shield of protection from currency strains and "transformational" recessions. Nominal interest rates, as the only policy instrument of central banks, could not do both jobs i.e. support the target exchange rate and regulate economic activity. With money supply treated as an endogenous variable, fixity of exchange rates led to deliberate or

de facto tightening of monetary policy. The end result in many cases was "overshooting" in the increase of real interest rates and appreciation of real exchange rates. These developments led to economic policy dilemmas in view of the "accession (to EU) syndrome" prevailing in the transition economies of Europe.

The Rationale for Choosing Exchange Rate Regimes

The literature of the factors influencing the choice of exchange rate regime by an economy is extensive [eg. Eichengreen et al. (1999), Isard (1995), Mussa et al. (1954), Frenkel et al. (1991), Argy (1990), Genberg (1989), Wicklam (1985)]. The starting point is that the choice of regime varies with the size, stage of development and the structural characteristics of the internal and external sector of an economy. Furthermore, although the choice of regime must be based on long run considerations, if circumstances change or the general environment of the international economy is altered, a change in the regime may become imperative.

This last point finds an application in the significant shift we have observed in recent years from currency pegs to more flexible exchange rate schemes. This shift has occurred in many areas of the world and refers to a large number of developing countries. It is estimated (IMF, 1997) that forty percent of the developing countries have changed from some type of pegged exchange rate to a flexible regime. In the late 90's less than 50 percent of the developing world were in fixed regimes. These countries represent less than 20 percent of the developing world's foreign trade. It must be mentioned, however, that the type of managed flow practiced by many developing economies is somewhat unique in that, unofficially, there is an exchange rate that serves as a reference point, or target in their exchange rate policy.

In looking for the changes in the international environment that led to this shift, one has to start with globalization and openness which led to the pressure for market determined exchange rates. The increased capital mobility has created shock-prone open developing economies that have been forced to adopt more flexible exchange rate regimes.

Inevitably, economic stabilization surfaces as one of the main criteria for the choice of foreign exchange regime. It makes sense that stabilization of economic performance and balanced growth of the relevant macroeconomic variables are basic considerations in the choice of exchange rate regime. Obviously, the structural characteristics of the economy is of critical importance. If the economy is prone to inflation predominantly due to monetary disturbances domestically, fixity of the exchange rate is supposedly to be preferred. Instead, flexible exchange rates are preferred to cope with shocks, domestic or foreign, in the real sector of the economy that affect competitiveness (R. Flood, 1989).

Until recently, fixed exchange rates were associated with lower inflation on account of the discipline imposed by the pegged regime on policy matters. To begin with, pegging the exchange rate to a low inflation currency limits the possibility of active of "aggressive" monetary policy since the latter is subordinated to the requirements of the peg and the money supply is treated as an endogenous variable. The target is the nominal exchange rate and the lending rate is the main policy tool of the central bank. In this sense, nominal interest rates act as a second anchor which supports the pegged exchange rate. This limits the possibility to use "loose" monetary policy to finance fiscal deficits.

Expansionary fiscal policy is also restricted when the exchange rate is used as a nominal anchor. In general, exchange-rate-based stabilization programs rely on disciplined fiscal policies. Expansionary fiscal policies and large budget deficits run high risks to cause reserves losses and put strain on the exchange rate. To avoid shifting fiscal imbalances in the future through accumulation of external debt, budget deficits are expected to be financed with the sale of bonds which in turn affects the rate of interest and eventually the exchange rate. This implies restrain from spending increases by the policy makers.

The performance of exchange-rate-based stabilization programs of developing economies in recent years does not support the view that the fixed exchange rate regime secures discipline in economic policy. Fiscal policy in particular, in many cases, gets the blame rather than the credit about the outcome. In fact this raises the very question about the credibility of pegged of fixed exchange rate regimes.

As mentioned, pegging to a low inflation currency is expected to bring inflation down through the restraint in government spending. Also, the external sector is expected to have stabilization effects through the lower price increases of traded goods. To the extent that fiscal authorities are committed to a fiscal stabilization program that adheres to the exchange rate nominal anchor, whether rigidly fixed or adjustable, credibility may be achieved. For this to happen the market must believe that the fixed rate will be maintained. Positive expectations about the restraint of inflation provide the basis for credibility.

Credibility may be shaken, however, despite the good intentions of the agents of economic policy. A potentially virtuous (long term stabilization) cycle, that could come about as the result of positive expectations about inflation, could turn into a vicious one with inflation and adjustment of pegs following each other. Thus, instability may start at the external sector of the economy where many countries with fixed exchange rates have experienced loss of competitiveness in the last two decades. Fixed nominal exchange rates and higher domestic inflation, due to higher unit labor costs, would lead to real appreciation of the currency over time. The resulting price-increase differentials of the non-trade goods section of the economy would lead to the shift of consumption expenditures to imported goods causing deterioration in the current account. In the first stages the deficits due to this "real appreciation syndrome" could be financed from capital inflows from abroad that would respond to the higher real interests and the positive expectations of low inflation. Now, to the extent that productivity growth domestically is not high enough to offset the negative effects of real appreciation, capital inflow will be reversed and eventually the peg will be abandoned. The structural idiosyncrasies of each country as well as the degree of openness of the economy will determine for how long the economy will resist going into depreciation of its currency (M. Klein 1994).

It is possible that the monetary authorities of a country that goes through this strain may deliberately choose to resist adjustment by allowing losses of international reserves. This would amount to postponement of adjustment with additional costs if productivity improvements do not materialize in the meantime. Of course, with

"shaken" expectations of the foreign capitalists, the postponement is expected to be short lived.

In a case like this the inevitable question arises whether credibility is on the side of flexible exchange rates where no delays in adjustments are allowed by the market mechanism. In the long run, under these circumstances, the cost of the "built-in" pegged-rate stabilization is contrasted to the efficiency secured by flexibility in the exchange rate regime. It is in this sense that credibility of fixity is contrasted to the virtues of flexibility in the long run.

Finally, the historical record on inflation experienced by countries in the "pegged" and "flexible" categories shows convergence with the passing of time (IMF, 1977). While in the more distant past inflation in fixed regimes was considerably higher than in countries with flexible exchange rates, in recent years this difference has been narrowed considerably (IMF 1997).

European Transition Economies: The Record of Performance in Recent Years

The traumatic experience of the transition economies of Europe belongs to the past. Since the beginning of the second half on the 1990's the picture has unproved considerably. The leading reformers in particular –The Chech Republic, Estonia, Hungary, Poland, Slovenia- have already shifted the emphasis in their economic policy to fine tuning matters. The other European transition economies –Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic, -although further behind in their transition process, are facing similar economic policy challenges in their efforts to cope with problems of stagflation and disequilibria in their external sectors.

In the late 1990's some of the transition economies of Eastern Europe and the Baltic countries were faced with a slowdown in the downward trend of inflation and in the upward trend of growth. The problem of lower to negative growth rates of these economies seems to be of a lasting nature for some economies and goes beyond the Russian crisis as its main cause. But even for the advanced and dynamically growing transition economies, which by mid-1999 started to exit this recession, the experience

of the last years showed that the fragility of these economies is still a matter of concern.

Table 1
Transition Economies : GDP Growth Rates, Unemployment

	GDP (growth rates), 1996-99				Unemployment Rate, 1996-99			
	1996	1997	1998	1999	1996	1997	1998	1999
Eastern Europe								
Bulgaria	-10.1	-6.9	3.0	1.5	12.5	13.7	12.2	12.8
Croatia	6.0	6.5	2.7	1.5-2	15.9	17.6	18.6	18.9
Czech Republic	3.9	1.0	-2.7	-0.8	3.5	5.2	7.5	8.4
Hungary	1.3	4.6	5.1	4.5	10.5	10.4	9.1	9.4
Poland	6.0	6.9	4.8	4.0	13.2	10.3	10.4	11.6
Romania	3.9	-6.9	-7.3	-4.8	6.6	8.8	10.3	11.3
Slovakia	6.6	6.5	4.4	3.0	12.8	12.5	15.6	17.7
Slovenia	3.5	4.6	3.9	4.0	14.4	14.8	14.6	13.4
Baltic States								
Estonia	3.9	10.6	4.0	2.5	5.6	4.6	5.1	6.7
Latvia	3.3	8.6	3.6	2.0	7.2	6.7	9.2	10.0
Lithuania	4.7	7.3	5.1	4.0	6.2	6.7	6.9	7.5

Source: U. Nations, *Economic Survey of Europe*, 1999. No. 1,3

Table 2
ECE Transition Economies : Inflation (per cent change) 1996-99

	1996	1997	1998	1999
Eastern Europe				
Bulgaria	311.1	578.7	0.9	-3.2
Croatia	3.5	4.0	5.6	3.9
Czech Republic	8.7	9.9	6.7	2.2
Hungary	20.0	18.4	10.4	9.1
Poland	18.7	13.2	8.5	6.3
Romania	56.8	151.7	40.7	48.1
Slovakia	5.5	6.5	5.5	7.1
Slovenia	9.0	8.8	6.6	4.3
Baltic States				
Estonia	15.0	12.3	6.8	6.7
Latvia	13.2	7.0	2.8	10.0
Lithuania	13.1	8.5	2.4	7.5

Source: U. Nations, *Economic Survey of Europe*, 1999 Nos. 1, 3

The reversal in the overall trends of economic growth in the European transition economies is reflected in the statistics of Tables 1,2. Disinflation in most countries during 1999 continued in a rapid pace. At the same time, however, industrial output growth decelerated rapidly with negative repercussions on economic activity across the board. The external sectors of the transition economies, for the most part, experienced growing imbalances with substantial declines in both the volume and value of exports (U. Nations 1999).

The global financial turmoil in 1998 and especially the Russian crisis led to financial turbulence in many transition economies with continuing weakening of their currencies. In several cases the crises led to sizeable depreciations of exchange rates causing reemergence of inflationary pressures.

Economic Policy Dilemmas in The European Transition Economies

The recession of 1998-99 showed clearly that, in the current state of transition, the issue of economic policy surfaces as the number one challenge for both the leading reform countries and the ones that lag behind. To be sure, after a decade of transformational work there are institutional and structural disparities between the two groups as well as within each group. Also, it seems that, despite the remarkable progress in regime changes during the first five years of transformation, both groups have a long way to go before they reach the level of market maturity suggested by their macroeconomic statistics.

In this phase of transformation, the European transition economies, having implemented the main regime changes, albeit with different degrees of success, seem very eager to pursue the type of modern economic policy that applies to western market economies. Macroeconomic policy-mix and coordination of fiscal and monetary policies to pursue balanced growth and stabilization seems to be the target of economic policy makers in all countries. Despite the fact that country specific structural idiosyncrasies of the different economies suggest variations in macroeconomic policy measures, the experience of the last years suggests common priorities both in terms of goals and policy measures. Thus, the disinflationary bias of

economic policies continued to be the main objective throughout the second half of the 1990's. It turns out that performance in the last two years surpassed expectations inflation-wise. To a large extent favorable external factors are responsible for it. In particular, the considerable fall in world commodity prices was of decisive importance for the acceleration of deflation in most transition countries.

In terms of policy approach the prevailing transformation paradigm was one that relied very heavily on monetary policy for sustained macroeconomic stabilization. Macroeconomics stabilization of a lasting nature required, according to this paradigm, strict monetary policy. This choice of approach was expected to go hand in hand with rapid liberalization so that the market mechanism would come into the picture early enough for the economy to soon pass into the stage of high and self-sustained economic growth.

A reform agenda that relies so heavily on monetary policy and condemns fiscal polity to permanent atrophy, at least during this transformation phase, requires a relatively sound institutional infrastructure and an efficient banking sector. With a few exemptions, this requirement seems to be lacking and in most economies fragility of the markets and imperfections interfere with the smooth operation of this paradigm.

The Role of Exchange Rate Regime in Transition Economies

The role played by the exchange rate regime is obviously of crucial importance. For the most part, transition economies up to the year 2000, relied on fixity of exchange rates (see Table A-1 in the Appendix) albeit of different degrees. Even in the few cases of managed float, however, unofficially there were nominal exchange rate targets that surface as important macroeconomic variables in the process of monetary policy. As we saw in the first part, in fixed or pegged exchange rate regimes money supply is, for all practical purposes, an endogenous variable. Exchange rate anchors to pursue stabilization policies by central banks interfere with the independence of monetary policy. In the extreme cases of currency boards, the independence of monetary policy is in effect non-existent.

With fixed or pegged exchange rates, the central bank, as a lender or last resort, uses the lending rate as its own policy tool. However, this is the only tool in the hands of monetary authorities to pursue more than one goals. One such important goal is to retain the targeted level of the exchange rate. At the same time monetary policy is expected to accommodate capital flows in the external sector according to the needs of the economy. A policy conflict may arise, therefore, in the event of capital outflows due to external or internal causes. In such a case high interest rates, to serve the needs of the external sector, may not be what the economy needs internally.

The Russian and the Asian crises showed that the fixed exchange rate regime did not operate as a shield of protection from currency strains for the transition economies. With the exception of Hungary and Poland the transition economies experienced major turbulences in their external sectors with losses of reserves and other financial disturbances due to exchange rate volatility. Interestingly enough, Slovenia and Croatia were affected the least. Thanks to direct capital controls and consistent macroeconomic policies their managed float exchange regime "held up" quite well. Romania and Slovacia were affected the most. Romania's currency weakened while Slovacia abandoned the fixed exchange rate regime and floated the Koruna in Oct 1998.

The main monetary policy instrument of the transition countries with fixed exchange rates was the lending interest rate which served as nominal anchor for macroeconomic stability. Nominal interest rates were called upon to play the dual role to support the target exchange rate and regulate economic activity. The decrease of foreign demand in 1998 which was creating contractionary effects on aggregate spendings called for a "loose" monetary policy with lower nominal interest rates.

It is on account of this conflict in policy targets that nominal interest rates saw a great deal of fluctuation throughout 1998 and 1999. In the second half of 1998 monetary policy became less restrictive in some countries in order to face the slowdown of economic activity. In the more advanced countries (Poland, Hungary, the Chech Republic) and Croatia the net change in the lending nominal interest is negative. Bulgaria experienced a spectacular decline in interest rates following the introduction of the currency board in July 1998. The rest of the European transition

economies experienced higher nominal interest rates due to tightening of their monetary policies.

Table 3
Changes in Real Lending Rate in Selected Transition Economies (1996-98)
 (year averages. ↑: increase, ↓: decrease)

Country	1996	1997	1998
Croatia	↓	↑	↓
Czech Republic	↔	↓	↑
Estonia	↓	↑	↑
Hungary	↓	↑	↑
Latvia	↔	↓	↑
Lithuania	↔	↑	↑
Poland	↓	↑	↑
Slovakia	↓	↑	↑
Slovenia	↓	↑	↓

Source: United Nations, *Economic Survey for Europe*, 1999

It seems that, in the final analysis, the anti-inflationist sentiment continued to prevail in most all transition European economies in 1998-99. Although world market prices of internationally traded goods were declining, in nominal terms, the external disturbances due to the financial crises became an issue of overriding importance that accounted for the tightening of monetary policies, through the raising of **real** interest rates. Higher interest rates were deemed necessary to raise the yields of local assets in order to offset the higher risk premium.

As shown in Table 3, monetary austerity during 1998 led to increases of the real interest rates in all transition countries except Croatia and Slovenia, two countries with managed float regimes. For some countries this de facto increase in real interest rates was the outcome of an inefficient monetary policy due to the lack of adequate means of intervention. As mentioned earlier, this problem is more likely to be faced

by fixed regime countries that rely on interest rates to accommodate both foreign exchange targeting and the outflow of capital. Under these circumstances, and in view of the decreases in the relative prices of internationally traded goods, there was a high interest policy bias with initial "overshootings" in the levels of real interest rates and subsequent "ratchet" effects in their downward adjustment which was deemed necessary following the slow down in price increases during the second part of 1998.

Exchange Rates and Competitiveness in the European Transition Economies.

Current Account deficits in most European Transition Economies, as percentage of GDP's increased in 1998-99. Country specific causes of imbalances may differ. A common trait was the fast expansion of imports of business services which led to negative balances of invisibles.

In most cases the capital account was relied upon to, partially at least, offset current account negative balances. As mentioned above, high real interest rates are responsible for the increase in the inflow of capital which took place in the second part of 1998.

Table 4
Current Account Balances in Transition Economies
(per cent of GDP)

	1996	1997	1998	1999
Eastern Europe				
Bulgaria	0.2	4.2	-3.1	-9.4
Croatia	-4.3	-12.1	-7.3	-10.6
Czech Republic	-7.6	-6.2	-1.5	-0.9
Hungary	-3.7	-2.1	-4.8	-5.2
Poland	-0.9	-3.0	-4.3	-6.9
Romania	-7.3	-6.7	-6.9	-5.6
Slovakia	-11.2	-6.9	-11.3	-7.9
Baltic States				
Estonia	-9.7	-12.0	-9.7	-5.5
Latvia	-5.4	-6.2	-9.7	-9.3
Lithuania	-9.2	-10.2	-13.0	-12.1

Source: United Nation, *Economic Survey of Europe*, 1999, No 1

Table 5
Real Exchange Rates for European Transition Economies 1995-98
[Based on Unit Labor Cost. Against the Dollar]
(1993=100)

	1995	1996	1997	1998
Eastern Europe				
Bulgaria	125	100	170	170
Croatia	125	140	150	140
Czech Republic	125	160	150	195
Hungary	85	90	100	90
Poland	110	118	125	130
Romania	95	80	145	160
Slovakia	115	130	150	135
Slovenia	110	120	125	130
Baltic States				
Estonia	210	235	260	320
Latvia	170	200	210	250
Lithuania	160	195	250	250

Πηγή: United Nations, *Economic Survey of Europe*, 1999 No 1.

Of more importance in the present context is the question of evolution of competitiveness in the transition economies of Europe. The answer to this question can be approximated with the help of the real exchange rates (RER) that prevailed in the second half of the 1990s. The RER in Table 5 are based on relative unit labor costs in industry (ratio of domestic unit labor costs in dollars and unit labor costs in the USA). Although there was some deceleration over time, wage growth in most transition economies remained high. This increase has caused cost inflation to increase at a higher rate than consumer prices. The implication is that in the transition economies, especially the Baltic countries, the inflationary pressure is to a large extent

of domestic nature which makes it all the more difficult to fight as it is related to structural problems. This is consistent with the fact that reducing inflation further to one digit annual rate has proved a difficult task even for the more developed transition economies.

Now, a persistent anti-inflationary policy could accentuate the divergence between nominal and real exchange rates in a fixed exchange rate regime. As we saw, interest rates, as the only policy instrument in the hands of the central bank, is used to attract foreign capital in the context of supporting fixed or pegged exchange rates. This, de facto, tight monetary policy results in high real interest rates to begin with. Furthermore, with higher prices, prevailing in the domestic sector due to higher production costs (and higher relative labor unit costs) the real effective exchange rate is appreciated. The subsequent result is loss of competitiveness and negative balances in the current accounts.

The above analysis suggests that the ill-effects on the level of economic activity and the external sector in a fixed or pegged rate regime can be traced back to monetary austerity. Now, given the difficulty to eradicate single digit but relatively high cost inflation, which is usually attributed to transition-related structural weaknesses of these economies, one can see the possibility for a transition economy to be trapped in a stagflationary vicious circle. Managed float exchange rate regimes ought to be in a better position to avoid such negative developments if they do not practice adherence to an unofficially set exchange rate. In such a case there is a de facto understanding of the range of exchange rate movement. If under the managed float regime extensive exchange market intervention aims at a tight relationship between domestic money and a foreign currency over long periods of time then, de facto, this system resembles a rigid official peg with narrow bands.

It would seem that in the case of the European transition economies, whether more or less advanced, the exchange rate regime although nominally may imply different degrees of flexibility in reality do not differ much. For the most part the chosen exchange rate regimes as practiced, do not leave enough room for the market mechanism to determine the competitiveness of the economies in a manner that efficiency in the external sector will prevail.

In essence, then, there seems to be more uniformity in the development strategies of the transition economies in Europe as far as priorities of goals and processes followed for their achievement. The tightness of monetary policies and fixity of exchange rate to achieve economic stabilization, are common features of this process of transition from centrally planned economic activity to liberalized market economies and eventually to accession in the European Union. One wonders if it is the "accession syndrome" that leads to a uniformity of processes, albeit not free of policy dilemmas.

APPENDIX

TABLE A-1

Exchange Rates in the Transition Countries of Eastern Europe and the Baltic States, 1993-1998.

(Annual Average National Currency Units per Dollar)

Country	Unit	Exchange Rate Regime	1995	1996	1997	1998
Eastern Europe						
Croatia	Kuna	Managed float	5,2	5,4	6,1	6,4
Czech Republic	Koruna	Managed float	26,5	27,1	31,7	32,9
Hungary	Forint	Crawling peg	125,7	152,6	186,4	214,4
Poland	Zloty	Crawling peg	2,4	2,7	3,3	3,5
Romania	Leu		2033,0	3086,0	7183,0	8876,0
Slovakia	Koruna	Fixed with band	29,7	30,7	33,6	35,1
Slovenia	Tolar	Managed float	118,5	135,4	159,7	166,1
Baltic States						
Estonia	Kroon	Currency board	11,5	12,0	13,9	10,0
Latvia	Lats	Fixed	0,53	0,55	0,58	0,59
Lithuania	Litas	Currency board	4,0	4,0	4,0	4,0

Sources : *Economic Survey of Europe*, United Nations, 1999.

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