CENTRAL BANK INDEPENDENCE IN TRANSITION ECONOMY JOINING THE EUROPEAN MONETARY UNION (WITH THE CASE OF SLOVENIA)

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DOI: https://doi.org/10.31410/ERAZ.2019.15

Abstract: *Legal independence of a central bank is a necessary but not a sufficient condition for actual independence. There might always be incentives to circumvent the legal framework with an aim to influence the behaviour of the central bank. That has a particular importance in transition economies. This paper sheds new light on policy choices when preparing to enter the European Union and euro area from the viewpoint of central bank independence in transition economy. The paper shows how to adjust to the legal provisions of the Eurosystem and, at the same time, achieve Maastricht convergence criteria to join the euro area.*

Keywords: *independence of the central bank, convergence, transition economy.*

1. INTRODUCTION

Independence of a central bank is about the separation of monetary policy from political influences and government authorities. At least that was an idea prior to the financial crisis in 2008. The argument for independent central banks evolved mainly from the experience of the 1970s when inflation was persistently high. As a result, a consensus was reached that price stability was a common good (Draghi, 2018) and that central banks needed a clear mandate to achieve that common good. This was supported by the then theoretical and empirical evidence demonstrating that central bank independence was important in reducing inflation. Legal independence is a necessary but not a sufficient condition for actual independence (Wagner, 1999; Fischer, 1995). Cukierman *et al* (1992) found that legal independence was a key component of actual independence of a central bank while the possible void between the exact limits of authority between the central bank and political authorities can be »filled with tradition at best and by power politics at worst« (Cukierman *et al*, 1992, p.355).

Prior to financial crisis in 2008 it was considered that in a currency union such as the euro area, institutional convergence, i.e. central bank independence, is "equally, if not more, important for a successful common monetary policy in an enlarged Euroland than nominal and real convergence" (Freytag, 2003, p.1). Central bank independence was considered essential for the credibility of the monetary union. The crisis of 2008 broadened the scope of central banks' objectives which has led to the critical voices about the independence, mandate and accountability of the central banks (Bernanke, 2010), especially in the euro area, where risks to its reputation, legitimacy and questions about democratic accountability and independence have grown (Issing, 2018). Regardless of that, formal requirements to become a member of the Economic and Monetary Union (EMU) have remained the same, as they are enshrined in the European Union (EU) treaties, and those are not easy to change. Adopting the single currency is the third stage of EMU. Treaty on the Functioning of the European Union[1] (hereafter: TFEU) in article 140 stipulates that the third stage involves implementing a single monetary policy in EU countries that meet specific convergence criteria.

[1] See consolidated version of the Treaty on the Functioning of the European Union in the Official Journal of the European Union, C 202, June 7, 2016, p. 108, article 140. This article was numbered according to the Lisbon Treaty which amended the Treaty on European Community, where the wordings of this article were in the article 121(1), article 122(2), second sentence, and article 123(5).

2. INSTITUTIONAL AND LEGAL CONVERGENCE

Institutional aspects of monetary union require monetary powers, held by member states, to be exercised in a new system, the European System of Central Banks (hereafter: ESCB).[2] Article 4 of the Act concerning the conditions of accession[3] of countries that joined in 2004 stipulates that each of the new member states shall participate in EMU from the date of accession as a member state with a derogation[4]. All 10 countries[5] that joined the EU in 2004 were therefore having a status of EMU countries with derogation, which means that they were in the economic and monetary union but had yet not adopted the euro as single currency. In view of their status as member states with a derogation, the European Central Bank (hereafter: ECB) has to examine[6] the level of achievement of legal convergence in each of the member states and the legislative measures that had been taken or had to be taken by them with a view to achieving legal compatibility between the national legislation and the EU legislation.

The basis for assessing the level of convergence of the national legislation includes various types of independence; namely functional, institutional, personal and financial independence. Functional independence requires a primary objective (i.e. price stability) to be determined with clarity and legal certainty. Functional independence implies that the national central bank (hereafter: NCB) has the necessary means and instruments to achieve this objective, independently of any other authority. In line with that is the principle of institutional independence, as defined in article 130 of the TFEU and article 7 of the Statute of the European System of Central Banks and of the ECB (hereafter: Statute). These two articles prohibit the NCBs and members of their decision-making bodies "from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body."[7]

As regards personal independence, the Statute provides that the NCB statutes should provide for a minimum term of office for a Governor of five years. The Statute also protects Governors from arbitrary dismissal, by providing that a Governor may be relieved from office only if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct. That can possibly be reviewed at the Court of Justice.[8]

According to the EU legislation an NCB can only be fully independent from an institutional and functional point of view, if it has appropriate economic means to fulfil its mandate. In other words, in order to fulfil its ESCB-related tasks NCB has to be financially independent to do so and have adequate financial resources.[9]

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[2] See Official Journal of the European Union, C 115, 9.May 2008, p. 167. Article 282 (1) of TFEU says: "The European Central Bank, together with the national central banks, shall constitute the European System of Central Banks (ESCB). The European Central Bank, together with the national central banks of the Member States whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union"

[3] Official Journal of the European Union, L 236, 23.September 2003, p.34

[4] Within the meaning of article 140 of TFEU

[5] Poland, Lithuania, Latvia, Estonia, Czech Republic, Slovakia, Slovenia, Hungary, Malta, Cyprus

[6] According to the article 140 of TFEU at least once every two years, or at the request of an EU member state with a derogation, the ECB and the European Commission must report to the Council of the European Union on the progress made by the member states with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union.

[7] ECB Convergence Report, May 2006, p. 63 (e-source)

[8] ECB Convergence Report, May 2006, p. 64 (e-source)

[9] ECB Convergence Report, May 2006, p. 64 (e-source)

3. ECONOMIC CONVERGENCE TO THE EUROSYSTEM

Nominal economic convergence criteria to the Eurosystem, also known as the Maastricht criteria, measure key nominal macroeconomic indicators. These are price stability, soundness and sustainability of public finances, exchange-rate stability and long term-term interest rates. In terms of price stability, the convergence criterion is to achieve inflation that is not more than 1.5 percentage points above the rate of the three best performing member states. Sound public finances establishes reference value at not more than 3% of GDP for government deficit, while sustainable public finances establish reference value of not more than 60% government debt as % of GDP. The Maastricht criteria also specify the requirement on the long-term interest rate and the allowed deviation of it from the average interest rate of the three countries with the lowest inflation rates. The idea behind all these nominal Maastricht criteria was that fulfillment of the criteria would help a country joining the euro area so that the implementation of the single monetary policy can be facilitated once the country becomes a full member of the euro area.

Before 2004 some acceding Central and Eastern European (hereafter: CEE) countries already complied numerically with several Maastricht criteria (with the exception of the two years of ERM II participation). Some countries had an inflation rate below the reference value, and debt-to-GDP ratio was on average around 40%, well below 60% of GDP. Figures on fiscal deficit varied among countries and Slovenia had its deficit below 3% of GDP. Long term interest rates were falling. According to the ECB Convergence Report in 2004, long term interest rates were on a broad downward trend in the Czech Republic, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia in 2001 and 2002, moving towards the euro area level. This development »reflected mainly low inflationary pressures, market perceptions as regards EU and euro area participation and, for some of the new member states, also the growing credibility of monetary policy. «[10]

In spite of the decline in inflation and expectations, long-term interest rates were still quite above the level of the euro area in most acceding countries. GDP income levels in acceding countries at the time of the accession in 2004 were below those in the euro area, with GDP per capita at around 50% of the euro area average. However, the span was from 36% in Latvia to 75% in Slovenia. Capital markets of acceding countries were small, undeveloped and newly liberalised, which could make them vulnerable to financial crises or trigger excessive exchange rate volatility.

4. TASKS FOR CANDIDATE COUNTRIES REFLECTING TRANSITION

Candidate states had to ensure that their national legislations were compatible with the TFEU and the Statute as failure to fully ensure central bank independence is, in fact, a breach of the TFEU, which justifies bringing an action before the European Court of Justice. Adaptations which relate to the central bank independence need to become effective at the latest when the country joins EU. Requirements about legal integration into the Eurosystem[11] only enter into force at the moment when an EU member state adopts the euro.[12] National legislative provisions on monetary policy have to acknowledge that the EMU's monetary policy is the task that has to be carried out through the Eurosystem.[13]

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[10] ECB Convergence Report 2004, p. 26 (e-source)

[11] ECB Convergence Report 2004, p.30 (e-source)

[12] Ibid

[13] Ibid

As regards legal adaptation in Slovenia, the legislation forming the legal basis for the central bank of Slovenia and its operations before joining the EU were the Slovenian Constitution and the Law on the Bank of Slovenia from 1991 which was amended in 2002[14]. In March 2006, Slovenia's Parliament adopted a law amending the Law on the Bank of Slovenia. As regards institutional independence, the draft law amendments clearly excluded the management of foreign reserves from the scope of Banka Slovenije's contract with the Ministry of Finance. The original law implied that the Bank of Slovenia required the agreement of the Ministry of Finance in determining matters concerning the management of foreign reserves. In regard to legal integration into the Eurosystem, the ECB recommended that the amending law on the Bank of Slovenia had some further adaptations in regard to particular inconsistencies with the TFEU and the Statute, in terms of more precise wordings, and not just of the tasks, but also in regard to economic policy objectives. The ECB was specific in its opinion on the Banka Slovenije's tasks in the implementation of monetary policy: »The wording of the proposed amendment to Article 58(2) of the Law (on Banka Slovenije's tasks after the euro is introduced) should be amended to state that Banka Slovenije 'implements monetary policy', without any reference to 'defining' monetary policy. Indeed, pursuant to Article 12.1 of the Statute, the Community's monetary policy is exclusively formulated by the Governing Council«[15]

ECB was also very clear in its recommendation on the prohibition of financing, as it said: «Under Article 24 of the Law, Banka Slovenije may not grant overdrafts or any other type of credit facility in favour of 'bodies of the Republic of Slovenia, of the European Union or of European Union Member States, or in favour of their regional and local authorities, and other public entities.«[16] The new law on the Bank of Slovenia was also to eliminate the incompatibility in terms of the single spelling of the euro so that the word *evro* was replaced by *euro* in all grammatical cases.

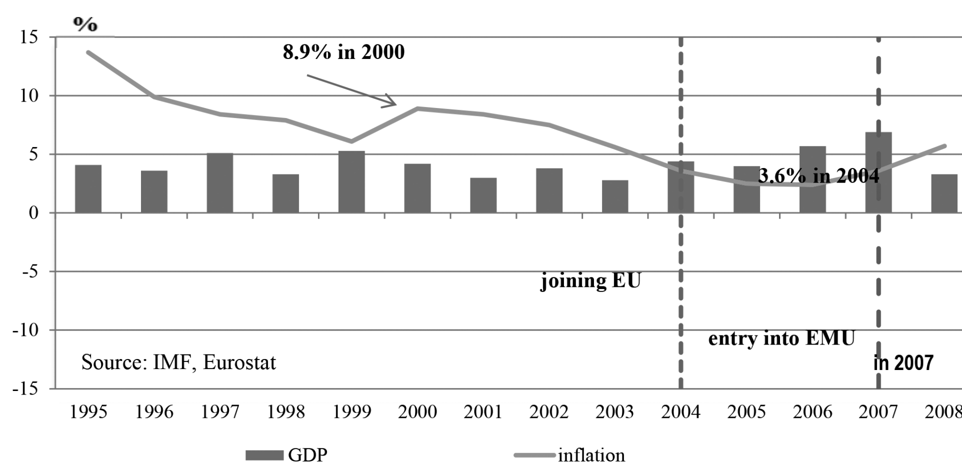

Figure 1: Inflation, the main concern

In terms of economic adaptation at the time when EU accession negotiations started in March 1998, Slovenia had the highest GDP per capita (in purchasing power standards) among the eight CEE countries, at about 67% of the EU15 average. From 1995 to 2004 the economic growth in Slovenia was about 4% on average, fiscal deficit was 0.8% of GDP and external imbalances and public debt burden were low. Current account deficit was 0.6% of GDP and public debt was

[14] ECB Convergence Report 2004, p.232 (e-source)

[15] ECB Opinion CON/2006/17 of 13 March 2006 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on Banka Slovenije, p.8 (e-source)

[16] ECB Opinion CON/2006/17 of 13 March 2006 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on Banka Slovenije, p.9 (e-source)

about 24% of GDP. However, there were many structural rigidities, a legacy of the previous system. Financial contracts, wages and social transfers were indexed to inflation and the structure of budgetary spending was not flexible enough to adjust to unexpected shocks. Substantial foreign ownership in financial systems that was characteristic for all acceding countries, was the lowest in Slovenia.

5. CHALLENGES FOR THE CENTRAL BANK

Although Slovenia and other CEE countries made progress towards becoming a market economy before 2004, transition was not completed and further progress in institutional, structural and economic development was needed. According to the law from 1991, the national central bank in Slovenia, i.e. the Bank of Slovenia, was independent in formulating and implementing monetary policy. The main objective of the central bank at the time was to maintain the liquidity of the payment system and the stability of the national currency, tolar. In transition economies like Slovenia »the exchange rate is the natural nominal anchor, both as a source of discipline and as a guidepost for monetary policy« (Fischer, 1995, p. 18). Prior to joining the EU, an exchange rate policy of Slovenia vis-à-vis currencies of major trading partners was to pursue gradual depreciation of the Slovenian currency (see Picture 4). A formal, de iure exchange rate strategy was managed float, but de-facto since 1992 Slovenian tolar has, for most of this period, been on a moderate and smooth depreciation trend against the Deutsche Mark and, since 1 January 1999, against the euro.[17]

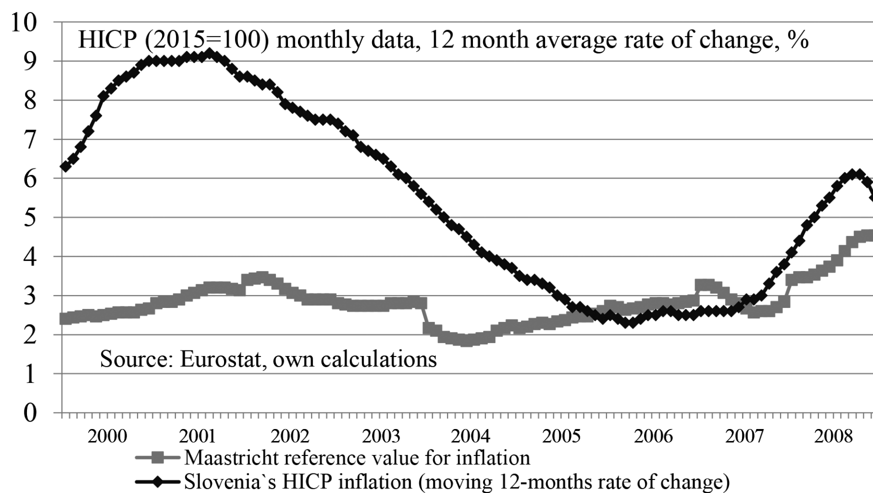

Figure 2: Maastricht reference value for inflation and Slovenian HICP

The strategy behind the gradual depreciation of Slovenian currency was to help Slovenia's exporters and their export competitiveness as exports of goods and services were seen as the main driving force for the Slovenia's GDP growth. It is important to emphasize that the policy of depreciation of tolar had an impact on domestic inflation, as imported goods and services became more expensive with a depreciating currency. In addition, in the then environment of Slovenia there was a need for the acceleration of additional structural reforms, such as further de-indexation, in particular of wages and some social transfers as they put pressure on inflation. For the Bank of Slovenia these and other economic policies that could influence inflation were important, including policies to continue with the liberalisation process across the economy and to strengthen policies aimed at improving competition in product markets. Since Slovenia was

[17] ECB Occasional paper no.10, 2004, p.15 (e-source)

experiencing capital inflows in years before EU accession, there was substantial exchange rate intervention (Lavrač, 1999) over the years prior to acceding to the EU. Exchange rate intervention was needed to maintain nominal depreciation of the domestic currency (see Picture 4).

Slovenia's participation in the ERM II had to be based on a number of policy commitments relating to pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms in order to be able to tame inflation. In addition, policy of gradual depreciation of domestic currency had to be phased out upon entry of Slovenian currency to the Exchange Rate Mechanism II (hereafter: ERM II). That was a particular challenge for the Bank of Slovenia as external adjustments via nominal exchange rates are not possible in a monetary union and that is tested while the domestic currency is in ERM II. Losses in competitiveness could not be corrected through devaluation of the currency. Keeping the central rate of Slovenian tolar vs. euro within the permitted fluctuation bands while in ERM II for two years without severe tensions was the most important challenge for the Bank of Slovenia.

6. POLICY STRATEGY IN SEARCH FOR THE BEST SOLUTION IN SLOVENIA

Applications of TFEU provisions on exchange rate stability focus on the exchange rate being close to the ERM II central rate while also taking into account the absence of severe tensions. That implies[18] examining the degree of deviation of exchange rates from the ERM II central rates against the euro; using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; and considering the role played by foreign exchange interventions.

Slovenia decided for early adoption of the euro. An important condition for Slovenia to enter the euro area as soon as possible was to comply with the Maastricht criteria during the period when the tolar would be in ERM II, which was envisaged for 2005-2006. Slovenia's monetary policy had to start with progressive fading of the policy of the exchange rate depreciation so as to embark on a disinflation process in the pre-ERM II phase and to reach relative stability around the central parity of the exchange rate in the ERM II phase.

The exchange rate of the Slovenian tolar while in ERM II was to be exposed to the effects of the market, especially free flow of capital because capital controls had to be abolished. In addition, privatisation of state assets would affect the exchange rate and to maintain its stability in the environment of such movements, the cooperation of the government was needed. After planned entry of Slovenian tolar ERM II in June of 2004, the Bank of Slovenia was expected to consistently ensure coverage of differences between interest rates in Slovenia and in the eurozone and ensure a stable exchange rate vis-a-vis the euro. It was concluded that the central bank probably could not always achieve the desired level of monetary policy restrictiveness necessary to control inflationary pressures. Therefore, Slovenia's policy makers committed to coordination and signed the action plan of the Slovenian Government and the Bank of Slovenia. The action plan, i.e. the Programme for ERM II Entry and Adoption of the Euro (hereafter: the Programme), determined that »the Bank of Slovenia and the Slovenian Government have adopted the goal of lowering inflation«[19]. That goal was further defined as lowering inflation to the level that is in line with the Maastricht criterion, which envisaged that year-on-year inflation had to fall to 2.9% by mid-2005.

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[18] See ECB Convergence Report 2004, p.11 (e-source)

[19] See Banka Slovenije, Vlada Republike Slovenije: Programme for ERM II Entry and Adoption of Euro,

The programme's aim was to neutralize negative effects of the structural shocks and large foreign financial inflows on inflation. The government committed to reverse the rising trend of its spending and stop the deterioration of the fiscal balance by policy changes. The government also committed to prevent the effects of tax and administrative measures by allowing directly and indirectly administered prices to rise only up to the maximum inflation rate. Through implementation of structural reforms, the government could also help to introduce policy changes pertaining to competition in sectors that were not enough opened to competition. All this would help the Bank of Slovenia to stabilise the tolar exchange rate and bring down inflation, the key indicator that was considerably exceeding Maastricht criterion for inflation. The Programme envisaged that the Bank of Slovenia would, prior to entering ERM II, conduct monetary policy so as to accommodate the goal of nominal convergence in »simultaneously determining movements in nominal interest rates and the exchange rate«[20]. The central rate for the Slovenian currency was set at 239.64 tolars per euro, which was the market rate at the time of entry into ERM II. A standard fluctuation band of ±15% was adopted around the central rate.

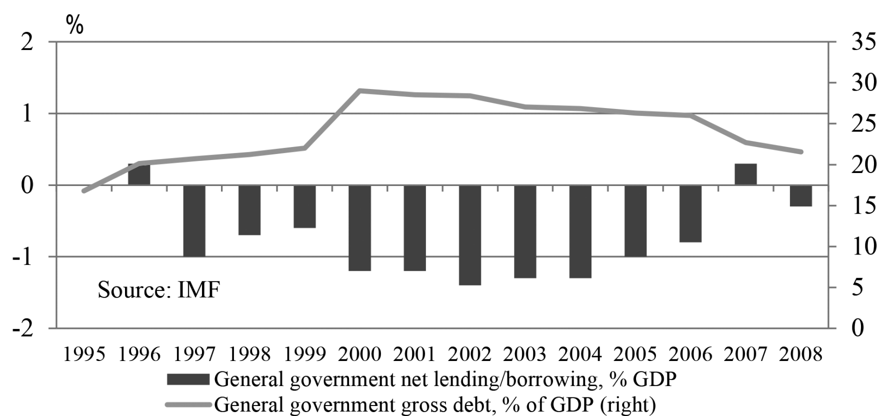

Figure 3: Fiscal policy stance

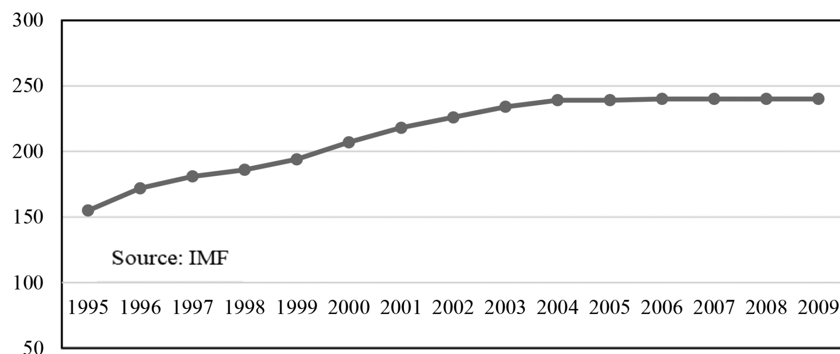

Figure 4: Exchange rate of Slovenian tolar (SIT) vs euro

Following ERM II entry on 28 June 2004, ECB in October 2004 concluded that »monetary policy of the Bank of Slovenia was oriented towards a relatively stable euro exchange and phasing out the gradual depreciation of the tolar vis-a-vis the euro«[21]. Banka Slovenije used its foreign exchange swap facility[22] to maintain the stability of the euro-tolar exchange rate while keeping domestic

November 2003, p. 35 (e-source)

20 See Banka Slovenije, Vlada Republike Slovenije: Programme for ERM II Entry and Adoption of Euro, November 2003, p. 36 (e-source)

21 See ECB Convergence Report 2004, p. 19 (e-source)

22 See ECB Convergence Report 2006, p.9 (e-source)

interest rates above those in the euro area. This policy, which translated into a high short-term interest rate differential with the euro area, facilitated the disinflationary process. The disinflation process in Slovenia gained momentum and inflation gradually came down to 2.5% in 2005.[23]

The Slovenian tolar participated in ERM II for around 22 months (from May 2004 to April 2006), i.e. for less than two years prior to the examination by the ECB in May 2006. The ECB then concluded that »Slovenia did not devalue its currency's central rate against the euro on its own initiative and managed to maintain the tolar close to its central parity, while keeping domestic short-term interest rates above those in the euro area. Banka Slovenije contained the volatility of its currency at very low levels by using its foreign exchange swap facility. In order to reduce the amount of accumulated swaps outstanding outright purchases of foreign exchange were occasionally made, implying overall significant net purchases of foreign exchange to absorb potential upward pressure on the currency. »[24]

7. WHAT ABOUT DE-FACTO CENTRAL BANK INDEPENDENCE UPON EMU ENTRY?

Central bank independence implies monetary policy to be free from government's influence. However, even the most independent central bank does not operate on another planet. In small countries central bankers and government officials can meet formally and informally at various events, conferences and meetings where they can discuss monetary and fiscal policy.

In order to achieve conditions to join the euro area, the central bank and the government of Slovenia decided to work together, as defined in the Programme: »coordinated implementation of the Government's fiscal and other policies and the monetary policy of the Bank of Slovenia; coordinated management of the proceeds from the sale of capital investments to nonresidents; the Bank of Slovenia and the Government informing each other about all movements and developments which could have an impact on the effective implementation of the joint programme for adoption of the euro; the Bank of Slovenia and the Government jointly seeking opportunities to deal with the effects of the tolar and foreign currency liquidity made available through Bank of Slovenia instruments for public debt management without increasing the level or costs of the public debt.« (Programme, 2003, p.8)

The government of Slovenia and the Bank of Slovenia in their joint endeavour aimed at reducing inflation below the reference value of the Maastricht criterion by stabilizing the tolar's exchange rate as the key policy. While Bank of Slovenia's task was to work on monetary and exchange rate policy, the government focused on prices that it could control, such as administered prices and counter-cyclical adjustment of excise duties on fuels. The government also focused on policies aimed at de-indexation and wage constraint in the public sector. The result of the collaborative government-Bank of Slovenia project worked so that the convergence criterion for inflation was fulfilled and Slovenia joined the euro area on 1st January 2007.

Comparing this joint government-central bank strategy with the legal adaptation requirements Slovenia had to enforce to ensure the legal compatibility with TFEU and the Statute by the date

[23] See ECB Convergence Report 2006, p.9 (e-source)

[24] See ECB Convergence Report 2006, p.10 (e-source)

of the accession, one could conclude that the Bank of Slovenia was not an independent central bank prior to joining the EU and EMU, strictly speaking. However, was working together with the government a setback for the central bank independence from the legal point of view? No, because »legal independence provides a guarantee neither of actual independence nor of superior inflation performance« (Fisher, 1995, p.3) and because »in an ideal world monetary and fiscal policies should be coordinated whereas the essence of an independent central bank is that monetary policy decisions should be made independent of fiscal decisions.« (Fischer, 1995, p.5).

In line with the above it could be argued that the joint strategy between the government and the Bank of Slovenia was done »in the first best world« where »all policy makers act at all times for common good, upon which there is widespread agreement«. (Fischer, 1995, p.5).

8. CONCLUSION

The basic idea about economic convergence within the EU framework was to narrow differences among countries on a macroeconomic level. It was believed that monetary union would provide more macroeconomic stability in member states. In order to qualify for EU membership, accession countries had to make their central banks legally independent. The requirement to adapt national legislation to be in line with the TFEU and the Statute was theoretically justified by the political nature of inflation processes. It was only inflation from the Maastricht criteria that Slovenia had not reached prior to entry to ERM II, a »waiting room« before adopting the euro. So, the Slovenian officials' policy choice was to choose the appropriate nominal anchor (central parity of the exchange rate) that would help control inflation from the external monetary relations' point of view. However, the central bank of Slovenia could not stabilise inflation just with its own policy options, it needed the help of the government.

Slovenia's example of joining the euro area provides an interesting insight into how a transitional economy, joining the monetary union, can comply with the Maastricht criteria. First, cooperation and coordination between the central bank and the fiscal authorities can help fulfil the Maastricht criteria. Second, cooperation between the central bank and fiscal authorities may possibly require a significant change of the fiscal policy, in particular if fiscal deterioration reaches such a state that it also jeopardizes inflation and interest rate targets. In relation to that, a tight interplay between monetary policy and fiscal policy can be essential. In the case of Slovenia, the redesign of fiscal policy towards stricter support of monetary policy was very important. Third, a joint determination can do wonders. Even if fiscal policy needs some additional modifications in the preparation phase before entering the euro area, the joint determination of commitments and coordination between the government and central bank can result in an efficient and controllable process of adopting the euro.

However, financial crisis in 2008 revealed some warning facts that can be also explained by Slovenia's case. Even though the country fulfilled nominal convergence criterion on inflation and joined the euro area on 1st January 2007 as the first CEE and ex-communist country, Slovenia's inflation immediately shot up after entry into the euro area and on average in 2007 reached 3,8% for the whole year. Slovenian HICP in the first quarter of 2008 even reached 6,5%, the highest in the euro area. Secondly, Slovenia was one of the countries that was hit the hardest with the crisis that started soon after Slovenia joined the euro area, at the end of 2008.Slovenia's GDP fell by 7,8% in 2009. Both facts raise questions if Maastricht convergence criteria is relevant in the new world, much different from 1992 when the Maastricht treaty was signed. Nominal

convergence criteria might not be an adequate measure for sustainable convergence. Slovenia's case shows that adapting national legislation to adjust to EU laws on institutional independence of the central bank does not guarantee low inflation after entry to the euro area. That is contrary to the popular belief that "increased central bank independence tends to improve inflation performance" (Loungani and Sheets, 1995, p.22) in transition economies.

Also, the question is how useful and sensible the concept of central bank independence is today in that respect considering economic environment of today. Criticism has been growing and demanding redefinition of central banks' mandate in order to make them more transparent and accountable.

Considering the new »normal« since 2008 in monetary policy making with ECB measures that were, in fact, in subtle ways de facto acts of fiscal policy, the comfortable conclusion can be that even the »most independent central bank in the world« does have a creative understanding of its own actions and its own compliance with its status of independence in pursuit of its narrow objective of price stability. The most important conclusion is pertaining to the question about how relevant the arguments about the Maastricht criteria and the legal independence of a central bank in the euro area still are, considering the consequences in the aftermath of the 2008 financial crisis.

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