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Goal independent central banks: Why politicians decide to delegate

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ABSTRACT

A motivation for central bank independence (CBI) is that policy delegation helps politicians manage diverse coalitions. This paper develops a model of coalition formation that predicts when delegation will occur. An analysis of policy preferences survey data and CBI indicators supports the predictions. The model also explains why the expected negative relationship between CBI and inflation is not empirically robust: endogenous selection biases the estimated effect towards zero. The data confirm this.

1. Introduction

> I'm the decider, and I decide what is best.
>
> President George W. Bush, April 18, 2006.

Politicians are generally happy to exercise their power to decide things. Monetary policy is perhaps the most glaring exception. Delegation to an independent central bank is now the norm.

However, the type of delegation differs widely across countries. One broad institutional model is goal independence, under which the principal (the government) delegates to the agent (the central bank) full policymaking powers, including the power to decide the appropriate policy target. The U.S. Federal Reserve, which has a broad mandate to target stable prices and full employment, is considered by most commentators to enjoy goal independence. It has the authority to prioritize between its employment and price stability goals and to interpret the latter (and operationalize via targets for monetary aggregates, inflation, etc.) as it sees fit. By contrast, the Bank of England (post-1997) has instrument independence. Its authority to act autonomously is well established within fairly narrowly defined limits: it enjoys freedom of action over its policy instruments in pursuit of a policy target decided by the government.

Of the two models, instrument independence seems to conform to other common institutional arrangements in democratic societies. Other government-sponsored bodies (such as the police, statistical agencies, electoral commissions) usually operate on this basis. The much broader mandate implied by goal independence, on the other hand, is rather anomalous. Perhaps only the judiciary enjoys the same degree of autonomy, but even here the delegated authorities (judges) are generally limited to enforcing

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and interpreting either laws passed by the executive or legislative branch of government or a written constitution, rather than legislating on their own account (Goodhart and Meade, 2004).

One could argue that the independence enjoyed by goal-independent central banks (GICBs) is particularly striking given the political sensitivity of their core role—the conduct of monetary policy. However, this political sensitivity could explain the decision to delegate. Because monetary policy is contentious, it can split otherwise homogeneous political coalitions. Taking monetary policy "off the table" makes it easier for these political actors to effectively combine to control policy with respect to other key issues. Far from being constrained, politicians who decide to delegate may see their overall freedom of action enhanced.

To analyze this question, I present a model of an economy whose agents hold heterogeneous views over monetary policy and other policy areas. Specifically, preferences are assumed to differ over monetary policy and a second dimension, where both are dichotomous. Policymaking is modeled via a political economy game which has three stages. In the first stage of the game, "factions" (groups of agents with similar preferences) can form coalitions with each other. In the second stage, coalitions determine their policy platforms. In the final stage, the largest coalition is given the opportunity to set policy. The game has a zero-sum element, so that the benefit of forming a broad coalition is obvious: the largest coalition is the one that sets policy. The cost of coalition formation lies in the second stage of the game: individual factions within coalitions must engage in (potentially costly) political lobbying in an effort to influence the coalition's platform.[1] This cost arises from the heterogeneity of potential governing coalitions, which in turn reflects the multidimensionality of the policy space.

The motive for delegating the monetary policy decision to a fully (goal-) independent central bank is that it removes the intracoalition conflict over monetary policy from the political arena. I derive the conditions under which delegation will occur. In equilibrium, the cost of coalition formation depends upon the relative sizes of the factions within each coalition. Since effective lobbying strength depends on faction size (because larger factions have lower per-member lobbying costs), equal-sized factions (with equal chances of winning) will invest heavily in lobbying for their preferred outcome. The contest will therefore be costly for the coalition as a whole, motivating both sides to take monetary policy "off the table." By contrast, if one faction dominates in terms of size, then lobbying strengths are clearly mismatched, the likely victor in the policy dispute is clear, and no faction will commit significant resources in the dispute. Incentives to delegate will be minimal.

How can we test this prediction? Since (as I demonstrate) coalitions form in equilibrium based on unanimity along one policy dimension and disagreement over the other dimension, then the relative size of the factions within each coalition is determined by the correlation between agents' positions with respect to the two policy dimensions. When this correlation increases, coalition preferences become more homogeneous (one faction dominates) and the costs of political campaigning relative to its benefits are lower. Correlated preferences make it easier to partition society politically and lessen the need for institutional remedies. Other things being equal, GICBs are less likely to be established in societies where preferences over the two policy dimensions are more closely correlated. This is the prediction I take to the data.

The model has a further implication: if goal independence is selected endogenously as in the model, then its estimated effect on inflation will be biased upwards, towards zero if the causal effect is actually negative (as seems likely). This is because goal independence will be endogenously selected when the central banker is likely to be neither too "hard" nor too "soft" on inflation, and since central bankers are conservative on average, it is largely the former ("inflation nutters") who are ruled out. This could then explain why the estimated negative effect of CBI on inflation, at least according to the standard de jure measures, has not been identified outside a narrow subset of advanced economies (Eijffinger and de Haan, 1996). Section 3 includes a further discussion of these issues, while Section 4 presents evidence of this bias in Ordinary Least Squares (OLS) estimates of the effect of CBI on inflation and of a strong negative effect of CBI on inflation once endogenous selection is modeled explicitly.

This paper draws on and contributes to several strands of literature: a mainstream macroeconomics literature on CBI; a political science critique of this approach; a newer political economy literature that combines elements of both; a parallel political science literature that takes a historical, case-study approach; and game theoretic literatures on both lobbying and coalition formation. Of these literatures the first is perhaps the largest and best known (see the surveys in Persson and Tabellini, 2000; Drazen, 2000; Eijffinger and de Haan, 1996, for useful summaries). For our purposes its key contribution (Debelle and Fischer, 1994) has been to clarify the distinction between goal independence—the full delegation embodied in Rogoff's (1985) "conservative" central banker model—and instrument independence—the kind of relationship suggested by agency models (Walsh, 1995). This paper makes the distinction more concrete by illustrating how the different institutional forms mold political incentives.

These economists' accounts of central bank behavior have come under criticism from a political science approach to institutional behavior, which has tended to focus on the actions and incentives of heterogeneous, conflicting groups in society (Wooley, 1984; Bowles and White, 1994). This paper takes heterogeneity seriously: indeed, it provides an account of CBI based on how preference heterogeneity shapes political incentives.

In this respect it follows other recent contributions to the political economy literature that have started to address agent heterogeneity, conflict over policy, and the role of the central bank within such an environment. The role of delegation in these accounts typically lies in its ability to alter the strategic interaction between political actors in the determination of monetary policy. For instance, Keefer and Stasavage (2003) show that an independent central bank can partially solve the time inconsistency problem

[1] This policy game can be thought of as representing all agents in the economy, although it might make more sense to think of the players in the game as political representatives, drawn in rough proportion to the population as a whole. The first, coalition-formation, stage of the game can then be interpreted as either pre-election party formation (in a majoritarian system), post-election coalition-building inside a legislature (in a proportional system), or simply as factionalism within a ruling group (in a nondemocratic system).