The “Hierarchy of Institutions” reconsidered: Monetary policy and its effect on the rule of law in interwar Poland

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\textbf{A B S T R A C T}

Traditional wisdom in economics holds that institutional change runs from political institutions to economic ones, with the distribution of political power affecting the creation of property rights and rule of law. This hierarchy of institutions has been observed in macroeconomic policy, where it has long been understood that there are political incentives for economic mismanagement, namely the creation of inflation. But are there longer-term effects of currency manipulation on the rule of law in a country? That is, does the hierarchy not always hold? This paper answers this question by focusing on a specific case of monetary instability, the newly-independent Second Polish Republic of 1918 to 1939. Using appropriate econometric techniques on a new database of historical data, I find that monetary profligacy correlates strongly with significantly lower levels of the rule of law. This result is robust to several tests and most specifications, including the use of a new variable for measuring access to the political system. The results suggest that monetary instability is a threat to political institutions in its own right, eroding the rule of law in addition to creating macroeconomic difficulties.

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“The best way to destroy the capitalist system is to debauch the currency.”

– attributed to V.I. Lenin by J.M. Keynes, 1919

1. Introduction

The economic wisdom of the past three decades has downplayed the role of economic institutions in economic outcomes, focusing instead on the role that political institutions play in determining broader economic outcomes. This approach, termed a “hierarchy of institutions” by Acemoglu et al. (2005) and further advanced in Acemoglu and Johnson (2005), argues that the distribution of political power affects the creation of property rights and rule of law, which, in turn, have been shown to mediate economic results (a finding echoed by Flachaire et al., 2014). Acemoglu et al. (2005) further formalize this hierarchy into a model of institutional influence, arguing that the distribution of resources and the distribution of power (likely, but not necessarily, linked) have the predominant effect on a country’s growth path precisely through their effect on economic institutions such as property rights.

There are numerous examples of how this hierarchy works in practice, showing where political institutions influence economic outcomes. In particular, money, as a unit of value or a method of exchange, has been subjected to political manipulation for centuries, leading to the development of an entire economics literature related to issues of “dynamic inconsistency.”
(Kydland and Prescott, 1977); most prominently, the literature on central bank independence (CBI, as shown in Cukierman et al. (1992) and continued by many papers since) has attempted to show how proper institutional arrangements could, in certain circumstances, mitigate political incentives for monetary manipulation.

However, the wrinkle in this vast literature is that while it reveals the channels in which political institutions may influence economic institutions, it does not necessarily consider that the relationship can run in both directions over a short time frame. Within the hierarchy, there is an acknowledgement that economic institutions may influence political ones in the long term, as a country’s distribution of power may be changed by shifts in “the relative bargaining power of rulers versus constituents (or rulers versus rulers) … [or] major, persistent changes in relative prices” (North, 1984:260). Acemoglu et al. (2005, among others) find that political institutions are slow-moving and difficult to change, as “political institutions as a means of allocating political power… regulate the future allocation of political power” (Acemoglu and Robinson, 2005:24). But while this reality is plausible in times of normal political processes and in the absence of external threats, this assertion can be challenged during severe economic disruptions. Extreme behaviour by economic institutions, either during or in precipitating a crisis, may, in turn, disrupt or determine political institutions and their subsequent paths, quickly altering the status quo in a destabilizing manner. Crisis periods, episodes of hyperinflation, and invasion all have the ability to force changes in power distributions across society and thus alter political institutions as well. Even more “normal” economic disruptions may change bargaining strategies and political coalitions, leaving a country’s political institutions transformed.

The reborn Second Polish Republic, existing from 1918 to 1939, appears to be a key example of the influence of economic institutions on political institutional formation. Unlike modern theories of monetary policy, which focus on the need for independence from political pressure, the experience of Poland seems to show instead that monetary institutions had a direct and deleterious impact on nascent political ones. Many researchers have argued a similar thesis regarding Poland’s large western neighbour during the interwar period—namely, that hyperinflation weakened the Weimar Republic (Hill et al., 1977) and led to the rise of the Nazis, who promised economic stability (van Riel and Schram, 1993). But despite the attention that Germany has received in the historical, political science, and economics literature, little attention has gone to Poland, which also saw both high inflation and a rapid decline in the rule of law.

In the Polish case, the hyperinflation of the early 1920s, in particular, and the seeming political impotence in fighting it, led to a more authoritarian-minded government coming to power in 1926. This government, the Sanacja (sanitizing) regime, progressively eroded the rule of law until Poland became a proto-fascist state on the eve of its dual invasion by Germany and Soviet Russia. And throughout the interwar period, Poland uniformly saw episodes of the degradation of the rule of law preceded by massive bouts of monetary instability.

The purpose of this paper is thus to revisit the “hierarchy of institutions” debate, tracing the effect of monetary policy in Poland in the interwar period. Assembling a new dataset of historical data on a monthly basis, tracing the development of macroeconomic and institutional aggregates in Poland and the rest of Central Europe, and using a new measure of rule of law, this paper attempts to formally model the relationship between monetary policy and rule of law econometrically. Extending the literature on institutional endogeneity, the key result of the paper is that there is a consistent, small, but highly significant effect of monetary policy on the rule of law in the Second Republic. This result is robust to various specifications, endogeneity, and different proxies of profligate monetary policy, and holds even after accounting for a large number of covariates, which could plausibly be related to the development of a rules-based political system. While political attributes are still important for the development of Poland’s political institutions, across the board, economic conditions and institutions appear to have had a much larger effect.

2. Monetary policy and the rule of law: the link

As the quote attributed to Lenin (White and Schuler, 2009) at the beginning of this paper makes clear, the relationship of money to the functioning of political and other economic institutions is not a new idea; in fact, it has appeared throughout the past two centuries in various works on political economy. However, much of the theoretical and empirical research in modern economics literature has inverted this research question, focusing instead on the effect that rule of law or overall institutional quality has on monetary policy or the design of monetary policy institutions (Mishkin, 1999; Fatás and Mihov, 2013). Driven by attempts to isolate the determinants of short-term macroeconomic outcomes (growth or inflation), this literature has tended to assume that a country’s level of rule of law is exogenously given rather than endogenously determined over short time frames (for a recent example, see Calderón et al., 2016, who examine institutions and macroeconomic policies from 1984–2008). The empirical results from these studies show that monetary institutions and their outcomes depend upon the rule of law to function properly (e.g. Eliffinger and Stadhouders, 2003). Much of the literature on central bank independence is formed around the assumption that monetary policy institutions are a derivation of political institutions (even if it is not explicitly stated), and thus central banks need to be insulated from political pressure via independence, whether legal or operational.

Left unspoken in the prevailing literature is how these monetary policy institutions, and the policies they then pursue, would translate into political institutional changes. It is highly likely, if not certain, that monetary policy at time t does not only affect other macroeconomic aggregates at times t through t+n but would also influence political institutional development during this same time frame and beyond. For example, over the long term, monetary policy can have a direct and profound effect on the distribution of power in a country (Woolley, 1985; Argitis and Pitelis, 2001), which then filters through to that country’s political structures. This influence is especially relevant under the assumption of central bank independence, where the economic institution of the central bank is theorized to be explicitly insulated from the political institutions of the government. If, instead, causality runs in the other direction, the effects from an independent monetary authority’s actions, unconstrained by political considerations, could be quite large.
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