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# Terms and conditions for the implementation of inflation targeting in Croatia



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### **Abstract**

Since the introduction of the Stabilization program in 1993, the Croatian National Bank has been following the monetary strategy of exchange rate anchor. During the first several years (from 1993 to 1997) this monetary strategy achieved acceptable results, accompanied with a low inflation rate and high GDP growth rates. However, the macroeconomic situation has changed in the last decade. The indicators of Croatian economy, such as trade balance, the level of external debt and GDP growth rates, are not satisfying. The critics of exchange rate anchor monetary strategy argue that appreciated kuna lowers the competitiveness of the domestic economy. Due to that, the current monetary strategy is in the focus of various economists' discussions.

One of the alternatives to the exchange rate anchor is inflation targeting. There are different theoretical and practical issues connected to the implementation of this, very popular, monetary strategy. Before the implementation of inflation targeting, the following conditions need to be fulfilled: (1) the independence of monetary authorities in choosing the monetary instruments should be achieved, (2) at least one monetary policy instrument should be efficient, and (3) the transparency of monetary policy should be accomplished. The process itself consists of several decisions, such as choosing the proper measure of inflation, the level of targeted inflation, targeted range or point etc., which is still a matter of theoretical debates.

The purpose of this paper is to contribute to the above mentioned debate. After the theoretical discussion, the inflation targeting will be analyzed from the two perspectives. Firstly, in order to evaluate the capability of Croatia to implement the inflation targeting, the analysis of the Croatian monetary system will be given. Secondly, in order to assess the suitability of the inflation targeting as Croatian monetary strategy, both positive and negative characteristics of this strategy will be considered.

### **Keywords**

inflation targeting, monetary strategy, Croatia

### **JEL classification**

E42, E52, E58

## 1. INTRODUCTION

Since the introduction of the Stabilization program in 1993, the Croatian National Bank<sup>1</sup> has been following a monetary strategy of exchange rate anchor. During the first period from 1993 to 1997 this monetary strategy achieved acceptable results, accompanied with a low inflation rate and high GDP growth rates. However, the macroeconomic situation changed in the last decade. The indicators of Croatian economy, such as trade balance deficit, the level of external debt and GDP growth rates, have not been satisfactory. The critics of the exchange rate anchor monetary strategy argue that appreciated kuna lowers the competitiveness of the domestic economy. As a result, the current monetary strategy is in the focus of various economists' discussions. One of the alternatives to the exchange rate anchor is inflation targeting – nominal anchor introduced by monetary policy authorities at the end of 20<sup>th</sup> century.

## 2. ISSUES OF INFLATION TARGETING

The first country which introduced the inflation targeting was New Zealand (1990), followed by a great number of other countries like Canada (1991), Great Britain (1992), Sweden and Finland (1993) etc. Although there is no clear consensus in the literature, the inflation targeting is often defined as a framework for monetary policy, characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate, over one or more time horizons, and by explicit acknowledgment that low, stable inflation is monetary policy primary long run goal (Bernanke, Mishkin, 1997; Bernanke et al., 1999; Petursson, 2000). According to the mentioned definition, Mishkin (2001) argues that inflation targeting encompasses five main elements: 1) the public announcement of medium-term numerical targets for inflation; 2) an institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated; 3) an information inclusive strategy in which many variables, and not just monetary aggregates or the exchange rate, are used for deciding the setting of policy instruments; 4) increased transparency of the monetary policy strategy through communication with the public and the markets about plans, objectives, and decisions of the monetary authorities; and 5) increased accountability of the central bank for attaining its inflation objectives.

### 2.1. Technical issues

The first step in the implementation of inflation targeting is to define the *measure of inflation* which will be used. The optimal transparency of targeting is best achieved by choosing the index recognized by the public, which contains the prices of the key products in order to ensure its accountability. Beside that, the index should exclude the changes that are unlikely to affect the core inflation. In most countries the inflation target is based on the Consumer Price Index (CPI). The main advantage of the CPI is that the index has a long history and is well known among the public. (Petursson, 2000). The fact that the CPI includes some items which are out of range of monetary policy and have temporary impact of inflation is the reason to use "modified" CPI as a target index (Table 1).

Table 1: Countries with formal inflation targeting

	Adoption year	Target band
New Zealand	1990	0 – 2% (until 1996.) 0 – 3%
Israel	1991	8 – 11% (until 1998.) 7 – 10%
Canada	1991	1 – 3%
England and Scotland	1992	1 - 4%, (until 1997.) 0 – 2,5%
Australia	1993	2 – 3%
Sweden	1993	1- 3%
Czech Republic	1997	5,5 – 6,5% in 1998, 4 – 5% in 1999, 3,5 – 4,5% in 2000
Switzerland	1999	0 – 2%

Source: Petursson (2000), according to Bernanke, Mishkin (1997), Bernanke, Laubach, Mishkin & Posen (1999), and central banks web-sites.

<sup>1</sup> Croatian National Bank – CNB

After defining the index, the second issue in the implementation of inflation targeting is the *target variable*. Due to a number of costs and benefits, a strong debate has taken place about whether to target the inflation rate or the level of prices. The choice between price level targeting and inflation targeting involves a kind of trade off between less low frequency price level variability and less high-frequency inflation and employment variability (Swensson, 1996). The inflation targeting entails more uncertainty in a long-term price forecasting than price level targeting does, which causes high variability in the price level. At the same time, long-term price level targeting is accompanied by lower variability in the price level. On the contrary, price level targeting causes short-term fluctuations in inflation and output, which is not the case with inflation targeting. Another disadvantage of the price level targeting refers to the fact that higher inflation rate in a period  $t$  needs to be followed by a disinflation measures in a period  $t+1$  in order to keep prices on the announced level. Parkin (1998) argues that nominal interest rates have a zero lower bound, and targeting a stable price level will conflict with the zero lower bound too often and leave monetary policy unable to speed the end of a recession. Beside that, he notes that inflation lubricates the labour market and makes it work more efficiently. Despite its opponents (See: Guender, Yooch On, 2005; Epstein, 2005), the number of inflation targeters is growing up.

The *level of targeted inflation* is the most important issue which has to be reconsidered by monetary authorities. There are two different approaches in the literature concerning this problem. According to Poole (1999), the most prominent advocate of zero inflation targeting, inflation uncertainty makes it difficult for individuals and firms to distinguish changes in relative prices among goods and services from movement in the aggregate price level. Beside that, maintaining a steady but positive inflation rate would probably be harder politically than maintaining a steady zero inflation. A third reason for targeting zero inflation concerns the distortions caused by the interaction of inflation with the tax code. Inflation indexing is incomplete, especially for investment income, because tax is levied on nominal interest and capital gains income. Arguments pros inflation targeting above zero rate are set up by Bosking et al. (1996). They found out that the HCPI index overestimates the real rate of inflation for one half to two percentage points, which brings to conclusion that targeting inflation at zero rate would actually bring to deflation, depending on observed economy. In addition to deflation problem, Mishkin (2001) emphasises the enormous costs of fighting deflation, which needs to be avoided. In accordance to the offered arguments most central banks target inflation values above zero rate level. The clearance from deflation is visible in the ECB strategy of inflation targeting at around level of two per cent: "While deflation implies similar costs to the economy as inflation, avoiding deflation is also important because, once it occurs, it may become entrenched as a result of the fact that nominal interest rates cannot fall below zero. In a deflationary environment monetary policy may thus not be able to sufficiently stimulate aggregate demand by using its interest rate instrument. Any attempt to bring the nominal interest rate below zero would fail, as the public would prefer to hold cash rather than to lend or hold deposits at a negative rate. Although various monetary policy actions are possible even when nominal interest rates are at zero, the effectiveness of these alternative policies is not certain" (ECB, 2004: 51-54.)

Another issue for policy makers is what to target, *range or strict inflation point*. Advocates of targeting the strict point argue that targeting the range (especially broader range) leads to uncertainty in inflation expectations which lowers the credibility of the central bank. On the contrary, targeting the range offers more flexibility in conducting the monetary policy. Thus, central banks usually target range rather than a point (See Table 1). Furthermore, problems on which the Bank of New Zealand has come across in early nineties (See: Bernanke et al., 1999; Brash, 2000) have made the controllability and credibility of narrow target bounds questionable. Narrow target bounds, just like targeting the point, lack flexibility. Consequently, most of inflation targeters deal with targeting broader range.

Inflation targeting can be implemented through *one or more time horizons*. Majority of central banks targets inflation within the one to four year range. The reason for avoiding short-term inflation targeting lies in the fact that the phenomena of inflation is not under the influence of monetary policy in the period shorter than one year. Theoretical background of this view can be found in the Friedman's "key assumptions of monetarism" (See: Perišin et al., 2001) Longer than four year inflation targeting horizon, on the contrary, seems to be questionable from the aspect of credibility of the monetary policy, due to its uncertain character

in the short term. The analysis of Batini and Nelson (2000) supports the view that, in practice, inflation targeting should be designed so that the target is achieved over the medium term. In other words, central banks wishing to act optimally should not attempt to neutralise inflationary shocks immediately, but respond gradually to them.

## 2.2. Preconditions for implementation of inflation targeting

The experience of long-time inflation targeters emphasizes preconditions which have to be fulfilled in order to implement successful inflation targeting. The first and probably the most important precondition for implementing the inflation targeting is the *absolute instrument independence* that must be given to central bank. Central bank needs to have the freedom to set its instruments of monetary policy, the way it believes that the objective will be achieved most adequately. Instrument independence mainly implies that the central bank is not constrained by the need of financing the government budget.

The second precondition for implementation of inflation targeting is the existence of *efficient monetary policy instruments*. In the inflation targeting process central bankers need to have the instrument which is useful in stabilizing inflation movements. Present experience supports indirect monetary measures, first of all short-term interest rates, as the best solution for inflation targeters. (Blejer, Leone, 1999)

The third but not less important precondition for inflation targeting is closely connected to the *credibility and transparency* of the central bank's functioning. Both, credibility and transparency are dominantly determined by the quality of central banks communication to the public. It is very important for central bank to inform the public about every circumstance connected to its policy, in order to make its goals and instruments clear and controllable. A transparent monetary policy makes for a central bank more difficult to deviate from set targets, since such behaviour would have serious and long-lasting impact effects on its credibility (Petursson, 2000).

## 2.3. Costs and benefits of inflation targeting strategy

Inflation targeting can have both positive and negative effects on the economy. In accordance to their experience, inflation targeting advocates emphasise its positive characteristics:

- Inflation targeting, unlike the other explicit monetary anchors, is a monetary strategy according to which the activities of the central bank are oriented to domestic economy and potential shocks generated in it.
- The success of this strategy is not dependent on the stable ratio between money supply and inflation, since it is not based on this ratio.
- Number of variables that influence monetary policy making are unlimited, all information available at the moment have to be taken into consideration.
- Inflation targeting is positively accepted by the public, meaning that transparency and communication are generally on the satisfactory level.
- Quantitatively determined targeted variable (inflation rate), high level of transparency and regular communication increase central bank level of responsibility, acting as a precaution against possible problems of time consistency.
- Very positive experiences have been observed in countries which have been implementing the strategy of inflation targeting, reflecting in the lower inflation rate, as well as decreased level of inflationary expectations. An additional positive point is the fact that after initial decrease inflation rate stays remained on this lower level.

On the other hand, there are some negative characteristics of inflation targeting. The opponents of this strategy find these characteristics sufficient to marginalize, if not merely to abandon the strategy.

- Numerous economists support the attitude that inflation targeting introduces significant rigidity into monetary policy making, restricting its potential for response in the circumstances of unpredicted shocks.

- The influence of the monetary policy on targeted variable in conditions of inflation targeting can be observed with a certain time delay. Taking into account these delayed indicators it is not possible to estimate the effect of central bank measures promptly.
- The key argument against inflation targeting is stronger fluctuations in terms of income, which are, in many opinions, caused by this strategy. Namely, when the inflation rate is above its targeted level, central bank is implementing restrictive monetary policy measures, and vice versa. Changes in the monetary policy trend leads to fluctuations in the income level.
- Relating to the delayed effects of the central bank actions and its unpredictable results, inflation targeting at the end leads to a low responsibility of the central bank, which is especially dangerous in the developing countries.
- Inflation targeting can not prevent fiscal dominance.
- The flexibility of the foreign exchange rate, necessary for the inflation targeting implementation, under some circumstances can result in financial instability. (Mishkin, 2001; Kadioglu et al., 2000)

### 3. INFLATION TARGETING IN CROATIA

As it can be seen from the previous chapter, inflation targeting, like all other monetary strategies, has its positive and negative points. Implementation of inflation targeting in Croatia, like in other countries, requires fulfilment of the implementation preconditions, followed by the analysis of the costs and benefits it carries.

Technical aspects of the inflation targeting (measure of inflation, target variable, time horizon), although theoretically questionable, are unified in the practice of inflation targeters. Most probably, these aspects would not be seen as a problem for Croatian monetary authorities. Special attention has to be given to the preconditions for the inflation targeting.

1) The accomplishment of the first precondition, instrument independence of the CNB, is mainly ensured by the Croatian National Bank Act accepted in 2002. "Article 2, Paragraph (2): In performing its tasks, the Croatian National Bank shall be autonomous and independent and shall be accountable to the Croatian Parliament. Article 36, paragraph (1): The Croatian National Bank may not extend credit to the Republic of Croatia. Paragraph (2): No legal arrangement concluded by the Croatian National Bank with the Republic of Croatia shall have credit features or be used for extending credit to the Republic of Croatia or to third parties acting as intermediaries through which the Republic of Croatia would become the final beneficiary of such credit (CNB Act, 2002). Instrument independence of CNB existed in practice even before, which can be confirmed by the analysis of the CNB balance sheet. After May 2000, CNB claims on government are equal to zero.

2) The second precondition for establishing inflation targeting is the existence of efficient monetary policy instrument, useful in stabilizing inflation. The accomplishment of this precondition could not be observed as an easy task. Despite the fact of achieving its main goals, price and exchange rate stability, the CNB practice has been offering a bit different approach from the usual in the last fifteen years. Liquidity and banking crises at the end of the last century have forced the central bank to conduct a rather restrictive monetary policy. The privatization of the banking sector has additionally exposed the vulnerability of the monetary policy and its instruments. Finding no adequate resources at domestic money market, Croatian banks have had two possible options in order to improve their credit potential: a) turning to the European money market and b) taking loans from their mother- banks. Both approaches have brought to optimal results for the banking sector, mostly because of the huge interest rate spread between both the foreign and domestic money markets. Consequently, the external debt of the Republic of Croatia expanded rapidly (Table 2).

Table 2: Gross external debt by domestic sectors (million euros)

	2000	2001	2002	2003.	2004	2005	2006*
1. Government	5.276	5.942	5.900	6.600	7.251	7.047	6.659
2. CNB	215	215	23	365	2	2	2
3. Banks	2.195	2.547	3.789	6.121	7.701	8.993	10.182
4. Other private sector	3.708	3.661	3.934	4.878	5.809	7.156	9.361
5. Direct investment	712	1.091,4	1.407	1.844	2.015	2.340	2.826
Total (1+2+3+4+5)	12.109	13.458	15.054	19.810	22.780	25.540	29.032

\*Data not revised

Source, Croatian national bank, May 2007; available at [http://www.hnb.hr/publikac/bilten/statisticki\\_pregled/h12.xls](http://www.hnb.hr/publikac/bilten/statisticki_pregled/h12.xls)

An additional problem arises from the slow but evident change in the bank credit policy - for the past five years Croatian banks have dominantly been oriented to crediting households sector. Thus, personal consumption became the dominant GDP component.

The above mentioned process resulted in strong efforts of monetary authorities to stop new assignments and credit expansion. Since 2002 the CNB has introduced several monetary policy instruments: 1) reserve requirement, 2) marginal reserve requirement, 3) special reserve requirement, 4) compulsory CNB bills and 5) minimum required amount of foreign currency claims, which are still in use. In spite of mentioned restrictions banks continued to borrow money on the European market. Furthermore, they connected Croatian private sector directly to their mother-banks. This way they succeeded to make extra profits by avoiding domestic regulations but brought Croatian monetary authorities to another dilemma: How to stop the private sector external debt growth? (Table 2). Unfortunately, but almost certainly, in the close future domestic public will witness the introduction of some new monetary policy instruments. Their efficiency will be a matter of some further discussion on this topic.

On the other side, CNB discount rate has not been referent for years. Furthermore, with the lowest existing 3,5% repo rate CNB offers inadequate amounts for banking sector. The analysis of the current monetary policy outlook brings to conclusion that CNB doesn't react proactively to movements that happen in the monetary sector. Its reactions seem to be passive and not supported with necessary projections of future events. Therefore, relevant evidence exists that actual monetary policy and its instruments are not in line with the inflation targeting strategy.

3) Credibility and transparency of central bank's functioning is the third precondition for inflation targeting. Transparency of CNB activities is confirmed by its adequate and ordinary communication to the public. Beside regular publications (SPF, Bulletin, Banks Bulletin, Annual Report, Macro prudential Analysis) CNB issues occasional publications (working papers, surveys, bilingual regulation booklets, other publications) too, which increases the level of its transparency.

Concerning credibility, the situation is slightly different. Although, the most important elements for building central banks credibility<sup>2</sup> are fulfilled, the credibility problem is emphasised. The lack of trust by the public in the national currency and its exchange rate is reflected in the large proportion of foreign deposits. Bank's accounts evidence that the amount of foreign deposits exceeds the sum of demand deposits and savings and time deposits during the whole observed period (Table 3).

Table 3: Banks' Accounts, Liabilities – deposits (million kunas)

	2000	2001	2002	2003	2004	2005	2006
Demand deposits	11,386.0	15,180.6	21,166.2	23,315.0	23,591.3	26,653.3	33,911.7
Savings and time deposits	7,651.1	10,213.1	13,001.1	18,370.7	22,479.2	27,992.1	44,836.8
Foreign currency deposits	46,901.6	71,836.9	72,054.6	76,035.3	81,742.9	86,760.8	88,256.7

Source, Croatian national bank, May 2007; available at: [http://www.hnb.hr/publikac/bilten/statisticki\\_pregled/d1.xls](http://www.hnb.hr/publikac/bilten/statisticki_pregled/d1.xls)

<sup>2</sup> According to Blinder (2000), the key elements for building central banks credibility are: 1) history of honesty, 2) Central bank independence, 3) history of fighting inflation and 4) transparency.



Furthermore, the process of indexation of transactions to foreign currency (primarily the euro) is still evident. As a result, the national currency has merely the function of the means of payment and conducting transactions, but lacks the functions of measuring value, saving and crediting. This means that the monetary policy credibility in Croatia exists as far as the stability of prices is concerned but the same cannot be stated when addressing the central bank's exchange rate policy (Ivanov et al., 2004).

CNB instrument independence is achieved, but another two necessary preconditions for implementation of inflation targeting in Croatia are not completely fulfilled. It is evident that Croatian monetary system has passed through significant positive changes since 1991. The preconditions for adopting the inflation targeting regime in Croatia, however, are not present yet. Improving the monetary and inflation performance of transitional economies should probably continue to rely on simpler and less demanding but not necessarily less effective monetary policy frameworks (Masson et al., 1998).

### **3.1. Costs and benefits of inflation targeting**

Due to the fact that inflation rate in the Republic of Croatia is low, among all above mentioned benefits of inflation targeting, one of them is specially interesting: under inflation targeting regime inflationary expectations are decreased. In spite of a long history of fighting inflation, the permanent effect of high inflation expectations is widely present in domestic economy. This thesis is best supported by price indexation of real estates and other valuables. In addition, the situation is worsened by the exchange rate clause introduced by commercial banks. Banks nominate most of their loans in euros in order to protect themselves of the exchange rate risk. Thus, decreasing inflation expectations under inflation targeting would bring significant benefits to the economy.

Negative characteristics of inflation targeting which need to be analyzed are: 1) Stronger fluctuations in terms of income, which are, in many opinions, caused by this strategy and 2) the flexibility of the foreign exchange rate, necessary for the inflation targeting implementation, in some circumstances can result in financial instability.

First of all, the current Croatian economic environment needs higher growth rates in order to lower unemployment and to make living standard better. Strong fluctuations of the income do not fit into this scenario at all.

Secondly, negative characteristic refers to financial instability which can arise from the flexibility of the foreign exchange rate, necessary for the inflation targeting implementation. Under the assumption of successful implementation of the flexible exchange rate policy, monetary authorities will probably face another problem. Namely, high degree of (partial) dollarization (in the Croatian case it is about dollarization with the euro - euroization) may create a potentially serious problem for inflation targeting. Croatia, like many emerging market countries, suffers from substantially dollarized balance sheets of firms, households and banks. Accordingly, the majority of long-term debt is denominated in euros. Because inflation targeting necessarily requires nominal exchange rate flexibility, exchange rate fluctuations are unavoidable. However, large and abrupt depreciations may increase the burden of euro denominated debt, produce a massive deterioration of balance sheets, and increase the risk of a financial crisis. This suggests that emerging market countries cannot afford to ignore the exchange rate when conducting monetary policy under inflation targeting, but the role they ascribe to it should be clearly subordinated to the inflation objective. (Mishkin, 2001)

## **4. CONCLUDING REMARKS**

Although the performance of the current monetary regime in the Republic of Croatia is not satisfactory, the change of nominal anchor and implementation of inflation targeting is not an option. In Croatia, like in most developing countries, the preconditions for adopting such a framework are not present yet. The instrument independence of the CNB is mainly ensured by the Croatian National Bank Act adopted in 2002. However, the credibility problem and the problem of efficient monetary policy instruments are still

unsolved. The credibility problem is emphasized by the lack of trust in the national currency and its exchange rate. The analysis of the current monetary policy outlook brings to conclusion that CNB doesn't react proactively to movements that happen in the monetary sector. Furthermore, an efficient monetary policy instrument is not detected.

The cost benefit analysis offers no obvious evidence that the benefits from adopting a new nominal anchor would exceed its negative impacts. Furthermore, under the assumption of successful implementation of the flexible exchange rate policy, exchange rate fluctuations and possible depreciation pressures could increase the risks of a financial crisis.

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