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IDEOLOGY, POWER AND THE RISE OF INDEPENDENT MONETARY INSTITUTIONS IN EMERGING ECONOMIES

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Ilene Grabel*
Associate Professor of International Finance
Graduate School of International Studies
University of Denver; Denver, CO 80208, USA
Office: 303/871-2546; Home: 303/331-8003
FAX: 303/871-2456; Internet: igrabel@du.edu

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1. INTRODUCTION[1]

The last quarter of the twentieth century will undoubtedly be regarded as an era of fundamental economic revolution—a revolution in which diverse economies in the South and East underwent a radical transformation toward a neoliberal form of capitalism. Like similar revolutions in the past [Polanyi 1944], this "great transformation" is the product of political contest and ideological struggle rather than the unfolding of some natural historical process. Providing theoretical justification for this transformation in emerging economies stands new-classical economic theory.[2] In particular, the new-classical theory of "policy credibility" has come to cement the case for the desirability and indeed inevitability of economic reconstruction along neoliberal lines. The concept of policy credibility is central to the broader task of elevating the market as the principal means of directing economic affairs and the effort to place severe constraints on state manipulation of economic policy toward particularist aims.

The movement to insulate the market and the policy-making process from politics is particularly pronounced in the realm of monetary reform in emerging economies. This effort to 'depoliticize' policy is reflected in the creation of independent central banks and currency boards that are beyond the reach of state representatives. However, the paper will argue that these institutional reforms necessarily fail on their own terms. Stated plainly: the effort to depoliticize financial policy via the creation of independent central banks and currency boards is ineluctably political.

The paper will argue that creation of independent institutions of monetary and exchange

[1] A number of the arguments presented here are developed in Grabel [2000], which explores the role of new-classical macroeconomics in providing intellectual justification for numerous facets of neoliberal economic reform in emerging economies (e.g., privatization, structural adjustment, financial reform).
[2] Two terms deserve clarification. The term "new-classical economic theory" refers to the extension of neoclassical (or orthodox economic) theory that emerged in the 1970s and 80s. It combines the "rational expectations" hypothesis with a presumption of instantaneous market adjustment. The term "neoliberal economic policies" refers to the free-market economic policies that derive from new-classical theory.

rate policy stems from the widespread acceptance of the theory of policy credibility within the academic and policy community. Motivated by the incorporation of rational expectations into new-classical economic theory, the credibility criterion contends that the policies implemented by representative policy-making institutions will ultimately fail because rational economic actors will expect these policies to collapse or be reversed. This is because politicized institutions are prone to implement monetary and exchange rate policies that are time inconsistent, inflationary, and/or at odds with the fiscal policies pursued by elected governments. New-classical theory offers a singular solution to these problems: politically insulated technocrats must be charged with the task of financial policy design and implementation. Within a politically insulated setting, technocrats are able to apply economic science in order to chart the uniquely appropriate course for the nation's monetary and exchange rate policy.

The paper will demonstrate that the theory of policy credibility promotes the creation of independent institutions of monetary and exchange rate policy. I will argue that the theory has powerful ideological aspects. First, the theory is elevated to the status of singular truth; as a consequence, its institutional corequisites are taken to be uniquely viable and efficacious. But despite its scientific pretensions, the theory and the policies inspired by it are fundamentally untestable and irrefutable ex-post. They demand to be taken on faith, and at present, they are getting their way.

Second, the theory of credibility obscures the particular interests served by the institutions and policies it recommends. It regards these simply as serving the public good. It therefore suppresses an examination of contestation among opposing interests in society and the role of power in securing the design of monetary institutions and policy. In this connection, the paper argues that new classicals treat a policy's viability as the consequence of the

epistemological status of the theory that generates it rather than as the outcome of endogenous social and political factors (such as political and economic power and class conflict).

At the broadest level, the paper demonstrates that the rhetoric of economic theory critically understates and indeed obscures the underlying politics of monetary reform. Along with other contributions to this volume, the paper argues that choices about institutional innovations are informed as much—and indeed more--by politics than by the uncontestable logic of economic science [see also Cohen, 1998; Kirshner, 2000]. In accordance with this perspective, the paper argues that monetary systems in emerging economies have been profoundly transformed by acceptance of the ideological aspects of the new-classical theory of policy credibility, and by the exercise of political and economic power by influential actors.

The paper first surveys the institutional terrain of central banks and currency boards in emerging economies. The paper next describes the manner in which advocates of these institutional forms defend them by invoking the new-classical theory of policy credibility. The paper then contrasts this new-classical explanation with an analytically more nuanced explanation focusing on the role of ideology and economic and political power. The paper concludes with some speculations on the likely significance of the ideology of new-classical economics and the power of vested interests in shaping monetary reform in emerging economies in the decades ahead.

2. THE INSTITUTIONAL TERRAIN: INDEPENDENT CENTRAL BANKS AND CURRENCY BOARDS IN EMERGING ECONOMIES

As described in Maxfield [1997: ch. 4], the 1990s witnessed the global rise in statutory central bank independence. Governments in emerging economies have taken steps to create independent central banks where they did not exist, and have enhanced the statutory

independence of existing institutions.[3] Whether legal or statutory independence translates into operational independence is a critically important consideration in emerging economies.[4] In view of the problems with inferring operational from legal independence, Cukierman et al. [1992] develop several measures of central bank independence in a study of seventy-two countries (see also the discussion of this matter in Maxfield [1994, 1997]).

In Latin America, the governments of Argentina, Chile, Colombia, Ecuador, Mexico and Venezuela have taken steps to increase central bank independence over the last decade. Among emerging economies in Asia and the Indian subcontinent, the governments of South Korea, Pakistan and Vietnam have taken modest steps toward creating independent central banks, as have the governments of Algeria and Egypt among North African countries. Among Eastern and Central European countries, efforts to enhance the statutory independence of central banks have proceeded apace throughout the 1990s, though with questionable success in many cases (see fn4). Measures to enhance central bank statutory independence have been implemented in Albania, Armenia, Belarus, Bulgaria, the Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, the Slovak Republic, and Ukraine [Loungani and Sheets, 1995; Maxfield, 1997].[5]

While the responsibilities of independent central banks are well understood, the same

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[3] Helleiner [2001] shows that the current trend toward central bank independence in emerging economies stands in sharp contrast to the creation of strong, politically-controlled central banks during much of the Bretton Woods era. His contribution to this volume focuses on the ideational and geopolitical roots of decisions to create "developmentalist" central banks in the post-1945 era. Helleiner observes that current central bank reform efforts are more in keeping with the institutional innovations of the 1930s.

[4] For example, a 1995 study of the former socialist countries by Loungani and Sheets found that the Armenian, Hungarian, Polish and Romanian central banks had less operational independence than the Albanian, Bulgarian, Czech Republic and Estonian central banks. To place even this finding into its proper context, it should be noted that the operational independence of the Estonian central bank is particularly weak in the view of many observers of the region (though the IMF continues to praise the country's progress in maintaining the operational independence of its central bank and currency board, see, e.g., IMF [2/7/00:42]).

[5] Though the Czech Central Bank has statutory independence, the lower chamber of the country's Parliament passed an amendment in July 2000 that quite obviously contradicts this intent. The law enables the government to appoint

cannot be said of currency boards. A currency board is a monetary institution that issues local currency that is fully backed by stocks of a hard foreign "reserve currency." By law, the local currency is fully convertible upon demand and without limit into the foreign reserve currency at a fixed rate of exchange. The rate of exchange between the local and the foreign reserve currency is inviolable: the IMF recommends that the exchange rate be written into the currency board's constitution [IMF, 5/20/96; Hanke et al., 1993]. The reserves held by the currency board consist of low-risk, interest-earning securities and other assets payable in the reserve currency. The amount of foreign reserves held by the currency board must typically be equal to 100 to 110 percent (as set by law) of the value of the local money stock.

Historically, some seventy countries have operated currency boards. Today, currency boards operate in Argentina, Bermuda, Bulgaria, Bosnia and Herzegovina, Cayman Islands, Djibouti, Estonia, Falkland Islands, Faroe Islands, Gibraltar, Hong Kong, and Lithuania.[6] Recent reports by IMF economists and consultants cite the success of existing boards in Argentina, Estonia, and Hong Kong as a basis on which to argue for their adoption elsewhere.[7] At the cost of severe recessions, the Estonian board is credited with having stabilized the economy, the Argentine board with having ended inflation and maintaining stability during the Mexican financial crisis of 1994-5, and the Hong Kong board with having maintained stability during the Asian financial crisis and during the transition from British to Chinese rule.[8] In the period prior to the Brazilian election in October 1998 and the IMF's "preventative bailout" of the country,

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the Central Bank's board members and requires the bank to consult the government before important policy decisions [NYT, 7/15/00].

[6] Ghosh et al. [1998] and Hanke et al. [1993, App. C] describe all current and past currency boards.

[7] For discussion of the success of the Argentine, Hong Kong, and Estonian currency boards, see IMF [2/2/97, 5/20/96, 6/8/98:176, 3/9/98:66, 3/10/99:158, 7/19/99:239], Enoch et al. [1997], Ghosh, et al. [1998], Hanke [1997], and Santiprabhob [1997]. Schamis [2001] explores the distributional considerations that underpin Argentine currency board performance.

[8] See Wang [2001] for discussion of the political considerations that drove Chinese maintenance of the Hong Kong currency peg during this time.

Dornbusch proposed the adoption of a currency board modeled on that of Argentina [IMF, 1/25/99:24]. More recently, he has advocated currency boards as the best way to avoid currency crises by "outsourcing monetary policy" [IMF, 6/21/99:195] and divesting countries from control over their national currencies [IMF, 3/6/00:74].

Currency boards complement the operations of independent central banks by providing an additional means by which the private sector can be assured that monetary management will proceed undisturbed by political pressure. Indeed, currency board credibility is seen to exceed that of independent central banks. This is because currency boards have responsibility for the single task of maintaining exchange rate fixity, while central banks (independent or not) have a broad range of responsibilities. Currency boards help fill the "credibility deficit" that confronts even independent central banks in countries where these institutions are new or where they have a poor track record. Like central banks, they are to be autonomous--with their members drawn from the ranks of technocrats, economists and bankers, and appointed for multiple-year terms--to ensure that exchange rate policy is in the hands of an independent authority that does not have strategic incentives to veer toward an expansionary course.

3. NEW-CLASSICAL ECONOMIC ARGUMENTS FOR THE CREATION OF INDEPENDENT CENTRAL BANKS AND CURRENCY BOARDS

The preoccupation of development economists with the idea of policy credibility emerged on the heels of two developments—one empirical and one theoretical. On the empirical level, the failure of the ambitious neoliberal economic reconstruction efforts in South America in the late 1970s and early 1980s prompted an anxious search for explanations. By the mid-1980s, a consensus had emerged among new-classical development economists that despite the inherent correctness of the neoliberal prescription for South America, the reform agenda nevertheless

failed to achieve its intended results because its architects had not taken into account the overall "policy environment" in which these programs were implemented [Grabel, 1996].

On the theoretical level, the current preoccupation with policy credibility stems directly from the precepts of new-classical economic theory. The seminal work of Kydland and Prescott [1977] was particularly important to the development of the theory of policy credibility.[9] In this approach, rational agents use the *uniquely correct* economic model and take into account all available information when forming expectations about the future. Among other things, agents must assess the credibility of an announced policy when forming expectations and making judgements about what actions to take. Unfortunately, however, assessing policy credibility is no simple matter. At issue are the perceptions of economic actors concerning the viability and effectiveness of announced policies, policymakers' commitment to sustain them, and hence, the likelihood of policy reversal or collapse. The credibility argument, then, depends on a kind of circular logic: economic policies are deemed effective only if they are credible to private agents; but policies are deemed credible only if they are seen to be effective [Blackburn and Christensen, 1989, p. 1].

In light of the recognition of the importance of policy credibility, economists now faced a challenging question: How could economic policy be developed in this complex environment, in which the success of policy depends critically on agents' perceptions of its viability? Two choices presented themselves: one could shade policy toward existing popular sentiments; or one could implement "correct" policy, policy that respects the fundamentals of new-classical economic theory. The former option is ruled out of court on the simple grounds that "incorrect" policy (no matter how popular) could not possibly retain credibility in the wake of the

[9] There are numerous surveys of the policy credibility literature, e.g., Alesina and Tabellini [1988], Blackburn and Christensen [1989], Cottarelli and Giannini [1997], and Persson [1988].

disruptions that would inevitably attend it. In the context of open capital markets, for instance, incorrect policy would precipitate capital flight. In contrast, correct policy (no matter how unpopular) would induce credibility over time as it proved itself uniquely capable of promoting development and economic growth. A correctly specified policy would therefore impel rational agents to act "properly," at once attracting international private capital inflows, achieving growth and stability, and inducing the credibility necessary to sustain the policy regime.

The application of credibility theory to the design of institutions of monetary and exchange rate policy

The theory of policy credibility has proven to be influential in the design and operation of the institutions that govern monetary and exchange rate policy in emerging economies.[10] From the perspective of new-classical economic theory, the logic of extending the theory of policy credibility to the design of financial policy-making institutions is rather straightforward: to be credible, financial policy must be insulated from the vagaries of the political process, where shortsighted political goals often predominate. In the absence of this insulation, financial policy can be manipulated instrumentally by governments seeking to garner political support. Aware of this possibility, the (rational) public will know that announced financial policies “may lack credibility because they are economically inconsistent or politically unsustainable" [Schmieding, 1992, pp. 45-6].[11]

Problems of financial policy credibility may also arise if policymakers have a history of

[10] Note that institutions and policy are treated herein as analytically distinct, but in practice they are thoroughly interdependent. For example, new-classical economists’ support for an independent central bank is tied to the view that such an institution is uniquely qualified to pursue credible (read: anti-inflationary) monetary policy.

[11] It is interesting to note that Harry Johnson anticipated many of these insights in a 1972 essay on the Panamanian monetary system. There he expressed strong concerns about the proclivity of governments to manipulate financial policy for their own political gain. He argued that such politically motivated mismanagement introduces the threat of inflation, the depletion of international reserves (with associated consequences for the value of the domestic currency), the public’s loss of confidence in the government and the monetary system, and “perhaps more important

reneging strategically on established policies in order to achieve a short-term political or economic objective. This is the problem of "time inconsistency" [Kydland and Prescott, 1977].[12] In this context, rational economic actors are likely to expect policy reversals, and will act accordingly (such as by hedging against reversal). At best, the policy will therefore fail to induce the intended results; at worst, it will be sabotaged. Financial policy credibility (and hence, success) may also be threatened if financial and fiscal policies are at cross purposes, introducing the problem of "Stackelberg warfare" [Blackburn and Christensen, 1989].

From the perspective of new-classical economic theory, the task of gaining the public's confidence in the technical abilities and the anti-inflationary resolve of financial authorities in emerging economies is somewhat daunting. In such countries, it is reasonable to expect that the public will have limited confidence in both the personnel of financial policy-making institutions, and in the likelihood that the institution will be able to stay the course of politically unpopular policies. It is even reasonable for the public to question the longevity of new or reformed financial policy-making institutions. These uncertainties may stem from the immaturity of the institutions themselves, from the legacy of high inflation and/or from the rapid turnover of personnel in the government and financial institutions [Schmieding, 1992, pp. 45-6]. In this context, new-classical economic theory maintains that it is necessary to staff politically insulated financial policy-making institutions with non-partisan technocrats in order to establish policy credibility.

A "credible financial policy-making institution" may thus be defined as one that is able to operate without "instruction, guidance, or interference from the government" [Henning, 1994, p. 63]. The hallmark of a credible institution is its willingness and ability to implement and sustain

[is] the destruction of foreign confidence in the currency and in the country and its government, which is harmful especially to foreign investment" [p. 227, see also p. 225].

correct policy, even in the face of short-term dislocations that it might induce. Freed from undue political influence, an autonomous institution achieves credibility by demonstrating a steadfast commitment to neoliberal economic policies. Thus reassured, economic actors will rationally commit to behaviors that promote the success of these policies and, thereby, the welfare of society.

Central banks

The case for independent central banks in new-classical economic theory follows directly from this view on the prerequisites for credible policy. Central bank independence imparts a degree of credibility to monetary policy that cannot be achieved when policy is developed by elected politicians. This credibility stems from the political insulation of the institution. Armed with respect for the precepts of new-classical economic theory, and protected by institutional barriers from political contamination, the non-partisan technocrats who staff independent central banks are able to pursue credible (and time consistent) monetary policy in pursuit of an anti-inflationary course for the national economy [Blackburn and Christensen, 1989].[13]

A vast empirical literature seeks to substantiate the theoretical claims for the anti-inflationary performance of independent central banks. Initial studies focused on central banks in wealthy countries; these tended to confirm the hypothesis [e.g., Alesina and Summers, 1993; Blackburn and Christensen, 1989]. More recently, efforts have been undertaken to substantiate these claims in the context of emerging economies. An empirical study of twelve former communist countries finds that countries with independent central banks experience lower levels of inflation and greater macroeconomic stability than do countries with dependent central banks [Loungani and Sheets, 1995]. However, a substantial body of empirical research on emerging

[12] Persson [1988] surveys the time inconsistency literature.

economies presents mixed results (at best) on the relative performance of independent central banks [Bowles and White, 1994; Cardim de Carvahlo, 1995; Cukierman, et al. 1992; Mas 1995; Maxfield, 1994, 1997:chs.1-2]. Indeed, Maxfield's [1997] thorough survey of the empirical literature makes clear that the data supporting the case for central bank independence in emerging economies is far from unambigious, particularly in light of the sensitivity of the empirical results to measures of independence.

Despite the ambiguous empirical basis for the case for central bank independence in emerging economies, independence is nevertheless taken as a necessary (though not sufficient) step for achieving monetary policy credibility. Where central banks are new institutions (as in the former communist countries) or where the public has little confidence in these institutions, it may also be necessary to import central bank credibility by adopting the actual operating guidelines of credible Western central banks or even by importing central bank staff directly. Indeed, the German Bundesbank Law has been adopted by the new Polish, Hungarian, Czechoslovak and Bulgarian central banks. Credibility can also be created via externally imposed constraints on central bank operations. Such constraints are often embodied in IMF structural adjustment programs that tie financial and/or technical assistance to the central bank's adherence to certain operating practices, such as the refusal to finance government debt [Schmieding, 1992].

The replacement of discretionary with rule-based monetary policy may also enhance central bank credibility.[14] As before, this may involve importing credible rules from abroad.

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[13] Some new-classical development economists argue that fiscal policy should also be designed by an independent authority in order to preclude the possibility of Stackelberg warfare [e.g., Mas, 1995].

[14] The August 2000 announcement that Chile's President Ricardo Lagos is preparing a new reform package that would severely limit his discretion over fiscal policy underscores the continued resonance of the theory of credibility in discussions of economic policy. The New York Times [8/6/00] reported that President Lagos is planning to introduce reforms that mandate an average one percent surplus in the structural balance. His Minister of Finance,

Increasingly, these rules are taking the form of inflation or monetary growth targets, about which there exists a gathering international consensus among new-classical economists. But central bank credibility will only be enhanced by these constraints as long as the rules themselves do not introduce time inconsistency or Stackelberg warfare, and as long as the public is confident that the rules will not be breached. This introduces a game-theoretic dilemma in which central banks must search for increasingly credible means by which rules can be enforced. If the public does not find the central bank's commitment to policy rules sufficiently credible, then the central bank may seek to have these rules incorporated into the legal system of the country. If mere laws are not sufficiently credible, then a constitutional amendment might be pursued (a "meta-rule") [Schmieding, 1992, p. 50].

Note that there exists a tension between the strictures of monetary rules and considerations of policy credibility. Unforeseen exigencies may necessitate bending rules, which will yield them in-credible. Anticipation of such potential problems should undermine the attractiveness of rule-based policy in the uncertain environment of many emerging economies. Perhaps because of these dilemmas, central bank reform efforts tend to focus on creating statutory and institutional independence prior to establishing monetary or inflation targets.[15]

Currency boards

Currency boards enhance the credibility of the local currency (and the exchange rate) via the establishment of a direct link between it and the board's hard foreign currency holdings. Provided that the currency board maintains sufficient holdings of the foreign reserve currency, investors and the general public can be confident of the board's ability (not just its willingness) to maintain a fixed exchange rate [Bhattacharya, 1997; Enoch et al., 1997; Santiprabhob, 1997].

Nicolas Eyzaguirre, explained the rationale of the measure in the following way: "We want to arrive at a position where macroeconomic policy is not just sound….It is based on rules."

Moreover, the public is also assured of protection against debasement of the local currency.[16] This confidence in the fixed exchange rate may prevent the public from engaging in currency substitution, destabilizing speculation against the currency, and other actions that will undermine the stability of the domestic monetary system. Hence, even though currency boards do not render speculation against the currency impossible, they reduce the chances that speculators will lose confidence in the currency.

Currency boards epitomize the credibility advantages of rule-based financial policy; in all cases where currency boards have existed, they have operated in accordance with a strict set of simple, transparent rules.[17] As a consequence, they possess even less scope for discretion than do independent central banks—an important virtue for new-classical economists concerned about abuses of monetary discretion in emerging economies.[18] The legally/constitutionally binding rules that govern currency boards, coupled with institutional independence, preclude currency boards from ceding to political pressures for monetary expansion.

Several prominent new classical economists have endorsed currency boards on several

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[15] However, currency board operations are rule based (see below).

[16] Indeed, a recent empirical study finds that inflation in countries with currency boards (all else equal) is 4% lower than in countries with other types of pegged exchange rate regimes [Ghosh et al., 1998].

[17] As Eichengreen [1999:105] notes: "Closing off all avenues for discretionary monetary policy not just for a time but for the foreseeable future is something that few societies are prepared to do." This may account for the relatively small number of emerging economies that today maintain currency boards as opposed to independent central banks. Eichengreen argues that there exists broad public support for the Argentine currency board precisely because of the profound distrust of discretionary policy engendered by the country's experiences with hyperinflation [cf., Schamis, 2001].

[18] Johnson [1973] argued that currency boards are more credible than independent central banks. Currency board operations are narrow in scope and are entirely rule based, and face less political interference. (Note that Johnson did not elaborate on this latter proposition.) Similar arguments in support of currency boards have been made by Jeffrey Frankel and Charles Enoch [IMF, 10/25/99:343, 11/8/99:365].

Johnson also argued that currency boards are more cost effective than independent central banks. On this matter, he wrote: "At a more practical level, a currency board has the great advantage over a central bank that its operations can be made fairly automatic, so that it need not require a comparable expenditure on both administrative staff and prestigious directors….Nor does it require an impressive building….It should be possible to run a currency board with a small staff and one to three commissioners who need to meet only two to four times a year" [p. 225].

grounds.[19] In the first instance, this support may seem surprising. After all, new classical economics preaches the virtues of unfettered markets, in which prices adjust instantly and without government interference in response to supply- or demand-side shocks. Currency boards obviously prevent this adjustment by fixing the rate of exchange between the domestic and a foreign currency. But new classicals reconcile themselves to currency boards as an important "second best" alternative for emerging economies, given the proclivity of governments to intervene in exchange markets and to print money to finance government expenditures. Insofar as these governments cannot be trusted to let foreign exchange markets operate freely or to exercise monetary discipline, currency boards provide a means for reducing government freedom while securing currency credibility. Moreover, the legal and institutional commitments under which currency boards operate renders the resulting currency values far more credible than those that arise under fixed exchange regimes that lack currency boards [Caramazza and Aziz, 1998; Ghosh et al, 1998].[20]

As with independent central banks, the credibility of currency board rules may be enhanced by introducing credible external mechanisms for ensuring compliance with the rules. This may involve efforts to import credibility by placing representatives of foreign central banks or multilateral institutions on currency boards, or by conditioning external financial or technical support on the compliance of the currency board with pre-determined rules.

A model currency board constitution prepared for Russia by US consultants contains just such provisions for importing credibility from abroad. The proposed constitution requires a

[19] The "arguments [of new classical economics] lend support to the case for currency boards, since currency boards are rule-bound and have no discretion in monetary policy" [Hanke et al., 1993, p. 39].

[20] This is not to say that all currency boards arrangements are intrinsically credible. For example, the IMF rejected an Indonesian plan to implement a currency board in February 1998 because the government's commitment to a fixed exchange rate lacked credibility due to low reserve holdings and political instability. (See former IMF President Camdesssus' comments on the Indonesian proposal [IMF, 2/23/98:50].)

majority of the members of the board of directors to be foreigners, to "help prevent the government from bending the rules of the currency board" [Hanke et al., 1993, p. 110]. Some analysts have proposed that even external enforcement of currency board credibility will be an inadequate guarantor of its independence. For example, Dornbusch [1997] proposes that the Mexican government cannot be trusted to leave a currency board unmolested. For this reason, he proposes that Mexico adopt the extreme measure of importing currency credibility by simply adopting the US dollar as its currency. The Ecuadorian government announced a plan in January 2000 to adopt the US dollar as the national currency for the same reason.[21]

Thus, independent central banks and currency boards are institutions that allow emerging economies to fill the credibility deficit that confronts economic policy. Currency boards and independent central banks that are either staffed or directly monitored by external actors or indirectly monitored by foreign investors, allow emerging economies to "import" or "borrow credibility" from abroad.[22] These independent institutions act as a monitor and an enforcer of monetary and exchange rate policies that respectively constrain inflation and currency risks. These institutions act as agencies of restraint that minimize "investors' risk of policy reversal and therefore helps to establish the credibility of the chosen policy options vis-à-vis market participants" [Dhonte, 1997, pp. 6-7]. Independent central banks and currency boards assure investors that governments will not bend to popular pressures to abandon the "right" policies. The penalties for policy reversal include the loss of investor confidence and the withdrawal of private capital flows.

It bears noting that independent central banks and currency boards are posited as the

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[21] As of September 2000, the dollar is the only currency in circulation in the country.

[22] Cottarelli and Giannini [1997] make this argument in the context of structural adjustment programs, while the former Prime Minister of Estonia, Mart Laar (quoted in Maxfield [1997:35]), makes this point regarding the signaling effect of IMF stand-by agreements.

institutional foundation for a more aggressive neoliberal policy agenda.[23] Bowles and White [1994, p. 237] describe the synergy between these institutions and neoliberalism, arguing that:

> [A]lthough the case for central bank independence is primarily based on providing lower inflationary outcomes, it also resonates with a wider agenda aimed at restoring 'discipline' and 'credibility' to economic decision-making in general.

Maintaining central bank independence is one way that the public and (domestic and foreign) investors can be assured that the central bank will be able to pursue anti-inflationary monetary policy, and hence foster a favorable investment climate.

The operation of currency boards also complements broader programs of neoliberal economic reform. Currency boards enhance neoliberal reform credibility by assuaging investor fears of policy reversal. Currency boards also promote reductions in government spending by precluding the printing of fiat money. This restriction also promotes privatization since central banks can not be used to provide aid to ailing state-owned enterprises [Hanke, 1997].

Currency board operations also complement neoliberal reforms that promote external economic openness. Currency board rules stipulate that the local money supply can be increased only following an increase in foreign exchange holdings. An increase in foreign exchange holdings may result from improved net export performance or from private capital inflows. Expansion of the local money supply is predicated on the success of capital and current account liberalization, themselves important components of neoliberal economic reform programs in emerging economies.

4. A POLITICAL EXPLANATION OF THE RISE OF INDEPENDENT CENTRAL BANKS AND CURRENCY BOARDS: IDEOLOGY AND POWER IN MONETARY REFORM

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[23] In a related vein, Kirshner [1998] argues that independent central banks exercise a deflationary bias on the

Against the new-classical economic explanation for the rise of independent central banks and currency boards (advanced above), I argue that political factors chiefly explain the emergence of these institutions. Specifically, the creation of monetary and exchange rate institutions that are independent of elected governments stems from the widespread acceptance of the ideological aspects of the theory of policy credibility, and from the exercise of political and economic power by influential actors.

The ideological foundations of the case for independent central banks and currency boards

The theory of policy credibility—on which the case for independent central banks and currency boards rests—has two ideological dimensions. First, the theory of new-classical economics (in which credibility is nested) is elevated to the status of "science," and its conclusions are presented as unambiguously "true." But, contra Popper, the concept of credibility serves to insulate this theory from meaningful empirical test or refutation. It must therefore be taken on faith. Second, credibility eliminates politics and power from view when explaining the rise and fate of distinct policy regimes. A policy's success, in this account, depends solely on its analytical (and epistemological) merits, not on the power of the interests it serves.

A few points deserve clarification before commencing the discussion of the ideological aspects of the new-classical theory of policy credibility. The argument that there are ideological aspects to the theory is not equivalent to the argument that the theory is nothing but ideology. It is not the individual propositions of new-classical theory (e.g., that agents are 'rational' in a particular way), but the epistemological claims that are made on behalf of these propositions that constitutes its ideological content. It is in the elevation of this one theory to the status of singular truth, and in the consequent suppression of all alternative economic theories on grounds of their inherent falsity, that new classical economics becomes something other than science.

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domestic and global economy.

The truth status of arguments for independent central banks and currency boards

Proponents of the theory of policy credibility make very strong epistemological claims on its behalf. Recall that a key premise of credibility theory is that all agents in an economy uniformly derive their expectations about the consequences of an economic reform program from the same correct (new-classical) economic model (this is the well-known "rational expectations hypothesis"). The purchase of the concept of credibility then requires the truthfulness of assumptions about the epistemic condition in which economic actors live and the economic models that these actors use to interpret the consequences of economic policies. The *assumption* that this is the uniquely true theory is projected onto the economic actors about whom the theory theorizes, and then their embrace of this theory is taken to secure the unique correctness of the policies that the theory generates! They are *rational*, after all, so they would not possibly choose the wrong theory. Elegant, wonderfully convenient, irreducibly ideological.

If instead we assume (more realistically) that even reasonably knowledgeable agents in the economy rely on different economic (let alone political and social) models when forming expectations, then we will expect them to pursue diverse behaviors in any particular policy context. This diversity may then generate unpredictable macroeconomic outcomes, including outcomes that jeopardize the viability of any policy program [Frydman and Phelps, 1983; McCallum, 1983]. Thus, a rejection of the assumption of rational expectations complicates any ex-ante judgements regarding the credibility of any economic policy—new-classical or otherwise.

For the sake of argument, however, let us assume that agents form their expectations rationally. Let us assume further that this implies that *under normal circumstances* these agents assign the identical, correct probability distribution to the likelihood of a policy's effects and to

the likelihood of its failure or reversal. In short, let us presume the validity of the rational expectations hypothesis. Nevertheless, the rational expectations presumption is implausible in the case of new or reformed institutions of monetary and exchange rate policy, particularly in those contexts where agents may have reason to be skeptical or may be ill-informed about the direction or consequence of monetary and exchange rate policy. The problem here is that a lack of experience with independent institutions of monetary and exchange rate policy means that agents have no basis for applying past learning (see discussion of this general issue in Lucas [1973], Backus and Driffill [1985] and Conley and Maloney [1995]). In such circumstances, agents might be expected to form diverse and inconsistent subjective probability distributions regarding a policy's effects and longevity, and take actions that undermine the policies implemented by new or reformed central banks and currency boards.

Complicating matters further, the adjustment of expectations and behavior in the wake of radical shifts in the policy-making process occur in real time. In the process of adjustment, we must recognize the influence of any number of informational asymmetries and imperfections that will necessarily affect agents' decisionmaking [Agenor and Taylor, 1992]. The behavior of agents in the short run, then, may very well generate economic outcomes that are inconsistent with the long-term policy objectives of independent central banks and currency boards.

All of these complications are seemingly ignored by today's proponents of independent central banks and currency boards. Their implication, after all, is that policy design is a much trickier business than is generally acknowledged by advocates of these institutions.

I say *seemingly* ignored because they are in fact dealt with implicitly, and unfortunately, with implications that are anti-pluralist in theory and practice. This is indeed the most problematic aspect of the way in which the criterion of policy credibility has been incorporated

into the case for independent central banks and currency boards. This criterion has functioned to discredit the design of institutions of monetary and exchange rate policy that incorporate popular participation. Let us explore what is involved here.

On its face, the propositions that credible monetary and exchange rate policies are more likely to succeed, and that policy credibility depends on empowering independent technocrats seems entirely innocuous. However, the ideological import of credibility theory is made quite clear when one explores its underlying epistemological assumptions. The truth status of the theory of credibility (and its application to discussions of optimal institutional form) can be best understood by reducing the theory to a straightforward set of five propositions. These may be stated as follows: 1) monetary and exchange rate policies will garner credibility only to the degree that they are likely to survive; 2) monetary and exchange rate policies are likely to survive only to the degree that they attain their stated objectives; 3) monetary and exchange rate policies are likely to achieve their stated objectives only to the degree that they induce behaviors (in the aggregate) that are consistent with these objectives; 4) monetary and exchange rate policies are likely to induce consistent behaviors only to the degree that they reflect and operationalize the true theory of market economies; and 5) monetary and exchange rate policies reflect the true theory of market economies only to the degree that they are consistent with new-classical economic theory.

The anti-pluralist attribute of the theory of policy credibility is captured in propositions four and five. Monetary and exchange rate institutions that are subject to state influence are summarily rejected on the grounds that they could not possibly meet the unforgiving credibility test, because such institutions could not implement or maintain credible policies. Hence, monetary and exchange rate policies implemented by such institutions are destined for failure, in

part because of the inconsistent behaviors they necessarily induce. Writing on the intellectual maturation of new-classical economics, Frydman and Phelps [1983, pp. 27-8] identify this aspect of the tradition as a barrier to intellectual pluralism. In their words, the "thoroughgoing implementation of the rational expectations [new-classical] method in policy-making would entail the official promotion, or 'establishment,' of one model over others" [pp. 27-8].

Notice the epistemological foundation of the new-classical perspective. Advocates of independent central banks and currency boards impute credibility to policies based on the purported verisimilitude of the abstract theory from which these policies derive. Economic science then points us in the direction of the singular true model of policymaking, and hence to a single institutional setting in which monetary and exchange rate policies can be designed. The best that could be said of monetary and exchange rate policies designed outside of a politically insulated setting is that agents will lack confidence in their policies. Therefore these policies will induce inconsistent expectations and will fail.[24] In this manner, the credibility criterion discredits pluralistic discussions regarding the appropriate governance structure of the institutions that govern monetary and exchange rate policy. In short, the truth claims of the theory of policy credibility bar consideration of theoretical and practical alternatives to politically insulated policymaking.

Many critics have argued that autonomous monetary authorities are incompatible with the principles of democratic governance. [e.g., Arestis and Bain, 1995; Berman and McNamara,

[24] Part of the reason why these policies will fail is because conventional wisdom or what Blyth [2000] refers to as "governing conventions" (regarding the problems associated with policy implemented outside of politically insulated settings) induces behavior, such as capital flight, that precisely result in policy failure. See also Kirshner's [2000, 2001] discussion of the role of confidence in monetary policy success and the role of ideology in defining the feasible set of policy options. On this latter point, he suggests that the truth claims that support the case for institutional independence preclude the success of policies that are inconsistent with these claims by inducing self-fulfilling perceptions of policy failure. Hence, policy failure is not an inevitable result of technical policy mis-specification. The strength with which a theory's truth claims are held can be an independent cause of policy success or failure. The point here is that the strength of a theory's ideological dimensions matters deeply.

1999; Epstein, 1988, 1992]. After all, critics argue, monetary and exchange rate policies can and do have substantial distributive effects. Hence, these institutions must be accountable to elected government officials and, thereby, to the electorate.

New-classical economists dispense with these criticisms in part by claiming that monetary and exchange rate institutions must be insulated from political pressures to ensure policy credibility, as we have seen. In order to create an environment where good economic outcomes can obtain, the state must take steps to ensure that the processes of policy design and implementation are protected from democratic contestation by the populace and from capture by self-seeking politicians. Political contest over economic affairs might undermine confidence in even correct policy, and thereby subvert its effectiveness. Far better to take the domain of economic policy out of the orbit of politics. But this view makes sense only if we are prepared to accept the epistemological claims of the theory of policy credibility, and the unified, harmonious view of society and the cynical view of the state assumed by new-classical economic theory [cf., Toye, 1991]. Only in this case is it legitimate to view the autonomous monetary authorities as the champion of the national interest [cf., Blyth, 2001]. If there is only one true economic theory, then the insulation of monetary and exchange rate institutions from political influence hardly amounts to a democratic deficit. The same is true if all citizens share the same values, interests and goals, and if they will all be affected by a particular policy in substantially similar ways. This is precisely the view taken by new-classical economic theory. In this view, only politically insulated technocrats can guarantee the kind of economic outcomes that will ultimately benefit all of society's members.

The irrefutable nature of the case for independent central banks and currency boards

Credibility theory fulfills a vitally important ideological function in the new-classical

case for independent central banks and currency boards by allowing for perpetual ad hocery. Insofar as it can always be asserted ex-post that the environment in which failed new-classical monetary and exchange rate policies were implemented was not credible, it is possible to insulate the policies or the institutions themselves from critique. The failure of an independent central bank to curb inflation or of a currency board to create confidence in the domestic currency does not stem from the inappropriateness of the institutional structure or from the underlying theoretical framework that gives rise to that structure. Rather, policy failure is explained by the presence of all manner of distortions that characterize the economy, by political uncertainty, by the public's lack of confidence in the longevity of technocrats, by the failure to guarantee the operational (rather than de jure) independence of policy-making institutions, etc.[25] Credibility theory therefore precludes any substantive empirical refutation of the case for institutional independence.[26] It is the impossibility of testing (and therefore rejecting) its central propositions combined with its self understanding as the uniquely adequate and objective economic science that imparts to the new-classical theory of policy credibility its ideological content.

It should be recalled that empirical studies of the benefits of central bank independence in emerging economies do not provide unambiguous empirical support. But by allowing for perpetual ad hocery, credibility theory preserves the theoretical case for independence despite the empirical record. For instance, advocates of central bank independence can always invoke the gap between legal and operational independence. It should not be surprising, then, that the theoretical framework that supports this institutional innovation has never been revised in light

[25] Polanyi [1944] emphasized the propensity of advocates of free markets to explain their failure as stemming from insufficient liberalization rather than from the failure of markets themselves. He wrote: "Its apologists [defenders of market liberalization] are repeating in endless variations that but for the policies advocated by its critics, liberalism would have delivered the goods; that not the competitive system and the self-regulating market, but interference with that system and interventions with that market are responsible for our ills" [p. 143].

[26] In view of this perpetual ad hocery, the new classical extension of neoclassical thought acquires the features of what Lakatos [1970] identifies as a "degenerative research programme."

of empirical experience. Ad hocery notwithstanding, this unwavering commitment to central bank independence in emerging economies—in the absence of unambiguous empirical evidence—exemplifies the ideological character of the case for this monetary reform.

The role of power in creating the credibility of independent central banks and currency boards

In deriving policy credibility from the epistemological status of the theory that generates it, new-classical economic theorists deny the significance of factors that are endogenous to all societies that significantly influence the likelihood of a policy's success, and hence, its credibility [cf., Burkett and Lotspeich, 1993]. Notably absent from discussions of policy credibility within new-classical economic theory, for instance, are considerations of class conflict, and the distribution of income, wealth and political power. The credibility of the policies implemented by independent central banks and currency boards is not secured by their inherent rightness, but by enforcement strategies and capabilities of domestic and foreign capital and the state.[27] Together, these actors often have been able to suppress popular dissent against the social dislocation and recessionary consequences of the high interest rate policies associated with independent central banks and currency boards, and they have relied on the ideological and financial support of the international policy and investment community. The credibility of the policies implemented by independent central banks and currency boards is secured, then, through the mobilization of political and economic power. It does not arise as the natural result of autonomous decisionmaking of economic actors forming rational judgements about the future and pursuing voluntary courses of action that intrinsically validate these policy options.

The way in which the credibility criterion is presently understood by new-classical economic theorists and policymakers reflects a particularly naive vision of society. That vision

[27] See Kirshner [1995, 1998, 2000, 2001] and numerous papers in this volume for discussion of power in monetary relations.

is of a society marked by largely homogeneous (or at least harmonious) goals and expectations, in which policymaking institutions, to the extent that they can free themselves from interest groups, are able to implement policies designed to secure these goals. In short, it is a vision of society free of class and other fundamental social and economic conflicts [cf., DeMartino, 2000]. To the extent that conflicts do exist (particularly among interest groups that seek to capture policy to serve their particularist aims), new classicals propose the construction of institutions that *transcend* these conflicts. What is absent from this view is an understanding that in societies that are stratified by wealth, class and power, all economic policies (monetary, exchange rate or otherwise) are inherently biased in terms of their effects. Policies always serve some interests against others.[28] Hence, a policy's credibility always requires securing the willful consent of some groups and the coercive acquiescence of others. This political-economy view is no less true of policies implemented by politically insulated institutions purporting to promote the national interest than of those designed under other institutional configurations. *Credibility, in short, is founded on politics, not metaphysics*.[29]

From this perspective, the support of foreign capital in the form of inflows of direct foreign and portfolio investments or loans (or the threat of withdrawal) and the financial and technical support of multilateral institutions is critical because it *creates* policy credibility rather than simply *reveals* it. The importation of outside "experts" plays the same role: the act of "signaling credibility" should be understood to produce the effect of credibility rather than merely to reveal something that was already there, latent in the policy-making institution itself. In addition to the policy credibility created by foreign experts, domestic experts (not least economists and members of the business community) likewise play a role in validating the case

[28] For a related (though different) perspective on economic policy and interest groups, see e.g. Frieden [1991] and citations in Eichengreen [1998]. See also the discussion on pp. 63-4 of Cohen [1998].

for independent central banks and currency boards.

Note that the argument advanced here is different from (though not inconsistent with) Maxfield's [1997] argument that emerging economy governments use central bank independence to signal international private investors and lenders. From Maxfield's perspective, governments use central bank independence strategically to signal their commitment to the "right" policies as a means of attracting external private capital flows. I am arguing that it is the success of the signaling effect (i.e., the response of external actors) that actually creates the credibility of the institutions and their policies. These institutions, and the policies they implement, are not inherently credible—their credibility results from the response of investors and multilaterals whose actions provide important ideological and material capital to those who advocate the neoliberal agenda.

The exercise of political and economic power (in addition to ideology) also explains the creation of independent institutions. US economics faculties have long sought to export ideas about monetary governance to emerging economies via economics education in the US and via educational programs sited in emerging economies. The early 20th century work of Princeton economics professor Edwin Kemmerer represents perhaps the most well known effort to export the case for independent central banks to emerging economies [see Drake, 1994; cf., Helleiner, 2001]. This project was taken up in the 1970s by the University of Chicago, in its work with Chilean economists [see Becker], by a consortium of US universities to retrain Russian economists (academic and policy makers)[Wu, 1997], and by the IMF through its extensive technical training programs. These include the "IMF Institute" which offers seminars for government and central bank officials, and various regional training institutes (such as the Joint

[29] Indeed, this is a theme that runs through many of the papers in this volume (e.g., Blyth [2001] and Wang [2001]).

Vienna Institute for officials from the former socialist countries).[30] The IMF's Monetary and Exchange Affairs Department also works with finance officials on central banking, exchange rate, and monetary policy issues.

When these educational initiatives have proven to be insufficient, the IMF has not hesitated to expend its political and economic capital to pressure emerging economy governments to establish (or enhance the operational autonomy of) independent central banks and currency boards, such as through structural adjustment programs. For instance, during its 1996 negotiations with Bulgaria and Bosnia, the IMF explicitly tied the continued receipt of financial support—and hence the viability of the economy--to creation of currency boards [Ghosh et al., 1998; Bhattacharya, 1997]. In negotiations with Brazil in February-March 1999 over receipt of an installment of its (post-Asian crisis) bailout, the IMF pressed for and received assurances from the government that it would take steps to strengthen the operational autonomy of the central bank [see IMF, 2/8/99:33, 3/22/99:82].

Recent events in emerging economies illustrate the endogeneity of central bank and currency board credibility. The Estonian currency board experiment has largely been kept afloat by Finland and Sweden for geopolitical reasons. During the turmoil of the Asian financial crisis the credibility of the Hong Kong currency board was secured by the implicit commitment of China's financial support of the fixed exchange rate [see Wang, 2001] and by the ability of the Hong Kong monetary authority to intervene aggressively in markets to support the economy. More generally, IMF-World Bank financial and technical support and structural adjustment programs play a pivotal role in maintaining investor confidence in the credibility of central banks and currency boards.

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[30] See Strassmann [1976] for a discussion of the contribution of Chicago-school economists to the theory and practice of development economics in the 1950s and 1960s.

Conversely, central banks and currency boards can be rendered "non-credible" if those governments that attempt to put them into place are not able to secure the consent and support of development banks and/or the IMF. Governments that do not protect the independence of these institutions sometimes face capital strike. New-classical economists take this flight as evidence of the inherent in-credibility of such institutions. But investors deciding if/when to flee are not taking a referendum on the purported rightness of such institutions in the abstract; they are assessing their credibility in the context of the anticipated reaction of external *political and economic* actors to such state initiatives. Investors flee when they anticipate the withdrawal of external loans and loan guarantees, aid, trade credits and technical assistance programs upon which emerging economies often depend. In short, we have here a game-strategic situation in which the IMF can activate capital flight as a means of gaining leverage over recalcitrant national governments to ensure that they pursue those policies that the IMF deems appropriate. It therefore rings hollow when IMF economists assert that the reactions of investors are an "independent" gauge of the rightness of economic policy. Signaling, then, is a far more complex phenomenon than is commonly recognized in the new-classical economics literature. It must be seen as a means to leverage and exercise power, not merely as a means of conveying information.

IMF signaling can be vitally consequential. For example, the IMF's high profile rejection of former Indonesian president Suharto's plan to create a currency board during the Asian financial crisis essentially condemned this proposed initiative. In the public wrangling over this issue, IMF warnings ensured that investors would act in ways that would undermine rather than support this institution. Confronting this likelihood, Suharto was forced to abandon this plan.[31]

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[31] The IMF rejected the currency board proposal because it did not trust the government to protect the institution's independence and because it did not want its bailout resources being used to protect the value of the currency. The

If we adopt a political-economy approach to policymaking, an approach in which conflict in economic interests, values and goals is endemic to all societies, then it becomes quite clear that independent central banks and currency boards are hardly apolitical. They "do not exist 'above' or 'outside' politics" [Bowles and White, 1994:240], but instead represent a strategic means by which some groups seek to secure their own economic interests at the expense of the interests and goals of others [cf., Kirshner, 2000, 2001]. Policymaking institutions that are structurally precluded from capture by elected officials do not operate in some presumed "general" or "national" interest, but in accordance with the particularist interests of some, and against the particularist interests of others. In the case of independent central banks and currency boards that pursue neoliberal policy, the financial community represents the interest group whose concerns about monetary and exchange rate policy are paramount.[32]

One of the enduring challenges of policymaking (and more broadly of democratic society) is to find ways to mediate the opposing claims of contending social groups. New-classical economic theory attempts to do what is simply impossible: to sidestep this challenge by pretending that it does not exist. In so doing, they have unwittingly produced a set of institutional reforms that allow those already best off in society to further their own economic interests—all under the ideological cover of apparently scientific economic theory.

The architecture of ideology-power interactions in monetary reform

In what follows I draw together the discussion of this section by examining the dynamic interaction of ideology and power in the process of monetary reform in emerging economies. In particular, I focus on the process by which these two political factors have co-determined the

former concern was no doubt warranted. However, the IMF appeared to have no difficulty with the latter strategy during its preventative bailout of Brazil in 1999. The Indonesian and Brazilian examples illustrate the endogeneity of credibility insofar as the success of the government's policy initiative depended upon the actions of the IMF.

creation of independent institutions of monetary and exchange rate policy. For purposes of analytical clarity, the discussion is organized around a series of questions that ape the standard journalistic investigative formula. We ask the following: *who* are the actors that are influenced by the ideological aspects of new-classical theory and by the expression of material and political power, and *by whom* are they influenced; *of what* exactly are these actors convinced; w*hy* do they institute the particular reforms *when* they do; and, most importantly, *how* do these political factors co-determine the reform outcome?

Who?

It is a rather straightforward matter to assess w*ho* is being convinced of what *by whom*. The principal actors involved in negotiating the process of institutional reform in emerging economies are national-level politicians, technocrats employed in the government service, and members of the financial community (who may directly or indirectly influence decision-making by government officials). Whether or not the populace (taken broadly) is supportive of the reforms undertaken is not directly relevant. In cases where the democratic process functions well, the preferences of the populace should map onto politicians' behavior; where the democratic process is compromised, the question of whether the populace is influenced by the political factors under consideration is moot. The views of these internal actors are shaped and reinforced by powerful external actors who are, using Wade's [1998] awkward (extension of Bhagwati's) terminology, members of the "Wall Street-US Treasury-US Congress-City of London-UK Treasury-IMF complex."

As one would expect, the relative weight of internal and external actors in the reform process varies from country to country. In some cases, external and internal actors work more or

[32] See Posen's [1995] discussion of the financial sector's political support for central bank independence as a long-run means of inflation control.

less in tandem to institute reforms consistent with the world view of this epistemic community; in other cases, external actors serve as a "push factor" in the reform process by either subtly "teaching" internal actors about the necessity of creating independent institutions, or by playing a more determinative coercive role in pressing for institutional innovation; and in still other cases, internal actors strategically use external actors to legitimate or make palatable to the populace their own reform goals.[33]

Note that those working within the literature on ideas and policy formation would term these internal and external actors "carriers" or "policy entrepreneurs." Berman [1998] for example, argues that carriers play a pivotal role in the process by which ideas influence policy outcomes. In her view, there are several factors that influence the efficacy of carriers vis-à-vis the reform process; for our purposes, most significant among the factors she identifies is the status (and, I would add, the power) of carriers within the system and the extent to which their ideas are institutionalized and embedded in organizational structures. Needless to say, the internal and external actors carrying the mantle of independent central banks and currency boards to emerging economies fit this profile—together they command significant material, political and intellectual capital.

What?

Regardless of national differences in the weight of internal and external actors in propelling financial reform, the issue as to *what* these actors are convinced of is unambiguous. Reformers behave as if they are convinced of the necessity of creating independent institutions of

[33] The term epistemic community obviously is taken from Haas [1992]. The term "teaching" is taken from Finnemore's [1993] study of the way in which UNESCO socialized states about the importance of creating a national science bureaucracy. Finnemore [1996] extends this work in three case studies that explore the process by which state leaders are socialized by international (governmental and non-governmental) organizations.

monetary and (in some cases) exchange rate policy.[34] This institutional structure is understood to ensure that financial authorities pursue policies that maintain a sound currency, and hence preserve investor confidence in the economy. The assumed fit between institutional structure and desired macroeconomic outcomes stems directly from acceptance of the new-classical theory of policy credibility, a view that is validated by the expression of political and material capital by powerful actors.

For more than a decade, the necessity of institutional independence has taken on the status of a universal truth that holds for all countries regardless of the peculiarities of their economic, political or historical development [cf., Helleiner, 2001]. Given the standing of the theory of policy credibility, it is simply impossible to imagine a policymaker or an economic advisor making a (credible) case for the desirability of an alternative governance structure.[35] This universality is maintained despite the fact that the link between macroeconomic outcomes and policy independence remains largely unsubstantiated empirically in the emerging economy context. Moreover, the developmental contribution of government control over monetary and exchange rate policy in many Asian states (let alone in Western Europe during much of the post-WWII era) is simply ignored by advocates of independent central banks.[36]

Why?

As argued earlier in the paper, there are numerous reasons *why* reformers create financial

[34] I do not venture here into the question of whether reformers' decisions actually map to their beliefs; for our purposes, it matters only that they undertake particular reforms. In some cases, reformers may actually believe in what they are doing; in other cases, they may be coerced into making these reforms by powerful actors; and in other cases, they may implement these reforms as a strategic means to obtain resources from multilateral institutions or private investors.

[35] By elevating operational independence to the status of universal truth, policy failure under alternative governance structures is guaranteed precisely because the perception of likely policy failure is self-fulfilling. See Berman's [1998] discussion of the power of ideas to shape actors' perceptions of constraints.

[36] In this connection, see Finnemore's [1993, 1996] discussion of the rhetoric of norms in the absence of supporting evidence. See Wade [1992] for empirical discussion of the developmental contribution of government control over monetary and exchange rate policy in Asian economic development and Helleiner [1994] on the contribution to

policymaking institutions that are independent of state direction. On the macro-level, it is quite clear that the ideological aspects of the new-classical theory of policy credibility resonate with contemporary reformers, precisely because they are embedded in a broader neoliberal worldview. In this context, embrace of the type of institutions that are the theory's co-requisites is hardly surprising. On the micro-level, receptivity to new-classical theory (and hence to its institutional counterparts) in the early to mid-1980s was enhanced by policymakers' shared understanding of the causes of past policy failures and the presentation of a comprehensive theoretical and practical alternative to past strategies. At the time (and continuing today), new-classical theory was presented by economists, foreign advisors, and policymakers as the only sound alternative to the failure of South American neoliberalism in the late 1970s and early 1980s and Keynesian-inspired statist policies during the Bretton Woods era. Needless to say, this policy and institutional agenda was not (and is not) articulated in a political vacuum: it is pressed ideologically and validated materially by powerful actors sharing a common world view. Absent the exercise of political power and material support, these reforms may never have been implemented, at least not to the extent they have been.

The causal explanation of institutional innovation that is advanced here is consistent with explanations of a range of policy innovations proffered by a number of analysts in this volume (particularly, Abdelal, Blyth, Gavin, Helleiner, Kirshner, and Wang). Looking beyond this volume, Berman [1998] demonstrates that ideology principally shaped the policy choices made by the Swedish and the German Social Democratic parties during the interwar period.[37] In her study of European monetary integration, McNamara [1998] finds that ideology played a

Western European and Japanese development. World Bank [1993] exemplifies the "revisionist" view that downplays the contribution of state control over finance to Asian development.

[37] To be precise, Berman's [1998] independent variable is what she terms "programmatic beliefs" rather than ideology.

critically important role in explaining why this historic economic policy convergence occurred across the majority of European governments beginning in the mid-1970s and solidifying in the 1980s. She concludes that an emergent neoliberal policy consensus about the goals and instruments of monetary policy—itself a product of policymakers' shared perceptions of the failure of Keynesian economic strategies and the presentation of a paradigm innovation in the form of monetarist theory--produced this policy innovation throughout the majority of countries in the European Community.[38] In the work of Finnemore [1993, 1996] and Meyers et al. [1997], the existence of shared ideological constructs (which the former terms norms, and the latter terms global culture) explains the presence of common institutional and policy innovations around the globe. For Meyers et al. the existence of behavioral and institutional similarities across countries (e.g, the omnipresence of independent central banks) reflects the existence of shared understandings by powerful actors. Finnemore documents the myriad mechanisms by which international organizations socialize policymakers into accepting shared normative understandings and embodying them in policy and institutional innovations.

Why, we might ask, is educating policymakers on the need for a sound currency taken to be insufficient means to ensure this result? Why the additional need for the institutional reforms advanced by new classical economics? The answer is found in a related branch of neoclassical economics, the new political economy, which the new classicals fully embrace. Since new-classical theory begins with the proposition that government agents are rational, egoistic, utility maximizers, they should be expected to use the policy tools at their disposal to secure their own interests rather than those of the broader society they have been appointed to serve. They will

[38] The neoliberal consensus was also fueled by a process of policy emulation in which Germany's success with a pragmatic version of monetarism provided European policymakers with a persuasive example of the merits of monetarist strategies. Note that neither Berman [1998] nor McNamara [1998] investigate whether power reinforces

manipulate economic outcomes (such as currency values, employment levels, and so forth) to further their own careers, unless the institutional framework in which they operate prevents these strategies (and ideally, rewards appropriate behavior).

It follows then that where credibility problems are most severe (e.g., in new countries, in countries with particularly dramatic histories of hyperinflation, in countries where the turnover of government officials is high, etc.), even an independent central bank may be an insufficient guarantor of operational independence. In such cases, or where policymakers have a strong desire to attain exchange rate stability (and investor confidence) quickly, currency boards may be pursued.[39] Currency boards represent a stronger and more rapid institutional fix for credibility problems because they operate under tighter restrictions than do independent central banks. And though consideration of currency substitution or "dollarization" is outside the scope of this paper, it bears noting that this strategy may be pursued in those cases where problems of credibility are most severe, where the government cannot be trusted to respect currency board independence, and/or where policymakers seek the most rapid route to exchange rate stability. Hence, independent central banks, currency boards, and dollarization all represent means by which reformers may solve the credibility problem by eliminating discretion over monetary policymaking.

Certainly factors other than the severity of the credibility problem and the speed with which policymakers seek to attain a sound currency may influence the choice among the institutional fixes considered here. In some cases, policymakers may be driven by strategic

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the ideology they identify. Moreover, McNamara [1998] can be read as suggesting that the economic analysis underlying the new consensus is indeed "correct."

[39] A wide body of scholarship seeks to establish the economic preconditions for currency board success [e.g., Williamson, 1995]. For example, currency boards are appropriate to small countries. Note, however, that Argentina is an important exception to the size criterion (see Eichengreen [1999] for discussion of the Argentine exception).

concerns to implement a currency board or even dollarization.[40] Currency boards and dollarization may be used to signal a strategic commitment to countries to which the national currency is tied. The very success of this signaling process itself creates the credibility of the strategy, thereby reinforcing the ideological claims of its proponents. Alternatively, in those countries where concerns about the protection of national identity are strongest, currency boards and especially dollarization are infeasible strategies. In such cases, policymakers will likely attempt to resolve the credibility deficit via the construction of an independent central bank. Thus, the historical, economic, and political context matters deeply in understanding why countries adopt one institutional fix to their credibility problem over another (as numerous contributions to this volume make clear, e.g., Abdelal, Blyth, Gavin, Helleiner, Schamis, Stasavage, Wang).

One must not over-emphasize the concept of policymaker choice in the emerging economy context, however. In the case of emerging economies, power plays at least as important a role as policymaker choice in explaining the form of institutional innovation. To be sure, the degree of freedom granted emerging economy governments by powerful external actors varies across countries and across time. (See Helleiner [2001] for discussion of this variance.)

When?

The question of the timing of the institutional innovations under consideration deserves mention. Ideology and power co-determine *when* reformers in emerging economies create independent institutions of monetary and exchange rate policy. For "early adopters" of these reforms, it is clear that the ideological aspects of new-classical theory played a precipitating role in stimulating the institutional innovation. Reformers were receptive to new-classical ideas

[40] Stasavage [2001] argues that for many African countries continued participation in the CFA Franc Zone has been inextricably linked to strategic considerations (particularly to the desire on the part of national leaders to maintain

about the preconditions for policy credibility at precisely the time when older models of economic development were being discredited. The persuasiveness of economists as an epistemic community in pushing these ideas and in promulgating an interpretation of past policy failures cannot be understated. In addition to the power of ideas in shaping these reforms, more traditional expressions of power (e.g., over external assistance and over private capital flows) play a central role in explaining these reforms. Since the debt crisis of the 1980s, the power and autonomy of the IMF and the private financial community has increased vis-à-vis the policy decisions of emerging economy governments [see Blyth, 2001].

Thus, in the 1980s a search for alternative development strategies coincided with the ability of powerful actors to present a persuasive case that the right path was found in the new new-classical paradigm. As Ikenberry [1993:82] writes "not all increments of time are equal," a point that underscores the particular temporality of the implementation of independent central banks and currency boards. Goldstein and Keohane [1993] write in a similar vein about the openness to new ideas during uncertain times when the old conventional wisdom is seen to break down. Moreover, Halpern [1993] describes how following important upheavals, there is a tendency toward mimesis of imported strategies in policy design (or of policy emulation in McNamara's view [1998]). While Halpern focuses on the post-revolutionary moment, the tendency she identifies clearly figures into explanations of the spread of institutional independence in emerging economies following the collapse of the institutions (e.g., dependent central banks) and strategies associated with Keynesian state-led development.

Moving from earlier to later adopters, we can see that the initial momentum behind the creation of independent institutions creates a reform dynamic. For later adopters, ideology takes on an ex-post role in validating and legitimating decisions to create these institutions. The more

French aid and security support).

that countries are rewarded and validated for this institutional innovation (via the receipt of external assistance and private capital flows), the greater are the incentives and pressures for other countries to follow this path and no other.[41] In this manner, an international consensus around the inevitability of these reforms is cemented.

How?

Much of the above discussion anticipates the issue of *how*, and by what mechanisms, ideology and power drive the creation of independent central banks and currency boards. There are, in fact, several (mutually reinforcing) channels by which ideology and power promote this institutional innovation.

First, by supplying an abstract understanding of the causal link between institutional independence and desired macroeconomic outcomes, the ideological aspects of new-classical theory provide an intellectual justification for one type of governance structure over all others. Once an independent governance structure is established, inertia sets in largely because policy choices are path dependent (unless and until a crisis of confidence emerges, forcing a rethinking of strategies). Goldstein and Keohane [1993] (and many of the essays therein) trace the manner in which ideas serve as important "causal pathways" and/or discourage policy innovation via ideational inertia.

Second, in the emerging economy context, considerations of material power, as well as the power to persuade, must inform analyses of how new-classical ideas about institutional independence have been institutionalized over competing views. Although Berman [1998] and McNamara [1998] do not introduce power into their analyses, they do introduce useful considerations of the process by which particular ideologies become institutionalized. Berman

[41] The political interpretation of monetary reform advanced in this paper implies that mimesis is not simply a matter of adopting the institutional innovation that works best.

[1998] elucidates the multiple mechanisms that policy entrepreneurs employ in efforts to secure the acceptance and institutionalization of their ideas. This discussion is relevant to understanding how an international epistemic community successfully leveraged its intellectual and political capital to establish new-classical theory as the conventional wisdom. By overlaying power on McNamara's [1998] model, one can better understand how new-classical policy entrepreneurs were able to articulate a particular explanation of policy failure in the 1980s and advance their approach as the only viable alternative to past strategies. Finnemore [1993, 1996] presents a comprehensive description of the multiplicity of strategies by which policy entrepreneurs "sell" their ideas to policymakers, thereby redefining state objectives and policy targets. Finnemore's approach emphasizes that the institutional innovations under consideration in this paper are a product of intellectual "marketing" and ideational and material coercion by influential actors. Finnemore and Sikkink [1998] attempt to generalize the norm diffusion process by developing a "norm life cycle" model. Though the temporality and distinctness of the model's stages are drawn too neatly, the model does illuminate well the diverse means employed by norm entrepreneurs to elevate the case for institutional independence to the status of conventional wisdom.

Third, once the case for institutional independence assumed the status of conventional wisdom, this innovation necessarily took on a life of its own as a necessity for all emerging economies. Processes of mimesis [per Halpern, 1993], policy emulation [per McNamara, 1998], and contagion [per Jackson, 1993]—*reinforced* by the expression of power and the continued sway of new-classical ideology in a neoliberal world—combine to diffuse further the adoption of institutional independence.

5. SPECULATIONS ON THE ROLE OF IDEOLOGY AND POWER IN SHAPING

MONETARY REFORM IN EMERGING ECONOMIES IN THE 21st CENTURY

This paper has argued that considerations of ideology and power are central to the task of understanding why independent central banks and currency boards are becoming increasingly common institutional forms in emerging economies (despite an ambiguous empirical record). From the perspective of new-classical economic theory, independent central banks and currency boards embody the singularly correct, inevitable resolution to problems of monetary and exchange rate credibility in emerging economies. Upon examination, however, the theoretical edifice that provides intellectual justification for these institutions is found to have important ideological attributes, attributes that render the theory and its institutional co-requisites uniquely efficacious and irrefutable. Moreover, the ideological attributes of the theory also mask the critical role of power in establishing and defending independent central banks and currency boards.

By foregrounding these political variables I have not completely rejected the new-classical economic arguments in favor of institutional independence. Rather I have argued that the new-classical economic arguments for institutional independence critically understate and, in some cases, obscure the central role of politics (over economic science) in driving these reforms. Ideology and power figure not only into the positive decision to create independent central banks and currency boards, but also into decisions not to consider alternatives institutional forms.

This raises the question as to whether it is reasonable to assume that the ideology of new-classical economics and the power of the vested interests it serves will continue to secure and advance the neoliberal agenda in the early decades of the 21st century. The answer, I think, is yes. There are several reasons for reaching this conclusion.

1. The theory of policy credibility (and the new-classicism on which it depends) has

served to revitalize neoclassical development economics. Credibility provides insulation from empirical refutation, and so sustains the theory, despite recurring development disappointments and even disasters. This insulation may ultimately prove to be credibility's most enduring contribution to neoclassical theory.

2. More broadly, and partly as a consequence, new-classical economic theory and its embodiment in the fundamental aspects of the "Washington consensus" shows no signs of losing its hegemonic status within the economics profession.[42] The recent effort by the American Economics Association to purge the participation of heterodox economists from the Association's annual conference does not prove this point, but it does underscore the power (and, I would add, the hubris) of new-classical economic theory within the profession today. Certainly, heterodox economists and others critical of the Washington consensus in policy were heartened by the brief moment of self-doubt that plagued new-classical economists following the Asian financial crisis (and following the earlier crisis in Mexico in 1995-6). However, with only a few notable exceptions, the destabilizing effects of the crisis for new-classical economic theory and its most important policy co-requisites have largely disappeared [see Grabel 1999, 2000]. The new-classical economic consensus has been restored. Polanyi would have predicted as much.

3. There is today an increasing emphasis worldwide on the need to place policymaking authority in the hands of technocrats, or what Williamson [1994], following Dominguez and Feinberg, terms "technopols."[43] This effort is not just confined to emerging economies, as the

[42] The Washington consensus refers to a broad set of economic policies embraced by the IMF, the US Treasury, international investors and market-oriented reformers in emerging economies. Williamson [1994:26-8] details these policies.

[43] Technopols refer to economists in key policy-making positions. Toye [in Williamson, 1994] suggests that the term "econopols" is a more useful descriptive term, though it should be clear that the term technocrats is most commonly employed to refer to those economists who occupy policy-making positions.

creation of an independent ECB and independent national central banks in the region demonstrates. The delegation of authority to unelected technocrats around the world--whether in the realm of monetary, exchange rate, fiscal, or any manner of administrative or juridical functions—suggests that the trend toward the creation of independent central banks and currency boards is part of a larger movement to depoliticize economic policymaking.

This paper excavates the politics that underlay the economic arguments for establishing independent central banks and currency boards in emerging economies. As the papers in this volume collectively make clear, politics plays a significant and often determinative role in shaping monetary affairs. This is as it should be, insofar as monetary policy and institutions always have differential effects on the groups constituting society. As such, the effects of these reforms should be identified, assessed and contested—in a word, politicized. But this makes new classical economists uncomfortable. For them, the economics they advance is an entirely objective science, whose policy findings should be secured through thoroughly apolitical institutions. In short, new classical theorists respond to political challenges by attempting to depoliticize economic policymaking. But as this paper has argued, the effort to depoliticize policy is a deeply ideological and radically political project indeed.

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