BANKING ON REFORM

Political Parties and Central Bank Independence in the Industrial Democracies

William Bernhard

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Chapter 1

Political Parties and Central Bank Independence

Central banks stand at the intersection of economics and politics. These bureaucratic institutions implement monetary policy by regulating the supply of money and credit to the economy. Both academic and popular accounts emphasize how a country's central bank significantly shapes its economic destiny (e.g., Beckner 1996; Deane and Pringle 1995; Greider 1987; Marsh 1992). In many countries, opinion polls and newspaper stories recognize central bankers as the most influential nonelected public officials.

Although central banks perform a similar function across the industrial democracies, their institutional structures—their levels of independence—differ across systems. The structure of an independent central bank restricts the government's ex-ante and ex-post influence over monetary policy, often by limiting the number of cabinet appointees on a bank's governing board, by preventing the cabinet from vetoing the bank's policy decisions, and by prohibiting the cabinet from punishing central bankers through dismissal or budget cuts. A dependent central bank, on the other hand, places few limitations on the government's authority.

In the 1970s and 1980s, only a few central banks were independent; the majority of industrial democracies had dependent central banks. In the 1990s, however, this distribution shifted significantly as many countries legislated more independence for their central banks. Most dramatically, European Union (EU) member states agreed to a single currency under the administration of an independent central bank. In this book, I explain these patterns of central bank independence.

Central Bank Independence: The Reform Trend

Throughout most of the post–World War II period, only a few industrial democracies, including Germany, Switzerland, and the United States, possessed independent central banks. The German Bundesbank, for example, is generally recognized as one of the most independent central banks in the world (Deutsche Bundesbank 1989; Goodman 1992; Kennedy 1991; Marsh 1992; Sturm 1989). The German federal government appoints only a minority of the Central Bank Council, the bank's main decision-making body. Further, the government cannot veto the bank's decisions, although it may delay for two weeks the implementation of a bank decision.

In countries such as Britain, Italy, and France, on the other hand, the government retained full control over the central bank's policy actions. In Britain, for example, the government appointed the entire governing board and could veto the bank's policy decisions. The Treasury dictated the Bank of England's policies (Fay 1988). Nigel Lawson, a former chancellor of the Exchequer, described the relationship between the government and the bank in this way, "I make the decisions and the Bank carries them out" (*The Economist*, 10 February 1990).

Many economists and policymakers argue that an independent central bank insulates monetary policy from political influences to produce more stable and predictable monetary policies and as a result, lower levels of inflation. Indeed, countries with an independent central bank generally had better inflation performance during the 1970s and 1980s than countries with a dependent central bank. Yet during this time, no country moved to make its central bank more independent.

In the late 1980s and 1990s, however, a wave of central bank reform swept across the industrial democracies. Politicians in Italy and New Zealand made the earliest efforts to grant their central banks more independence. In Italy a 1981 administrative decree freed the Bank of Italy from its obligation to purchase unsold public debt, an act known as the "divorce" of the Bank of Italy (Epstein and Schor 1989; Goodman 1991, 1992; Tabellini 1987, 1988). After the divorce, the Bank of Italy was less willing to finance budget deficits, forcing the government to pay for its debt through higher taxes and lower spending. Throughout the 1980s and 1990s, Italian politicians granted the bank widened authority over monetary policy, including control over the discount rate in February 1992 (Padoa-Schioppa 1987).

In New Zealand politicians reformed the central bank in 1989. Under the new law, the government determines the inflation objectives, and the central bank governor is charged with implementing monetary policy to achieve that goal. Uniquely, the reform links the bank's policy performance with the central bank governor's tenure: the governor can be dismissed if the bank does not achieve the inflation target (Dalziel 1993; Walsh 1995b). Additionally, the governor must report to the Parliament regularly about the government's economic policy choices.

Perhaps the most spectacular monetary reform occurred in December 1991, when the EU member states committed themselves to an audacious experiment: the creation of an Economic and Monetary Union (EMU) with a single currency for all participating countries. The Maastricht Treaty established deadlines for the transition to a single currency and an institutional blueprint for the management of EU monetary policy. Under the plan, a European central bank, independent of direct political control, would administer the currency. Modeled after the Bundesbank, the bank's governing board is composed of six individuals unanimously appointed by the Council of Ministers and by one appointee from each participating member state. Board members are supposed to receive no instruction from their national governments. Finally, the bank's mandate requires the board to focus solely on price stability in determining monetary policy.

Member states also agreed to make their central banks independent as a precondition to participation in the final stage of EMU. Belgium, France, Spain, and Portugal moved promptly to follow through on this commitment.

However, not all industrial democracies moved so quickly to initiate central bank reform, even within the EU. In Britain, for example, the Conservative government thwarted reform efforts in the early 1990s. Not until 1997 did a newly elected Labour government increase the Bank of England's independence, granting the bank institutional authority over interest rates and reforming the bank's decision-making procedures. Moreover, several countries continue to have dependent central banks. Australia and Norway, for instance, have not increased the independence of their central banks.

The Puzzles of Central Bank Independence

Central bank institutions have obvious substantive importance—they affect monetary-policy choices and overall economic performance. But the issues surrounding central bank independence also inform larger debates in political economy concerning the relationship between politicians and bureaucrats, the influence of the international economy on domestic policy autonomy, the institutional consequences of electoral change, and the balance between economic optimization and democratic accountability. The following puzzles illustrate these issues.

Cross-National Variations in Central Bank Independence

The cross-national variation of central bank independence in the 1970s and 1980s raises some interesting questions about bureaucratic design and delegation. Given that central banks perform similar functions across countries, why did some countries have independent central banks while others possessed dependent central banks? Why were politicians in some countries willing to limit their control of monetary policy with an independent central bank?

Many political economists have noted an association between federalism and central bank independence. Prior to the 1990s, independent central banks tended to be found in federal systems, including Germany, Switzerland, and the United States (Banaian, Laney, and Willett 1983). Unitary systems—Britain, New Zealand, France—usually had dependent central banks. What explains this relationship? How does federalism affect the choice of central bank institutions?

The Commitment to an Independent Central Bank

A second set of questions concerns politicians' commitments to an independent central bank. An independent central bank limits the government's ability to manipulate monetary policy for its own short-term gain. In certain instances, conflict between an independent central bank and the cabinet can even cause the government to collapse (Berger 1997; Marsh 1992). Yet politicians in countries with an independent central bank have remained committed to those institutions.

The German Bundesbank's independence, for instance, allows it to pursue economic policies that run counter to the government's wishes, which occurred most visibly during the Social Democratic–led government of the 1970s and early 1980s. The program of the Social Democratic party, which became the senior party in government in 1969, emphasized the goal of full employment. In 1973–74, however, the bank implemented a restrictive monetary policy to combat the effects of the first oil crisis. Although this policy kept inflation in check, it cost thousands of jobs, despite the Social Democrats' employment objectives (Scharpf 1987). The government and the Bundesbank clashed again in the late 1970s. In 1978 Social Democratic Chancellor Helmut Schmidt decided to pursue expansionary macroeconomic policies in a coordinated effort with the United States to ignite the sluggish world economy. The advent of the second oil crisis, however, threatened unacceptably high levels of inflation. In response, the Bundesbank pushed interest rates to their highest postwar levels, effectively derailing the "German locomotive" before it left the station. These actions negated the government's ability to maintain employment levels, hurt the Social Democrats' popularity, and hastened their fall from government (Goodman 1992; Kennedy 1991; Marsh 1992; Scharpf 1987; Sturm 1989).

The Bundesbank's independence appears to limit the ability of German governments to produce the types of economic outcomes they prefer. Why did the Social Democratic–led government not change the institutional status of the bank to provide the policies it desired? Why have German politicians remained committed to an independent Bundesbank?

The Wave of Central Bank Reform

Patterns of central bank stability and reform across the industrial democracies also raise questions about the relationship between the international economy and domestic politics. With a few exceptions, central bank institutions changed infrequently from the 1950s to the early 1980s. Then in the late 1980s and 1990s, country after country adopted a more independent central bank. What can account for these trends?

The stability of central bank institutions in the 1970s and early 1980s warrants explanation, especially given the dramatic economic shocks of this period. First, the Bretton Woods international monetary system collapsed in the early 1970s. After World War II most industrial countries pegged their exchange rates to the U.S. dollar. The system operated smoothly through the 1950s, but strains appeared in the 1960s, when the commitment to a fixed exchange rate with the United States forced countries to "import" inflationary policy from the United States. In 1972 the Nixon administration abruptly ended this system and initiated a system of floating exchange rates. Many countries welcomed the floating exchange rate regime because it promised greater monetary-policy autonomy. One might have expected these states to reform their domestic monetary institutions in order to take advantage of this new autonomy.

Second, the energy shocks touched off high inflation in the industrial countries. In 1973–74 the oil-producing countries increased oil prices over 400 percent almost overnight. Uncertainty about the Iran situation in 1979–81 again increased oil prices. As a result, inflation entered double digits in many countries, levels not seen since the immediate postwar period. Central bank reform might have helped quell these crises, but again, no state made central bank independence a priority during this period. What factors account for the remarkable stability in central bank institutions during the 1970s despite the enormous changes in the international economic environment?

In turn, why did the wave of central bank reform take place across the industrial democracies in the late 1980s and 1990s? The temporal proximity of these reforms suggests that they shared a common cause. Changes in the international economy are a possible culprit. The size and pace of the international economy continued to grow during the 1980s and 1990s, as both technological changes and regulatory liberalization increased cross-border capital mobility. How did these developments influence the choice of central bank institutions? What are the mechanisms that link increased economic openness to domestic institutional change?

Variations in the Timing of Central Bank Reform

While some countries embraced central bank reform, other countries were slower to adopt independent central banks. And some countries have not increased the independence of their central banks. What explains these cross-national differences in the timing and nature of reform?

Britain, for instance, would have seemed an ideal candidate for early central bank reform. In the late 1970s, inflation in Britain was out of control, reaching 18 percent in 1980. Public discontent with the Labour government's economic performance swept the Conservatives into power in 1979. Under Margaret Thatcher the government implemented a drastic program designed to halt inflation. The government raised interest rates and announced strict monetary targets, hoping to limit the growth of the money supply. These measures plunged the economy into a recession. Unemployment quickly doubled and remained above 10 percent throughout most of the 1980s. But the recession had its intended effect; by 1986 inflation had fallen to less than 4 percent.

An independent central bank could have helped the Conservatives demonstrate their commitment to sound monetary policies and perhaps lowered the employment costs of disinflation. Additionally, an independent Bank of England might have prevented future Labour governments from manipulating monetary policy for their own electoral gain. Finally, an independent central bank, insulated from the short-term political pressures of Britain's antagonistic parties, could have provided greater policy stability, creating an environment in which economic agents could plan and invest for the future. Despite these potentially beneficial economic and political consequences, the Thatcher government never moved to grant the bank more independence. Why?

Central Bank Reform and Institutional Reform

Interestingly, central bank reform has coincided with the implementation of broader political reforms in several industrial democracies. For example, in Italy, just as the central bank received greater policy autonomy from the government in the early 1990s, the political system disintegrated under the weight of corruption scandals, increasing regional disparities, and voter dissatisfaction with the ruling parties, particularly the Christian Democrats. In a series of referenda, Italian voters approved a new mixed proportional representation–majoritarian electoral system. In Britain the Labour government announced the 1997 reform of the Bank of England amid plans for other institutional changes, including regional devolution and the exploration of electoral reform. Finally, in New Zealand the adoption of an independent central bank in 1989–90 occurred just prior to major electoral reform. In 1992–93 New Zealand voters rejected the majoritarian electoral system in favor of mixed-member proportional representation. What, if anything, explains the coincidence of central bank reform and these other institutional changes? Are both the result of an underlying cause?

The European Union's Commitment to the Single Currency

The Maastricht Treaty established the goal of an economic and monetary union for member states, a major step toward political integration. By signing the treaty, Europe's leaders hoped to build on the popular enthusiasm surrounding the completion of the single market by January 1993. Yet plans for a single currency immediately met with skepticism and mistrust. Many economists were wary of the scheme, noting that Europe did not yet constitute an optimal currency area and that European political institutions were probably not strong enough to handle the task. Although European business interests generally supported the project, they did not rally around the single currency as they had done with the 1992 project. The public response was apathetic, if not hostile, especially in Germany and northern Europe. Indeed, the ratification process did not go smoothly. In referenda Danish voters initially rejected the treaty and French voters passed it by only a thin margin. As a result, the future of the single currency remained in doubt throughout much of the 1990s.

Despite this lack of public support, most politicians in Europe continued to advocate the Maastricht plans for a single currency. And in January 1999, the euro came into existence. Why were Europe's politicians so committed to the single currency? Why were they willing to tolerate the short-term political costs associated with the transition to the euro? What does the euro imply for the EU's democratic deficit?

The questions raised by the patterns of central bank independence extend beyond issues of economic performance and speak to deeper debates concerning the nature of the relationship between markets and governments, capitalism and democracy, and accountability and representation. Explaining central bank reform can provide insight into how politicians balance political concerns and economic priorities, as well as international pressures and domestic goals.

Conventional Explanations

Simple political economy arguments do not provide satisfactory explanations for the choice of central bank institutions. Political economists, for example, often assume that governments are overridingly concerned with reelection, making them myopic manipulators of economic policy (Cukierman and Meltzer 1986; Nordhaus 1975; Rogoff and Sibert 1988; Tufte 1978). An independent central bank, however, limits the government's ability to manage monetary policy for its own short-term benefit. Consequently, the government may be prevented from generating economic booms around election time. If an independent central bank restricts the policy options available to the government, why would self-interested politicians ever agree to an independent central bank?

A second group of political economists contends that the economic objectives of the governing party shape monetary policy (Alesina 1989; Alesina and Sachs 1988; Havrilesky 1987; Hibbs 1987). Partisanship theories typically assume that Right parties place a priority on price stability, whereas Left parties emphasize employment and income redistribution. Given the empirical relationship between central bank independence and inflation performance, these theories imply that Right parties will institute independent central banks, whereas Left parties will choose dependent central banks (Goodman 1991). Yet central bank independence does not correlate with government partisanship. In Britain, for example, the Conservative government during the 1980s retained a dependent central bank, whereas in Germany the Social Democratic government of the 1970s remained committed to an independent Bundesbank. In addition, central bank reforms in France, Belgium, New Zealand, Italy, and Spain enjoyed cross-partisan support.

Explanations that focus on the economic consequences of central bank independence, electoral opportunism, or government partisanship cannot account for the variation of central bank institutions. They do not tell us why some countries were quicker to adopt independent central banks while monetary reform was delayed or thwarted in others. These arguments cannot explain the association between federalism and central bank independence or the coincidence of monetary reform and other institutional reforms.

To better explain the variation of central bank independence, I focus on the politics surrounding the choices of these institutions, particularly the role of political parties. In particular, I contend that the choice of central bank institutions reflects the potential for intraparty conflicts over economic and monetary policy.

Political Parties and the Supply of Central Bank Institutions

Traditional partisan and opportunistic models assume that political parties are unified actors. But parties are more than just sets of policy priorities. And winning elections requires more than just producing good economic outcomes around election time. Instead, political parties organize choices for voters, putting together packages of policy alternatives. Parties translate citizen demands into public policy, coordinate the legislative process, and in parliamentary systems, determine the composition of the cabinet. In short, parties are central to every step of the policy process: elections, legislation, and governance.

Political Parties and Elections

Political parties represent teams of politicians—politicians who sometimes have diverse preferences and incentives about the party's policy program (Aldrich 1995; Downs 1957). Although individual party politicians want to attain office themselves, they also have an interest in ensuring that other members of their political party hold office as well; many rewards of office are contingent on the electoral success and cooperation of other party members. Politicians need fellow party members to pass legislation. Additionally, the distribution of leadership positions in the legislature and the cabinet often reflects the party's overall electoral performance.

Differences between an individual candidate's objectives and the party's electoral goals, however, can create conflict within the party, especially in the area of economic and monetary policy. Individual party politicians, for instance, may have to appeal to constituents with opposing preferences over monetary policy. Or they may run for election nonconcurrently, giving them different incentives over policy sequencing. The intraparty divergence of these policy incentives can lead to conflicts—conflicts that can threaten the ability of the party to attain and remain in office.