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An independent central bank faced with elected governments

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Abstract

The literature argues that the benefits of an independent central bank accrue at no cost to the real side. In this paper, we argue that the lack of correlation between monetary autonomy and output variability is due to the proactive role of fiscal policy when faced with rigid monetary objectives. Few of the attempts to measure these correlations actually allow for a changing fiscal role. Yet, when an independent authority handles monetary policy, fiscal and wage/social protection policies remain instruments in the hands of elected governments. We find that, so long as the two authorities pursue their goals independently of each other, a conflict arises that becomes stronger as preferences diverge. We also find that the establishment of a conservative central bank encourages more divergent preferences among the public (as reflected in the government that is elected). The election of more interventionist governments then makes it harder for either authority to reach its own preferred objectives, unless cooperation is possible.

JEL classification: E52; E63; F42
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1. Introduction

The original research on the importance of coordinating monetary policies was conducted by Hamada (1976, 1977) and Canzoneri and Gray (1985). Their technique

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was to examine the costs of noncooperative monetary policies in a multicountry setting, compared to some form of cooperation. Since then, a large literature on the advantages of central bank independence for inflation control has emerged, with clear conclusions for the design of monetary policy and monetary institutions. That literature, however, has proceeded as if we were concerned with a single-issue economy and as if monetary policy were the only policy instrument available.[1] This paper returns to the coordination issue but focuses on the issue of coordination between institutions rather than between countries as in the earlier literature.

We start with an analysis of noncooperative policy making when there are two (or more) policy instruments controlled by different policy authorities, when there are private forward looking expectations and the possibility of time-inconsistent policies.

In our case, these instruments are fiscal and monetary policies. However, they could also represent wage policies, supply side reforms or policy influences from abroad. We then extend that analysis to examine how electoral outcomes will be affected by the conflicts that emerge between the independent policy authorities in this context and what those electoral outcomes may mean for the effectiveness of policy. We find that many of the literature's classic conclusions can be turned on their head. That happens because unrestrained competition between independent policy makers creates conflicts in which one policy has to be used (in part) to neutralise the other. The result is a loss in efficiency as everyone has less than they might.

Our first contribution therefore is to show the determinants and extent of the competition between an independent monetary policy and other policies in an economy where private sector behaviour is subject to rational expectations of future developments. We find that potential policy conflicts increase with the differences in preferences between policy makers, and that policy effectiveness falls accordingly. That has consequences for the cost of an independent monetary policy, and hence for the design of the policies which remain in the government's hands. In other words, we are analysing the consequences of delegating monetary policy, not whether one would want to delegate it. Nonetheless, the motivation for delegating monetary policy is the usual one; inflation is higher without delegation because elected governments are less inflation averse than the central bank.

More interesting perhaps is our second innovation that government policies will be subject to electoral outcomes and electoral preferences. We show how policy conflicts and policy ineffectiveness affect electoral outcomes, and how those electoral outcomes affect the stance of policy. In general, we find that the more "conservative" the central bank's policies, the more "liberal" or "populist" those of the government become. That of course increases the degree of conflict. Consequently, one-sided interventions designed to limit

[1] Important exceptions are Alesina and Tabellini (1987), Debelle and Fischer (1994), and Nordhaus (1994). Others have speculated that the outcomes of this literature might look different if a second policy instrument were brought into play (Blackburn and Christensen, 1989; Rankin, 1998). Notice however, that we do not consider the level of public debt explicitly, as Beetsma and Bovenberg (1997) or Beetsma and Uhlig (1999) do. This is because: (a) our focus is elected governments, where the electoral process naturally takes a rather shorter horizon; and (b) because we want to keep open the possibility of interpreting our second instrument as a labour market or supply side reform instrument. However, to make sure that there is no build up of debt, we consider only solutions that respect the budget constraint (this is assumed in Section 3 and discussed further in Appendix A).