

# Free Enterprise and Central Banking in Formerly Communist Countries

Robert L. Hetzel\*

## I. INTRODUCTION

The economic difficulties manifest in communist countries have encouraged a desire in many of them to move toward a market economy. This paper surveys specific reasons for the breakdown of centrally planned economies and discusses the difficulties of making the transition to a market economy. A general theme is that a market economy requires the limitation of government intervention in the marketplace. This theme is illustrated by a discussion of the central bank. The final part of the paper advances the proposal that formerly communist countries eliminate their central banks by adopting the currency of a large western country with a stable currency. This proposal is discussed in the context of the German monetary union, which will eliminate the East German central bank.

## II. BREAKDOWN OF THE SOCIALIST ECONOMIES

### Market Pricing

The economies of communist countries collapsed in part because external forces overwhelmed their pricing system. In a market economy, prices equate the value consumers attach to consuming more of a good to the costs of producing more of it. This equality between the (marginal) cost of consuming and producing a good derives from the incentives in the price system to eliminate discrepancies between the marginal benefit of consuming and marginal cost of producing a good. In contrast, central planners set prices as part of an implicit tax-and-transfer policy designed to subsidize some goods by taxing others. On first pass, central planners set the price of a firm's output at whatever level is necessary to cover its average labor costs. They then adjust price differentials among firms in order to tax some kinds of output and subsidize others.

\* I received useful criticism from John Caskey, Norman Fieleke, Anne Krueger, Ivo Maes, Mark Swinburne, Steven Webb and colleagues at the Richmond Fed.

Typically, basic foodstuffs and commodities are subsidized, while goods considered luxuries are taxed. For example, the *New York Times* (1/7/90, p. E3) reports that every pound of butter sold in Czechoslovakia costs the government more than \$1.70 in subsidies. The *Times* (4/3/90, p. A16) also reports that in the Soviet Union, "the government is forced to spend about \$160 billion in subsidies on food and some consumer goods annually, while the cost of many industrial goods is far higher than in the West." The banking system extends credit to cover the deficits of firms whose prices are set below average cost.

Because central planners did not change prices in line with changes on world markets, over time, the subsidies required by their price system became intolerably expensive. For example, in the Soviet Union, energy prices were not raised with the rise in world prices. The resulting increased subsidy to energy-intensive activities and to Comecon countries receiving oil and natural gas exports removed the incentive to economize on the use of energy and forced the Soviet Union to make large investments in energy production that strained its economy. The lack of a free-market price system to coordinate economic activity in communist economies meant that these economies could not adjust to changes in the world economy.

Communist countries promised equality and individual security to their citizens in return for their acceptance of authoritarian control. As the standard of living in communist countries fell behind that of capitalist countries, the need to deliver on this promise became more pressing. In practice, in communist countries, equality meant subsidizing basic commodities and foodstuffs. Individual security meant keeping open inefficient enterprises in order to prevent unemployment. The required system of taxes and transfers became too costly and collapsed. The rationale for communism then collapsed.

In countries like Poland and the Soviet Union, the pressure to provide subsidies overcame the ability

of the government to tax. From that point on, credit extension to enterprises running a deficit had to be financed by printing money. The resulting inflation interacted with unchanged, centrally set prices to produce shortages and lines. The time spent waiting in line raises the effective price paid for goods and limits demand. Workers waiting in line, however, cannot produce. As production fell, the tax base also fell and exacerbated the lack of revenue needed to finance subsidies. In a letter to the *New York Times* (12/11/89, p. A15), a visitor to Poland wrote:

I can testify to the harshness of everyday life, where there were lines for every kind of food, for appliances and clothing, etc. There were lines of people waiting in the morning when we went to work, and they were still there in the evening. There were lines forming on Sundays, awaiting the stores' opening on Monday if some home appliances such as refrigerators, TVs or kitchen stoves were promised. The average housewife had to run out before 6 a.m. to get some breakfast, and after work or school each member of the family had an assigned task to stand in line for foodstuffs or other essentials.

By reducing the real value of fixed prices, inflation lowered the return to producers, who then decreased supplies. An article in the *New York Times* (10/31/89, p. A4) reported that:

. . . in the last three years stocks of hogs, Poland's principal livestock, fell from 22 million to fewer than 14 million. . . . In a reversal that would be bizarre in the West, but is common enough here, the supply of pork has diminished precisely as the demand has grown. What has happened is that the farmers have killed off their own herds rather than prolong their own agony of paying the high prices fixed for fed grain available only from a state monopoly and at the same time selling their butchered hogs for prices fixed low enough to appease consumers.

Market pricing requires an end to price controls. Price reform, however, is difficult because it redistributes income. The queuing produced by the use of price controls to suppress inflation redistributes income to people whose time has little market value, such as the elderly and unskilled. The price rises necessary to eliminate suppressed inflation eliminate queues, but they also raise relative prices to groups with a comparative advantage in queuing.

The bribery and black markets that inflation and price controls create also render price reform difficult politically. Because price rationing through bribery and the "high" price of black markets is illegal, these rationing mechanisms create a class of criminals. The popular impression is that this class enriches itself at the expense of the ordinary person by charging exorbitant prices. This impression is correct when

state employees accept bribes and when individuals who sell in black markets acquire goods from state-owned enterprises at controlled prices. As a result, the public believes that market-determined prices favor the few.

Piecemeal decontrol of prices exacerbates the public's distrust of market pricing because groups selling goods at prices that are high relative to state-controlled prices become a target of popular resentment. For example, in the Soviet Union, the private cooperatives, which initially could sell at unregulated prices, became natural scapegoats for politicians in crises. The *New York Times* (11/20/89, p. A1) reports, "Mr. Gorbachev told the Soviet parliament this fall that the soap shortage was the fault of the fledgling private sector cooperative movement, something that he began as part of perestroika but which has become so unpopular with the people—because of allegations of profiteering—that even Mr. Gorbachev himself often finds it an easy target."

## Free Trade

In a market economy, resource allocation is based on the value placed on private property by market prices. In market economies, price-coordinated voluntary exchange among individuals solves the related problems of how to assign value to scarce resources and of how to allocate them. Integration into the world economy requires that a country make its pricing system compatible with that of the world economy by adopting market pricing.

The practice in communist countries of using the price system to provide subsidies collapsed when they lost their ability to limit foreign trade. With free trade, market economies export goods for which they possess a comparative advantage in production. By contrast, with free trade, communist economies export goods they subsidize, thus creating bargain bazaars for foreigners until the communist governments run out of funds to finance exports. As explained to the *New York Times* (11/30/89, p. A1) by Gerhard Stauch, Chief Inspector for East German customs:

The smuggling-speculation spree has been stimulated by the relative abundance here of consumer goods that are inexpensive because they are subsidized up to 45 percent by the East German Government. . . . Last Friday the East German government initiated measures to curb the smuggling and speculation by declaring it illegal for foreigners, including American soldiers, to purchase a variety of goods. This placed an additional burden on the customs service, Mr. Stauch said, because many of his officers had to be posted in . . . department stores.

Local governments in the Soviet Union are even attempting to keep Soviet citizens from other areas from purchasing subsidized goods available locally. According to the *Financial Times* (3/9/90, p. 19),

In Leningrad . . . the City Council has just introduced a measure which forbids non-residents from buying a wide range of basic consumer goods: fresh fruit and vegetables, cheese, meat, sausage, knit-wear, china, watches, and so on. This act of self-defense against marauders from neighboring towns is certain to provoke counter-measures and could, if unchecked, lead to fragmentation of large parts of the Soviet economy.

### Private Property

In the Soviet Union, Hungary and Yugoslavia, decentralization of decision-making without allowing free-market pricing and without creating private property rights has exacerbated poor economic performance. In communist countries, coordination among enterprises is effected through commands issued by a central committee to ministries that in turn issue commands to enterprises. Committees of party members in enterprises enforce the centrally issued commands. Party members exercise control through the nomenklatura system, under which they appoint key officials in enterprises. In the Soviet Union, for example, this system gives the party direct control over as many as three million key jobs (*Financial Times*, 10/17/89, p. 2). In the Soviet Union, perestroika abandoned this system of coordination without replacing it with coordination by the price system.

Under communism, capital is controlled by members of the Communist Party. Authoritarian control of party members places control of the capital stock in the hands of the central committee. The breakdown in the authority exercised by the Communist Party with perestroika and with the discrediting of the party has meant that effective control of the capital stock has passed into the hands of the managers of enterprises. Pricing decisions then are based on the ability of managers to exploit the relative monopoly power of their enterprises. The returns to monopoly power are divided between managers and workers. This system, despite its decentralized decision-making, has proven to be even more inefficient than the centrally planned system it replaced. The *Financial Times* (3/12/90, p. XIII) reports, "A large part of the Soviet economy is like a quasi-medieval economy, based on exchange of goods in kind in an inefficient market, which operates without publicised prices. It is run by powerful industrial fiefdoms, rather than central planners."

## III.

### CREATING PRIVATE PROPERTY RIGHTS

#### Transferring State-Owned Property

In attempting to make the transition to a market economy, the most difficult problem formerly communist countries face is how to transfer the state-owned capital stock to private ownership. In countries like the Soviet Union, there is a lack of popular support for private ownership. Historically, ownership of resources has been determined through the coercive power of the state. In the Soviet Union, when the system of serfdom broke down and was replaced by the system of industrial labor relations in which workers are employed by capital owners, it was natural to view the capital owners as simply replacing the old landowners. Control of capital, like control of land formerly, was viewed as the basis for exploitation of workers. The belief that the ownership of resources is arbitrarily determined to benefit a few undermines the respect for property rights necessary to maintain a market economy.

The sale and pricing of state-owned assets will be socially divisive. Consider houses, which are owned by the government and rented at uniform rates. Viktor Geraschenko, President of the State Bank of the USSR, noted, ". . . housing is supplied by the state at a ridiculously low price which fails to differentiate between an apartment in the center of Moscow and one in the suburbs that is more than an hour's bus ride away." (*Corriere della Sera*, 11/22/89). In East Germany, the monthly rent for a two-bedroom house in the center of East Berlin is less than a meal for one person in a medium-priced restaurant in West Berlin (*New York Times*, 1/7/90, p. E3). The sale of houses at market prices established through auction would upset ownership patterns completely. The people who lost their houses would be dissatisfied. The sale of houses at below-market, uniform prices to current occupants, however, would preserve a status quo in property rights that was established arbitrarily or established through political influence.

Transferring state assets to private owners gradually will be difficult. The existence of private firms along with state firms creates incentives to loot the state firms by secretly transferring assets to the private

firms.<sup>1</sup> There may be no procedures for selling off state assets that will engender widespread public support for the resulting distribution of property. Governments may simply have to hold open auctions of all state-owned enterprises and accept that there will be winners and losers.<sup>2</sup>

### Committing to Private Property Rights

In a market economy, individual producers and consumers are the planners, and their plans are coordinated by the price system. Each individual (each planner) needs to know only the prices immediately relevant to his activity. In this way, the price system economizes on the knowledge that each individual (each planner) must possess. As a consequence, plans can be made by those who possess detailed information about particular productive activities. In contrast, a central planner needs in principle to know everything about an economy. The flaw in central planning is that no planner can organize such a vast amount of information—the infinite complexity and rapid change of modern economies simply overwhelm him.

The planners of a market economy, that is, the individual producers and consumers, follow the price system's signals out of a desire to find the most remunerative use for their physical and human resources. Private ownership provides the incentive to use resources productively. Governments of countries desiring to make the transition to a market economy must protect private property rights. Instead of assigning property rights directly, they must

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<sup>1</sup> In western countries, when a firm becomes insolvent, it is immediately placed in court receivership to prevent looting by the management. In the United States, the exception to this practice was the insolvent S&Ls in the early 1980s that were allowed to remain open through deposit insurance that relieved their creditors of default risk. The S&L experience is analogous, say, to what has happened in Poland, where the managers of insolvent state-owned enterprises have transferred resources of these enterprises to their own private firms.

<sup>2</sup> In the absence of market prices that can be used to value firms for sale, governments must simply release as much information as possible about these firms through independent audits. By offering large numbers of shares in these firms to the public, individual shares will be available in small denominations that can be purchased by individuals with only small savings. The auction of shares could be modelled after the U. S. Treasury bill auction. That is, investors would submit a tender in two forms. With a competitive tender, an investor specifies a price and the number of shares desired. With a noncompetitive tender, an investor specifies the number of shares desired (up to some maximum amount determined by the government) and agrees to buy that number of shares at the average of the competitive bids that are accepted. (A minimum payment is required when tenders are submitted.) The government then accepts competitive bids up to a given fraction of the total shares and assigns the remaining shares to the noncompetitive bidders.

allow the marketplace to do so. Government must maintain the rules of the competition over ownership of property and must provide an independent judiciary to adjudicate disputes over property rights, rather than decide the outcome of the competition for ownership of property.

A primary difficulty in maintaining private property rights in a market economy is the inherent ambiguity between private and public property. In particular, taxes appropriate part of the return on private property for the state and effectively force the individual to share ownership of property with the state. Although private ownership of property is not established in an absolute sense, market economies have been able to use the rule of law and public support for private property to reserve a large part of the return (and risk) of ownership of property to individuals. Just as important, these economies have been able to provide a significant degree of consistency in the rules that determine the share of the return to private property appropriated by the state through taxes. This consistency is essential in providing an incentive to accumulate productive property.

Communist countries have had difficulty in providing individual incentives because of their inability to commit to this fiscal consistency. As described above, in centrally planned economies, prices are maintained through a tax-and-transfer policy that subsidizes some activities by taxing others. Under pressure to provide subsidies, communist governments were unable to commit to allowing productive enterprises to retain some of their surpluses. Litwack (1989) describes how, in the Soviet Union, ministries under pressure to fund enterprises running a deficit impose taxes at their discretion at whatever rates are necessary to appropriate the surpluses of the remaining firms. Firms then have no incentive to operate efficiently and generate surpluses. On the contrary, discretionary taxation creates incentives to run a deficit. Establishment of private property rights requires a fiscal system that is operated without discretion and that ensures consistency in the share of income appropriated through taxes.

Countries desiring to make the transition to a market economy must find ways of committing their governments to a nondiscretionary fiscal system. More generally, they must find ways of limiting discretionary government intervention in the marketplace. It is, however, difficult to devise the institutional safeguards that provide for this kind of

commitment. Incumbent politicians possess an incentive to build the coalitions that keep them in power by assigning property rights and control over markets to groups that support them politically. Communist countries represent an extreme of this phenomenon. No competition is allowed over ownership of resources. Control over resources is assigned to party members in return for their support of the communist dictatorship.

There is a relationship between democracy and a market economy in that each requires a restriction of the government's ability to limit competition. Democracy is unusual historically because of the difficulty of devising ways to keep the coercive power of the state from being used to limit competition for political power. The self-interest of individuals in government works over time to erode the safeguards placed on the ability of others to compete openly for political power. Success in achieving democracy and a market economy will depend on the success of formerly communist countries in solving the related problems of how to put into place institutional arrangements that safeguard free competition in the political arena and in the economic marketplace.

#### IV. CENTRAL BANKS AND THE TRANSITION TO A MARKET ECONOMY

##### Monetary Stability

Countries desiring to establish relative prices that measure the interaction between resource scarcity and consumer preferences need price level stability. Determining equilibrium relative prices is complicated by a constantly changing, unpredictable average price level. Price stability requires an end to rapid money creation which, in turn, requires fiscal discipline. Governments too weak politically to levy explicit taxes resort to an inflation tax, which does not require legislation. Eliminating inflation therefore requires that a government possess enough popular support to enforce payment of taxes.

Another difficulty in making the transition to market prices and price stability is the need to end price controls and allow a one-time rise in the price level to eliminate past, suppressed inflation. This one-time price rise will cause a perception of loss of wealth to the extent that persons were valuing their nominal assets with a shadow price level lower than the equilibrium price level. In countries like the Soviet Union, where the government has always maintained that inflation is confined to capitalist countries,

it seems likely that an open price rise will be seen by the public as destructive of its wealth.

Eliminating the ability of the central bank to create surprise inflation is an important part of limiting the ability of government to interfere arbitrarily in the economy. Surprise inflation appropriates part of the value of existing money holdings and fixed income securities. It is inconsistent with a fiscal system providing consistent rules to determine the share of private property appropriated for public use. Price stability also prevents the government from raising revenue through the interaction of a nonindexed tax code and inflation. In raising revenue, government must respect the democratic safeguards provided by requiring that taxes be enacted through explicit legislation. Finally, price stability prevents governments from creating a shadow fiscal system that redistributes income to politically influential constituencies through the combination of inflation and price controls. [The ideas of this paragraph are developed in Hetzel (1990).]

##### Market Allocation of Capital

In communist countries, banks are the only creditors of enterprises. In the transition to a market economy, banks will be *the* arbiters of which enterprises meet the market test of viability. Banks must be required to make the hard choice not to continue lending to an insolvent institution through having their own capital and their own depositors' money at stake. Bank failures must impose losses on holders of bank liabilities.

In general, in a market economy, the government must allow firms to disappear if the marketplace determines they are nonviable. Firm closings, however, produce concentrated pressures that governments find hard to resist. Separation of the central bank from commercial banks is necessary to prevent the government from using the central bank to lend to commercial banks in return for their lending to insolvent but politically influential enterprises. The base money creation of the central bank must be restricted to controlling commercial bank deposit creation and the price level, rather than subsidizing particular uses of credit. In particular, either the central bank should not lend at all to commercial banks or, if it does, it should lend only for short-term liquidity needs. Cutting commercial banks off from central bank credit ensures that commercial banks risk their own capital when they lend.

From a wider perspective, it is essential that legal arrangements strike a balance between requiring

lenders to be at risk and providing them with an incentive to lend. An incentive to lend rests on well-defined property rights and on an independent judiciary that adjudicates disputes over property rights. Legal arrangements must include bankruptcy laws that allow borrowers to post collateral that can be seized in case of default and, more generally, determine how the assets of bankrupt firms will be distributed among creditors. Private property rights also require elimination of government price controls. Banks cannot assess solvency without a price system that measures market-determined scarcity and demand. Price controls render problematic bank decisions about solvency. Nonviable enterprises can appear profitable because they obtain inputs at artificially low prices, while viable enterprises can appear unprofitable because they are forced to sell at artificially low prices.

### A Free Market in Foreign Exchange

A market economy requires a private market in foreign exchange with no capital controls. Communist countries have used their monopoly on trading in foreign exchange and capital controls to enforce an artificially high value for their currencies for two reasons. First, as discussed above, these countries subsidize basic commodities and food. If there were a free market in foreign exchange, these items would be exported. An overvalued exchange rate makes subsidized goods expensive to foreigners while allowing the state to sell them cheaply to domestic residents. Second, an overvalued exchange rate means that the free market price of the foreign exchange turned over to the government by exporters exceeds the price that the government charges importers. This excess is the economic equivalent of an excise tax on foreign exchange transactions. Like a regular tax, it can be distributed by the government. For a weak government, it is an easy tax to collect and distribute to politically potent state enterprises.

The price paid for an overvalued exchange rate is isolation from the world economy.<sup>3</sup> Market pricing and a market-determined exchange rate would produce efficient allocation of resources by encouraging a more open, export-oriented economy, which would bring the benefit of exports into line with their domestic resource cost. International trade has produced rising prosperity for countries integrated into

<sup>3</sup> Through Comecon, communist countries entered into a large number of barter arrangements with each other. These centrally imposed trades, however, do not indicate the existence of an open economy that produces according to its international comparative advantage.

the world economy through an efficient allocation of production and through the encouragement to innovation from worldwide competition.

## V.

### GERMAN MONETARY UNION

Governments desiring to establish a market economy can limit government intervention in the economy by limiting the ability of their central banks to produce unpredictable changes in the price level, to allocate capital, and to allocate foreign exchange. The most direct way to limit intervention of the central bank in the economy is to eliminate the central bank. Countries making the transition to a market economy should consider simply adopting the currency of a large western neighbor with whom they trade to a significant degree and which possesses a stable currency. The experience of East Germany with monetary union is interesting because it will demonstrate one practical way of limiting government intervention in the marketplace—elimination of a central bank.

This proposal was made earlier by Milton Friedman (1973, p. 59) in the context of LDCs:

For most such [developing] countries, I believe the best policy would be to eschew the revenue from money creation, to unify its currency with the currency of a large, relatively stable developed country with which it has close economic relations, and to impose no barriers to the movement of money or prices, wages, or interest rates. Such a policy requires not having a central bank.

The proposal is also similar in spirit to Wayne Angell's (1989) proposal that the Soviet Union adopt a gold standard.

Monetary union eliminates the East German central bank. East Germany, like states in the United States, will have surrendered its ability to run its own monetary policy. For example, without a central bank, Texas could not postpone the difficult adjustments required by the fall in the oil price in the mid-1980s. First, because Texas cannot exercise discretion over its money stock, it had no recourse to an inflation tax. It could not print money to finance the deficit in the state budget caused by the oil-related fall in revenues.

Second, the state of Texas could not use a central bank to keep alive thrifts rendered insolvent by the fall in the price of real estate. It could not lend to insolvent thrifts through use of the money-creating powers of a central bank. When the price of oil fell, Texas could not keep its terms of trade with the rest

of the United States from deteriorating by maintaining an overvalued exchange rate. Texas had no choice but to let its price level fall to reflect a deterioration in its terms of trade. Also, no one suggested that Texas impose capital controls to prevent capital outflows from reducing the value of its currency.

German monetary union can serve as a model for other East European countries. A country desiring to eliminate its central bank and adopt a deutsche-mark standard would first allow its currency to float freely to determine its equilibrium value relative to the mark. The central bank would borrow marks, perhaps through the new European Development Bank. On a preannounced day, it would exchange domestic currency turned in to banks for marks at the prevailing free market exchange rate. It would also exchange bank reserves for marks. The central bank would then go out of business. The country would maintain no restrictions on trade in foreign exchange and no capital controls. Henceforth, the marketplace would determine the quantity of money through the balance of payments. If the Treasury wanted to affect the domestic quantity of money, it would have to draw on mark accounts held with West German banks.

There are, of course, problems in eliminating a central bank. One problem is that if countries in Eastern Europe establish a mark standard, West Germany receives the seigniorage from money creation. Overall, however, governments can determine the net wealth transfer between Western and Eastern Europe. For example, partial forgiveness of the debts owed by Eastern European countries could offset the wealth transfer necessary to finance their imports of marks. The new European Development Bank could also finance the initial import of marks through interest-free loans. Another problem is that countries that suffered under Nazi occupation may be unwilling to use the mark as a currency. These countries could adopt the dollar as a currency. An example is Poland, whose residents already save partly through dollars received from workers in the United States.

Conversion to a mark standard requires a period during which countries stabilize the foreign exchange value of their currency in a freely operated foreign exchange market. After doing so, they may see no need then to abolish their own currency. A market economy, however, is not established by a one-time reform. It requires a lasting commitment to limiting the role of the government in economic activity. The existence of a central bank provides a continuing incentive for politicians under pressure to confuse

money creation with wealth creation. The resulting inflation then leads to myriad interventions in the economy in the form of wage, price, interest rate, exchange market, and capital controls. Eliminating the central bank is one way of committing to a limited role for the state.<sup>4</sup>

A few years ago, this proposal would have been radical. Today, it is quite conventional. It simply telescopes the likely evolution of monetary arrangements in Eastern Europe into a one-time reform. The countries of Eastern Europe want to integrate their economies with the economies of western Europe. Western Europe is itself moving toward monetary union. By adopting a mark standard, the countries of Eastern Europe simply accelerate the process of economic and monetary integration with Europe. They also eliminate the inflation, credit allocation, foreign exchange controls, overvalued exchange rate, and other mistaken policies that political systems under stress require of their central banks.

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<sup>4</sup> Creation of a currency board would be a close substitute for the proposal to eliminate the central bank. [See Hanke and Walters (1990).] With a currency board, base money is created only when someone turns in to the board a specified foreign currency, say, marks. Similarly, base money is extinguished when someone presents domestic currency to the board and asks for the foreign currency. A currency board would have the political advantage that a domestic currency would circulate, rather than a foreign currency. Also, the foreign currency held by the board could be kept in the government securities of the foreign country, so that the seigniorage from money creation would not go to the foreign country. The disadvantage of a currency board is that there is no absolutely binding way to keep the government from forcing it to devalue for domestic political reasons.

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