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Are independent central banks really as conservative as they like to pretend?

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Abstract

In a recent paper in this journal [Demertzis, M., Hughes Hallett, A., Viegi, N., 2004. An independent Central Bank faced with elected governments: European Journal of Political Economy 20, 907–922.] we showed that, when voting is endogenised, an independent and conservative Central Bank will create the tendency for elected governments to become more liberal or populist. That causes policies as well as preferences to diverge. But we did not show whether the Central Bank would then become more conservative in response, by way of disciplining the fiscal authority and protecting its own preferred targets. Building on these earlier results, we examine that question in this paper. I find that the Central Bank would, in its own interest, not retaliate in this fashion except where the government's *target* for output growth becomes very ambitious. This behaviour seems to match what little empirical evidence we have on Central Bank reactions.

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1. Introduction

This paper asks, under what conditions would an independent and potentially conservative Central Bank face down, or even discipline, governments whose fiscal policies appear too expansionary, or threaten to undermine the Bank's regime of strict monetary control, by using interest rate rises to protect its inflation target? In Europe the Stability Pact has come and gone with the larger Eurozone members having breached its deficit limits, some of them comprehensively. The European Central Bank has spoken out strongly and aggressively against this kind of behaviour, and has threatened interest rate rises in retaliation. But in practice it has done nothing; and rightly so according to the model below.

Hence the question in this paper is: are there circumstances in which the Central Bank would rationally give way and accommodate those expansionary policies as best it can? The literature remains divided on the issue. The thrust of the independence of the Central Bank literature, from Barro and Gordon (1983) on, is that all the Central Bank has to do is

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raise interest rates sufficiently to choke off the fiscal expansion pressures and then sit tight. And being independent, with a mandate to control inflation, there is nothing to stop them doing so. Arguably, this is the story of the Volker deflation in the United States (Erceg and Levin, 2003). But there is dissent on even this point. Beetsma (1999) shows that excessive deficits may induce the Central Bank to adopt a more inflationary stance than otherwise; and Beetsma and Bovenberg (1997, 2002) argue that free-riding among decentralised decision makers may lead to fiscal policies being chosen to influence the common monetary policy. More fundamentally, there is the "blackmail" argument: governments will threaten to expand their fiscal policies (to relieve what they perceive to be excessively restrictive monetary policies) in order to create "excessive" deficits and debt to neutralise the monetary policies (Dixit and Lambertini, 2001); leave the union (Dixit, 2001); or to produce an accumulation of debt that threatens insolvency or a collapse in the local capital markets (Kenen, 1995). This behaviour may imply that "real politik" has entered monetary policy making. But the issue matters because, as Dixit and Lambertini (2003) point out, we cannot expect to commit monetary policy if fiscal policy cannot be pre-committed at the same time.

This paper therefore identifies the conditions when a Central Bank should seek to tighten its monetary policies in response to new fiscal expansions, and when it should not. As a bi-product we are also able to show when governments would want to expand their fiscal stance as a result of the Central Bank's behaviour. We find that, except in some extreme cases, there are no circumstances in which the Central Bank would want to discipline an expansionary or populist government. It would either do nothing, or it would accommodate that government. Governments, on the other hand, face a number of incentives which will lead them to expand in response to Central Bank restrictions. It is important to stress however, that this has nothing to do with the short run political motives usually discussed in this literature. Here it is a political matter, but one derived from the strategic behaviour between two independent agencies whose policy targets and patterns of accountability differ.

2. Fiscal–monetary conflicts

Our starting point is that, as the Central Bank acquires more independence, then so does the fiscal authority. One might therefore expect to see political parties starting to compete to provide the kind of fiscal and labour market policies the voters want. Indeed, if voters are convinced that monetary policy is now properly conducted by the Central Bank, they will naturally demand that fiscal or labour market policies be placed in the hands of those who are able to deliver on the remaining targets. And they are likely to punish governments that do not deliver accordingly at the polls (Demertzis et al., 2004).

The natural reaction to such conflicts has always been to find ways to restrict the use of fiscal or monetary policies. Given an independent Central Bank, that has led to the Stability Pact for fiscal policy in Europe; whereas, in earlier times, governments had made monetary policy subservient to the needs of their fiscal programmes. Indeed, the Stability Pact might have been seen as a means of protecting the Central Bank against inflationary pressures of fiscal policy, without the Bank having to raise its interest rates in retaliation. However, arbitrary restrictions of this kind have seldom proved either effective or popular. How would independent policy making institutions behave in their absence?

2.1. Independent policy making when preferences differ

To answer that question, we adapt the standard analysis of Barro and Gordon (1983), Rogoff (1985), Debelle and Fischer (1994), and Alesina and Gatti (1995). Following Rogoff, we suppose that the Government delegates the conduct of monetary policy to a Central Bank with more conservative preferences than society would itself vote for. Suppose also that the Government is able to keep control of its fiscal instrument. The Central Bank's problem is then to minimise the loss function:[1]

$$L_{\mathrm{B}} = \frac{1}{2}\left[\pi^2 + \gamma(y-k)^2\right] \tag{2.1}$$

subject to

$$y = \pi - \pi^e - \tau + \varepsilon \tag{2.2}$$

[1] Gali and Monacelli (2002) have shown that under suitable assumptions, quadratic loss functions can be derived from the welfare of the representative consumer in the models of the new open economy literature.