

Monetary Politics

In many countries monetary policy institutions have been designed to minimize “political” influences on decision-making, but given the motivations of politicians, these protections will always be imperfect. This entry describes the most important political influences on monetary policy. We first consider monetary policy cycles related to the timing of elections, then those involving partisan change. Next considered are political models of inflationary biases, including applications of the time inconsistency problem and models of bureaucratic behavior. Finally, monetary policy choices are briefly described in the context of public choice models of committee decision-making.

Electorally Motivated Political Monetary Cycles

In Nordhaus’s (1975) model of the political business cycle, vote-seeking politicians opportunistically manipulate the economy to gain the support of myopic voters who are concerned with current macroeconomic conditions. Incumbent politicians engineer pre-election booms to gain votes; these booms are then followed by post-election contractions. Political business cycles could be produced with either fiscal or monetary policies, but monetary policy changes can be implemented quickly and without special enabling legislation.

The Nordhaus model was probably inspired by the 1972 U.S. presidential election. In that year, incumbent Richard Nixon was the beneficiary of a healthy pre-election boom, a boom that many suspected was engineered with the cooperation of Chairman Arthur Burns at the Federal Reserve (Fed). Woolley (1980) carefully reviewed Fed decision-making in that year, and concluded that the Fed’s Federal Open Market

Committee (FOMC) was not directly motivated by a desire to insure Nixon's reelection. However, price controls imposed by the Nixon administration transferred intense political pressure to the Fed – any move by the Federal Reserve to raise interest rates in a regime of controlled price and wages would surely have drawn ire from politicians and the public. Thus, while the Fed's accommodative stance probably reflected bureaucratic self-protection, the effect nevertheless advanced the reelection prospects of the incumbent.

Systematic quantitative evidence of political monetary cycles also exists. Grier (1987) estimated a monetary policy reaction function for the U.S. that was augmented with dummy variables to account for electoral timing. He found that the electoral dummies were statistically significant, supporting the hypothesis of cycles. These results were questioned by Beck (1987), who suggested that the electoral pattern primarily reflected accommodation of fiscal policy pressures, but Grier (1989), using more flexible empirical specifications, later found evidence of electoral cycles even when the stance of fiscal policy was accounted for. Subsequent evidence has been mixed, but the hypothesis of a monetary political business cycle clearly cannot be dismissed.

Partisan Political Business Cycles

In a pioneering cross-country study, Hibbs (1977) found that unemployment rates were lower under left-leaning than right-leaning political regimes, reflecting the underlying concerns of the parties' core constituencies. Supporting this theme in the monetary policy arena, Beck (1984) concluded that U.S. monetary policy is easier under Democratic presidents than Republicans; Cowart (1978) and Minford and Peel (1982) provided similar evidence for left- and right-leaning governments in Europe and the U.K.

Grier (1991, 1996) provided striking evidence that the partisan composition of Congressional oversight committees affects the stance of monetary policy in the U.S.

With the advent of the rational expectations revolution, political business cycle models of both partisan and electoral varieties were questioned, and ultimately reformulated. A rational model of electoral cycles was presented by Rogoff and Sibert (1988) and rational partisan models were formulated by Alesina (1987), Alesina and Sachs (1988), and Chappell and Keech (1986, 1988). In the rational partisan models, election uncertainty causes partisan-related policy surprises and fluctuations in real economic outcomes. Chappell and Keech (1988) empirically linked election-related surprises in monetary policy to changes in unemployment in the U.S., finding modestly-sized partisan impacts. Alesina, Roubini, and Cohen (1997) found broad supportive evidence for rational partisan cycles and related patterns in monetary policy across a panel of 18 OECD countries.

Channels of Influence

Partisan and political business cycle models require that politicians control, or at least influence, fiscal or monetary policies. How do they do so? Building on the arguments of Kane (1980), Havrilesky (1995) suggests that, in the U.S., presidential influence over monetary policy derives in part from the Fed's need to deflect Congressional threats to its independence – i.e., the Fed accommodates presidential wishes; in return, it is understood that the president will protect the Fed from threatening legislative intrusions. The Congress implicitly gains from this standoff as well: it can publicly “bash” the Fed for its bad performance, while escaping direct responsibility for

economic outcomes. Havrilesky's (1988, 1995) statistical evidence showed that the Fed was responsive to direct executive branch "signals" of monetary policy preferences reported in the press.

Politicians also influence monetary policy through the power of appointment. Havrilesky and Gildea (1992) have argued that economists are particularly reliable ideologues and that presidents, recognizing this, choose economists for their early-term appointments. Waller (1992) also investigates the appointments process, developing a model of bargaining between an appointing executive and a confirming legislature. Both Waller (1989) and Keech and Morris (1997) have noted that if influence over policy comes primarily through the power of appointment, policy shifts associated with regime changes in the executive branch may be gradual and delayed; it takes time for a president to "pack the Board" with loyal supporters. Chappell, Havrilesky, and McGregor (1993) have used dissent voting data to infer that U.S. presidents' partisan influences over monetary policy come primarily via the power appointment rather than direct pressure. This poses a particular challenge for rational partisan models described earlier: rational partisan models require that elections produce policy surprises, but election-related surprises will be minimal if policy change must await a packed Board.

The Political Origins of Inflation

In most economies the price level rises over time. In the absence of a strong case for the desirability of inflation, one is led to suspect a political bias toward inflationary policies. The time inconsistency problem, described by Kydland and Prescott (1977) and applied to monetary policy by Barro and Gordon (1983), provides a possible explanation

for such a bias. According to this theory, policymakers value both low inflation and output in excess of its natural rate. If the public expected zero inflation, policymakers would have an incentive to increase output with a positive money supply surprise. But if the public had rational expectations, this incentive would be anticipated, rendering a zero inflation equilibrium untenable. Rather, inflation will be positive in equilibrium, and will persist at a level where the marginal costs of inflation and the associated marginal (short-run) gains in output are balanced. Although it is not widely appreciated, a similar result was described by Nordhaus (1975) in a setting where expectations were adaptive rather than rational.

To avoid a suboptimal inflationary equilibrium, some have proposed that politicians might wish to appoint “conservative” central bankers (i.e., those who are less concerned with output gains than their political principals) and grant them independence in day-to-day policymaking (Rogoff, 1985). Such a solution is problematic: it is not clear how conservatives are to be identified and selected, nor is it clear how their independence is to be protected given the incentives of political principals (Toma, 1997). These issues aside, a substantial empirical literature has developed on the relationship between central bank independence and inflationary performance across countries. After exhaustive study, Cukierman (1992) concluded that the preponderance of the evidence supports the view that independence and low inflation are connected, but that evidence is not overwhelming.

Inflation may also arise from the desire of governments to directly extract revenue via money creation -- it is widely recognized that hyperinflations have political origins in the need to raise revenue without levying explicit taxes. Using a model that employs the

logic of the time inconsistency problem, Cukierman (1992) has shown that the revenue motive can produce an inflation rate exceeding the steady-state seigniorage-maximizing rate. He also provides some empirical support for the seigniorage motive from cross country evidence – seigniorage is a more important source of revenue when tax institutions are less efficient and political systems less stable. For the U.S., Toma (1997) has described how institutional changes affecting the Federal Reserve’s revenue generating capacities have mirrored changes in the government’s need for seigniorage revenue.

Although most theories focus on the political “demand” for inflation, the political “supply” is also an important public choice issue. In the U.S., the operating budget of the Federal Reserve bureaucracy is funded by interest earnings on government bonds that it holds. When the Fed exchanges money for bonds, it trades an asset that bears no interest for one that does, providing a bureaucratic incentive for monetary expansion (Toma, 1982). Tollison and Shughart (1983) have provided empirical support for Toma’s model by demonstrating that expansions in Federal Reserve employment have been related to expansions of the monetary base.

Committee Decisions

Monetary policy decisions are usually made by committees, and committee decision-making is a topic of intrinsic interest in public choice. In the U.S., monetary policymaking provides an excellent opportunity to study committee decisions because the FOMC meets repeatedly to consider a single issue (the degree of ease or tightness in the policy stance) and because there are extensive records describing both the preferences of

individual members and FOMC decisions. Formally, monetary policy directives require majority approval by the FOMC. Members must cast assenting or dissenting votes; these votes are recorded and later made available to the public.

Investigations of dissent voting patterns have shown that there are systematic differences in policy preferences across members. For example, district Reserve bank presidents tend to favor tighter policy than Federal Reserve Board governors (Belden, 1989), and Democratic appointees favor ease relative to Republicans (Havrilesky and Gildea, 1991). Policy preferences of FOMC members are also related to educational background, profession, and other career characteristics (Havrilesky and Schweitzer, 1990; Chappell, Havrilesky, and McGregor, 1995). Econometric analysis of FOMC voting patterns also reveals that the Fed Chairman has disproportionate weight in committee decisions, undermining the simple median voter hypothesis (Chappell, Havrilesky, and McGregor, 1993).

The availability of information on policy preferences of individual committee members suggests a fruitful direction for research on politics and monetary policy. Political influences, whatever their source, must operate through the decisions of individual policymakers. This in turn suggests that political influences may be more clearly detectable when individuals provide the unit of analysis, rather than a governmental entity that has already aggregated those preferences. A nice illustration of this is provided by McGregor's (1996) investigation of political monetary cycles using data describing individual FOMC members' votes. McGregor found that FOMC members who were appointed by the party of the incumbent president tend to favor pre-election ease, while members appointed by the opposition favored pre-election tightness.

At the individual level political influences were abundantly clear; at the level of committee outcomes these influences were obscured.

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