been associated with a sharp increase in the importance of North American regional factors in driving business cycles in Mexico during the 1990s. They also document a higher co-movement among (the same) aggregates of NAFTA partners during the last years. To illustrate to what extent the reduction in transaction costs (tariff and non-tariff barriers due to the agreement) affects key macroeconomic variables, they simulate a temporary one per cent shock in technology in the US in a dynamic stochastic general equilibrium model. Impulse response functions illustrate that the low trade cost scenario is consistent with a higher response of Mexican aggregates. They conclude that the agreement spurred an unprecedented increase in trade and financial flows between Mexico and its NAFTA partners.

In the third chapter, McCandless provides a brief review of the developments that led to the Argentinian crisis of 2001. He reviews traditional MP channels, but concentrates on the exchange rate, money and expectations channels in the aftermath of the crisis. With preliminary results from a VAR, he finds that the money channel was the most relevant after the crisis. He finds that the management of the short-term zero-coupon letters issued by the Central Bank – a new operating instrument called LEBACs – was ineffective because of the weakness and scarce credibility of the banking system.

In the fourth chapter, Hammermann studies alternative MP strategies in flexible exchange rate regimes for Chile and Poland using a VAR. After deriving a generalised reaction function, he tests whether a structural break occurs using the Chow test. A break is detected when the exchange rate is replaced by inflation targeting as the nominal anchor in Poland, although exchange rate targeting has not been abandoned completely. He finds that Chile follows inflation targeting, and an exchange rate policy is used only in times of international financial turmoil. Here, as Fratzscher's comments suggest, some reported results are at odds with the inflation targeting model's predictions.

The fifth chapter, by Braga de Macedo and Grandes, is a good theory review. It examines to which extent the European experience with earning rather than importing policy credibility is relevant outside of the EU or OECD membership, suggesting that it would apply especially to Argentina and Brazil in the context of the Mercosur. They stress that the high vulnerability characteristic of Mercosur partners is a result of euphoric expectations of future income generating over-borrowing.

In the sixth chapter, Loboguerrero and Panizza look at how macroeconomic volatility is transmitted to the labour market assuming a Cobb-Douglas production structure and using panel data techniques. They estimate employment, unemployment and wage Okun coefficients, and use them to show that, compared with industrial countries, LA countries adjust relatively more through wages than employment. Consequently, in the event of a crisis, workers suffer more. The interesting finding is that inflation increases labour market flexibility in LA countries that have highly regulated labour markets and that enforce regulations.

In the final chapter, Mohanty and Klau review and test whether central banks react to changes in inflation, the output gap and the exchange rate in a consistent and predictable manner in emerging countries. They find that the interest rate strongly responds to the exchange rate and, in some cases, the response is higher than to changes in the inflation rate or the output gap. They conduct sensitivity analysis for alternative specifications. They conclude that this outcome highlights the importance of the exchange rate as a source of shock and supports the 'fear of floating' hypothesis.

This is a very stimulating book to read for all those economists interested in emerging economies, and contains many new findings. In general, the book supports the hypothesis that inflation targeting is becoming widely accepted in LA. However, with the exception of Chile, the 'political cycle and noise' is exerting non-trivial influence over the management of MP. This fact may weaken the throughout assumed and estimated (full commitment) central bank reaction.

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Imperfect Knowledge and Monetary Policy by OTMAR ISSING, VITOR GASPAR, ORESTE TRISTANI and DAVID VESTIN (Cambridge: Cambridge University Press, 2005), pp. 138, paperback, ISBN 978 0 521 67107 1.

Imperfect Knowledge and Monetary Policy is part of the Stone Lectures in Economics, jointly organised by the National Institute of Economic and Social Research and Cambridge

University Press. The book provides a readable and informative insight into monetary policy-making under uncertainty, and is written by two of the designers of the European Central Bank's strategy. Issing and Gaspar's vast first-hand experience in this field makes their book required reading for anybody interested in the monetary policy of any central bank in an uncertain environment, and of the ECB in particular. The central question is how the monetary authority should form its policy with imperfect knowledge, limited information and endogenous expectations on the part of the private sector, which further compounds the uncertainty encountered in policy-making. How should central bankers set monetary policy? How should uncertainty be taken into account when formulating strategy? Is a cautious or an aggressive response to a shock preferable? The authors provide an insightful discussion of the different strands of the literature regarding these questions and demonstrate its limitations in providing a conclusive set of answers.

The rest of the book is structured as two separate lectures. The first, delivered by Issing, proposes a two-way approach to the dilemma faced by a central bank under unrealistic levels of uncertainty: firstly, the central banker should firmly rely 'on the few fundamental and robust results of monetary economics'; secondly, he should approach monetary policy implementation pragmatically drawing on the experiences of other central banks. Issing thus supports an eclectic approach to day-to-day policy-making with the monetary authority relying on its judgement. The primary objective of the policy-maker has to be price stability, but he also needs to maintain credibility to ensure price expectations remain anchored. Unsurprisingly for a former Bundesbanker, Issing also argues that giving an important role to money helps in this, as does responding aggressively to inflation deviations from target. The most valuable contribution of Issing's lecture, however, is that, having been a professor and a member of the executive board of the Bundesbank and subsequently of the ECB, he is able to bring together the academic and practical side of central banking. Hence he can illustrate his points by giving a fascinating first-hand account of the challenges which German unification and European monetary unification – both episodes 'where the level of uncertainty reached exceptional heights' – posed to policy-makers, and how they were dealt with.

The second lecture, a collaboration between Gaspar and Vestin and delivered by Gaspar, discusses the limits of stabilisation policies when there is imperfect knowledge on the part of the central bank and when the private sector has endogenous expectations. The authors do not aim for theoretical generality, but simplicity and clarity. To this end they employ a very simple model with numerical examples. They come to the conclusion that a large weight on output gap stabilisation in the central bank's loss function proves destabilising when potential output has to be estimated: only a relatively low weight on the output gap leads to efficient combinations of output gap volatility and inflation volatility. The optimal weight is lower than society's but greater than zero, as in Rogoff's (1985) seminal paper. The case for a conservative central banker *à la* Rogoff remains unchanged when endogenous private-sector expectations are generated through a learning algorithm. Furthermore, the less reliable the monetary authority's knowledge of the economy, the lower the optimal weight on output gap stabilisation.

The overall message of the book is that establishing and maintaining credibility and anchoring nominal variables are the keys to successful monetary policy. Over-ambitious stabilisation policies, on the other hand, are to be avoided. Issing et al. reach these conclusions after clear and careful analysis, and the illumination of the ECB's monetary policy strategy by two of its major architects offers a unique contribution to the existing literature.

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India Policy Forum, Volume 1, 2004 by SUMAN BERY, BARRY BOSWORTH and ARVIND PANAGARIYA (eds.) (Washington DC: Brookings, 2005), pp. 332, £24.00, US$34.95 paperback, ISBN 0 8157 0811 5.

This is a new journal that aims to present high-quality empirical analysis on the major