Theory
Central Bank Autonomy
A Redistributive Perspective

The introductory chapter laid out the general contours of this book. The general theme is one of institutional autonomy as a form of political insulation. The setting is democracies in transition from authoritarian rule. And the specific institutional form in question is central bank autonomy.

The nuts and bolts of this argument are presented in chapter 3. In order to set the stage, this chapter provides some theoretical background. Above all, this entails a more detailed discussion of the literature on central banks.

Central banks are essentially government banks. First and foremost, they govern monetary policy, controlling how much domestic currency will circulate in a country’s economy at any given time. They also act as financial agents for governments, managing and disbursing liquid funds. Third, they may play an international role in setting a country’s exchange rate and/or managing its foreign reserves. Finally, they also have a number of supervisory and regulatory duties to ensure the ongoing stability of the private banking sector.1

Central bank autonomy refers to the extent to which the central bank carries out these functions independent of executive and legislative control. In recent years, central bank autonomy has assumed growing empirical and analytical significance. On the one hand, the number of countries undertaking central bank reform has gradually increased over the last two decades, escalating dramatically in the early 1990s (Maxfield 1997, 50–70). On the other hand, this more visible and powerful role for the central bank has been accompanied by a large literature in both economics and political science as to the causes and consequences of autonomy.2

This study focuses primarily on the decision by politicians to cede authority over monetary policy to an independent agency. The conventional view holds that politicians do so as a means of binding themselves against the temptation of generating inflationary surprises in the future. As a result, society as a whole is said to benefit.

2. There is also a separate literature that explores the conditions under which central banks are established. See, for example, North and Weingast 1989; Maxfield 1994; Broz 1998.
This chapter offers a different explanation. Drawing on discussions of bureaucratic design in the American politics literature, I raise the possibility that politicians who create autonomous central banks may be more concerned about their successors’ inability to commit to low inflation than their own. As a result, they may design central banks not so much to limit their own freedom of maneuver as they do to bind the policy choices of future governments. Viewed from this more political perspective, central bank reform may shift from being a story of welfare improvement to one of redistribution, wherein those actors who favor low inflation stand to win from autonomy, while those with a more interventionist policy agenda stand to lose.

The chapter is organized as follows. I begin by reviewing contemporary theories of bureaucracy to suggest why the onset of political change may provide incentives for incumbent politicians to embed their policy preferences in institutions, and I explain the corresponding welfare implications that flow from such a model of institutional choice. Next, I demonstrate how this “tying successor hands” logic might be fruitfully applied to the literature on central bank reform in the advanced industrial countries. I conclude by suggesting why a similar approach should prove equally valid in the developing world.

Bureaucratic Design: The Politics of Insulation

Contemporary theories of bureaucracy offer powerful insights into the relationship between institutional choice and political change. The basic problem can be cast in terms of the principal/agent literature. This literature refers to a class of problems in which one actor—the principal—considers entering into a contractual relationship with another—the agent—with the expectation that the latter will choose subsequent actions that produce outcomes desired by the principal (Jensen 1983). Within the literature on American politics from which most examples are typically drawn, members of Congress and the president are principals in an agency relationship with an executive bureau, whom they depend upon to execute policies in keeping with their wishes.

In addition to the standard moral hazard and adverse selection problems that typically plague this sort of control relationship, the principals also need to worry about what happens when a new set of principals takes over in the

3. For a more thorough review of the literature on this topic—as well as various critiques that have been leveled against it—see, among others, Mashaw 1990; Huber and Shipan 2000.

4. “Moral hazard” refers to a problem of hidden action (i.e., principals cannot observe the behavior of their bureaucratic subordinates), while “adverse selection” concerns hidden information (i.e., bureaucratic agents know more than their political principals do).
future. For even if the authors of a particular piece of legislation manage to structure incentives and/or employ monitoring techniques to ensure that the agency does exactly what they want during the current period, new coalitions may come into power who fail to respect these arrangements. Politicians currently in office thus need to worry about how they can control policy outputs by government agencies in an environment characterized by political uncertainty (Moe 1990a, 122–25).

This problem of “legislative drift” (Horn and Shepsle 1989) gets resolved in the literature in a variety of ways. McCubbins, Noll, and Weingast (1987, 1989) focus on various “deck stacking” strategies that politicians can employ to influence the process through which agencies make decisions. They suggest that by incorporating specific procedural arrangements (e.g., public notification and participation requirements), politicians can shape agency decision making in a way that privileges those interests who were actively involved in the creation of the original legislation and most affected by the resultant policy. The beauty of this approach—so the story goes—is that these rules need not dictate specific policy outcomes. Rather, they are intended to make sure that the agency will act on “autopilot,” so that as preferences of the initial constituencies enfranchised in policy-making change, so too should policies reflect such changes, making new legislation unnecessary.

Moe (1990a, 1990b) offers a similar analysis of agency structure. He identifies a variety of means through which incumbent politicians can manipulate diverse features of bureaucratic structure—for example, introducing sunset provisions, housing an agency in a “safe location,” front-loading the benefits of agency mandates—to make it difficult for their opponents to undo their desired policies in the future. In both cases, the basic idea is that politicians can—and do—structure bureaucratic agencies to favor both constituent interests and substantive policy outcomes that the legislation’s original framers deemed important, even when this enacting coalition is no longer around.

In addition to exposing the political strategy that underlies such institutional choices, this literature is also explicit about the welfare effects that flow from them. This is particularly true of Moe’s work. For Moe, the defining feature of political office is that it is imbued with a preexisting authority. Officeholders thus enjoy a de facto structural advantage over their opponents.

5. While McCubbins, Noll, and Weingast are more directly concerned with problems of so-called bureaucratic drift, their framework is equally applicable to control problems arising from changing legislative coalitions. See Horn and Shepsle 1989.

6. The delegation literature has been extended to provide more carefully specified empirical propositions about how different features of the political environment influence both the choice and type of control instrument. See especially Epstein and O’Halloryn 1994; Bawn 1997; and de Figuereido 1998.
in the process of institutional creation, as while in power, they have virtual carte blanche to design institutions as they see fit. And their opponents, like it or not, have little choice but to accept what they create. In this way, Moe suggests, politicians have both the incentive and the ability to use the power of office to impose their policy preferences on their successors. The main implication of his work is that the resultant institutions—far from benefiting all actors equally—may well leave certain actors worse off. At the very least they are likely to introduce a redistributive bias into the resultant policy (McCubbins, Noll, and Weingast 1989, 443).

While varying in their specific emphases, what each of these writings has in common is an emphasis on turnover of power as a key motivation behind institutional design. Turnover matters because it signals to politicians that they are vulnerable to a change of policy in the future and must thus seize the moment to protect their interests while they still have the institutional wherewithal with which to do so. And while the institutions born of this insulation dynamic will not necessarily lie outside the Pareto frontier, they may well generate winners and losers.

This study extends this redistributive view of institutions to the realm of central banks. As noted in the previous chapter, this is not a readily obvious application. But a closer look at this literature suggests that it is entirely plausible. In order to see this, however, we must first review standard accounts of why politicians create autonomous central banks.

Central Bank Autonomy: The Developed Countries

The Credibility Literature

Over the last two decades, research on central bank autonomy in the advanced industrial countries has mushroomed under the umbrella of the “credibility” literature. Models build from the premise that unexpected monetary expansion can generate short-term gains in output. As a result, pol-

7. Because he is analyzing agency design within the U.S. political context—where the passage of legislation per force requires negotiation among groups with diverse interests—Moe incorporates an element of political compromise into his theory. But such compromise only serves to further load down the bureaucracy with excessive rules and does not change the essentially coercive nature of the dynamic he describes.

8. In singling out the credibility literature, I am focusing on what I consider to be the conventional wisdom regarding central bank autonomy. In so doing, I do not address another important research tradition that claims that it is the structure of existing political institutions—and their effect on the number of actors in the policy-making process—that makes autonomy more or less likely to occur and/or guarantees its effectiveness. See, among others, Banian, Laney, and Willet 1986; Johnson and Siklos 1992; Lohmann 1998a.
icymakers have the ability to use surprise inflation to stimulate the economy in order to improve their electoral fortunes (Kydland and Prescott 1977; Barro and Gordon 1983a, 1983b).9

The problem is that in attempting to fool the public in this fashion, the government produces an inflationary outcome that is suboptimal for all concerned. This situation arises because private economic agents understand the incentives facing politicians. They know that although a government may announce an anti-inflationary policy in one period, it has an incentive to renge on this commitment by generating surprise inflation at some point in the future. Anticipating such inflationary behavior, domestic economic actors build this calculation into their nominal wage contracts and adjust these upward accordingly. The net result is an inflationary spiral with no corresponding gains in employment.10

In order to overcome this “time inconsistency” problem, policymakers must devise a means through which to credibly commit to low inflation. One way they can do this is to take monetary policy out of their own hands and place it under the control of an independent agency—an autonomous central bank.11 Central bankers are thought to be inherently more conservative than politicians and thus less willing to sacrifice low inflation for short-term real economic gains (Wooley 1984; Goodman 1992, 7). And because they do not have to respond to voters’ interests, they are also said to evaluate policies in a more technocratic manner than do officeholders (Cukierman 1992, 351–59). Finally, because they are not responsible for fiscal policy, central bankers have little incentive to collect the seignorage (“inflation tax”) derived from deficit spending (Grilli, Masciandaro, and Tabellini 1991, 365–66). As independent central banks acquire a reputation for anti-inflationary policies over time, the

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9. This can be done for a variety of reasons: to stimulate employment (as described previously), to finance the deficit (through the seignorage revenues derived from increasing the monetary base), or to avoid excessive deficits in the balance of payments (by devaluing the currency to increase exports). For a more detailed discussion of all three motives and their specific relationship to the “time inconsistency” problem noted subsequently, see Cukierman 1992, chaps. 2–5.

10. In the argot of the credibility literature, this dilemma is commonly referred to as the “time inconsistency” problem. This refers to those situations where the best plan made for some future period by an agent is no longer optimal when that period arrives. The time inconsistency problem results because monetary policy is chosen after expectations and actions based on those expectations by private actors have already been determined. Had the government credibly precommitted to an inflation rate of zero, nominal wage contracts would have been settled on the assumption that inflation would be zero, and actual inflation would thus be zero as well. Instead, monetary policy is tinged by an inflationary bias.

11. This is not the only policy alternative available. Other options entail legislating some form of monetary policy rule such as a $k$ percent monetary growth rule, establishing a currency board, developing incentive contracts for central bankers, or tying policy decisions to some external commitment such as the gold standard or a fixed exchange rate regime.
public’s expectations should eventually converge to this equilibrium, thereby eliminating monetary policy’s inflationary bias.

By delegating monetary policy to a conservative central banker who places greater weight on price stability than does the median voter, politicians can thus make good on their promise not to engage in inflationary opportunism in the future. The central bank thus acts as a benevolent social planner, and society, for its part, is left uniformly better off (Rogoff 1985). It is true that in the original Rogoff model, the low inflation yielded by central bank independence is thought to come at the cost of greater output variability. This is because an absolute commitment on the part of the central banker to refrain from using monetary policy to boost output also sacrifices its use as a stabilization device (Lohmann 1992). Thus, for example, in the wake of an exogenous productivity shock, society can be expected to incur large output losses. But because the credibility gains from low inflation are thought to offset losses arising from such output variance, on net, society is still thought to benefit.12

Building as they do on early models of opportunistic business cycles (Nordhaus 1975; McRae 1977), many models of central bank reform assumed that all politicians have the same incentives to inflate. The logic behind such models is that preelectoral inflation is merely a tool for generating votes and that politicians can be expected to return to a norm of price stability once they have been elected. Over time, this literature has also expanded to incorporate the notion that politicians of different ideological stripes may differ in the relative weight they place on inflation versus real outcomes. While parties of the left are thought to emphasize low unemployment, government intervention, and the redistribution of income to favor lower socioeconomic groups, right-leaning parties pursue low inflation, a greater role for the market, and distributive policies favorable to business and higher socioeconomic strata (Hibbs 1977).

Early variants of these partisan theories of political economy were discredited for their assumption of a permanently exploitable Phillips curve, which implied that governments could indefinitely skew macroeconomic outcomes to favor their core constituencies. These earlier theories failed to recognize that if economic agents were perfectly informed about the objectives of different parties, they would eventually adjust to changes by bringing wage contracts—and hence employment—in line with existing inflation. But while the notion of a long-run Phillips curve is no longer theoretically

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12. In order to correct for this loss of flexibility, Lohmann (1992) introduces the possibility that the government agent can override the central banker at a positive but finite cost. For an argument suggesting that the inflation/output variance trade-off will only occur above a certain level of independence, see Jordan 1997a.
viable, most economists do believe that there is a short-run trade-off between inflation and unemployment (Bernanke and Blinder 1992; Sims 1992). And a fairly sophisticated body of theoretical work has emerged that demonstrates how politicians can take advantage of this short-run Phillips curve in order to favor their preferred set of economic outcomes. More specifically, in the wake of the uncertainty surrounding electoral outcomes, politicians are afforded a brief window in which they can either stimulate the economy or generate a recession before economic agents adjust. And the greater the policy distance between two competing parties, the more pronounced the effect on output is likely to be (Alesina 1988; Alesina and Sachs 1988; Alesina and Rosenthal 1995).

Rational partisan models of political economy have recently been extended to account for central bank reform. In such models, politicians of different partisan hues engage in a preelectoral bargain in which they agree to forego their partisan objectives and install a more independent central bank. Not only is such an agreement said to reduce inflation variance (Alesina 1988), it is also thought to eliminate the politically induced output variability stemming from short-term electoral cycles (Alesina and Gatti 1995).

In short, whether one assumes politicians to be strictly office seeking or intent on delivering benefits to targeted constituencies, the credibility literature views an independent central bank as a uniformly beneficial outcome. Unable to credibly commit to low inflation on their own, politicians instead delegate authority over monetary policy to an independent agency that can do this for them. And because this commitment yields credibility, central bank independence is thought to yield anti-inflation policies at—on average—no real costs.

This “efficiency” view of central bank autonomy has been bolstered in recent years by numerous empirical studies revealing an inverse relationship between central bank independence and inflation (cf. Bade and Parkin 1980; Alesina 1988; Cukierman 1992; Alesina and Summers 1993), as well as autonomy’s ability to reduce preelectoral manipulation of the economy (Beck 1982; Clark et al. 1998). Without extensive empirical work to the contrary, many economists have come to conclude glibly that “having an independent central bank autonomy is like having a free lunch; there are benefits but no...
apparent costs in terms of macroeconomic performance” (Grilli, Mascian-daro, and Tabellini 1991, 375).

The Redistributive Challenge

The bottom line according to the credibility literature is that politicians create autonomous central banks in order to solve a commitment problem, with the result that society is left unambiguously better off. The validity of this perspective hinges critically on the assumption that central bank reform is necessarily cost free. Recent work in economics and political science challenges this assumption, opening the door for a more contentious—and in my view, more compelling—interpretation of central bank reform.

There are two reasons to question the validity of the credibility hypothesis as the sole explanation for central bank reform. The first is theoretical. The credibility literature assumes that all politicians have the same incentives to undertake central bank reform. This is true even in some of the more recent work that explicitly incorporates partisan disagreements over the ideal mix of inflation and unemployment. And yet, it is not immediately obvious why one should necessarily assume such symmetry on the part of political actors. The implicit assumption behind the rational partisan models is that the long-term credibility benefits that flow from central bank independence should outweigh any short-term benefits to be derived from manipulating the Phillips curve. But why should this necessarily be the case, particularly for parties on the left?

After all, while inflationary variance is surely costly to any sitting government, as these models suggest, one must evaluate this cost against the potential political gains to be had from being able to engineer these short-term postelectoral booms. As long as voters are willing to reward left-wing political parties for such behavior, it is not at all clear why these parties would want to sign on to an institutional arrangement that removes this resource from their political arsenal. And even if we were to accept the additional claim that left-leaning political parties value an independent central bank’s ability to reduce politically induced output variability, these models say nothing about the Rogoff-style output variability that is due to unforeseen productivity shocks. Given differing weights on nominal and real outcomes, there is no question that the greater real variance induced by such economic shocks should be more painful to the left than to the right. The overall effect of central bank independence on output stabilization is thus at best ambiguous—if not out-and-out costly—for the parties of the left.

In addition to this theoretical rationale, there is a second, more empiri-
cal reason to suspect that not all political actors are likely to share the same enthusiasm about central bank reform: the noninflationary consequences of central bank independence are still remarkably unclear (Pollard 1994; Eijffinger and De Haan 1996). Despite its reputation as a “free lunch,” we still know very little about autonomy’s long-term impact on growth, unemployment, and budget deficits. And what we do know suggests that central bank independence may actually prove costly for more left-leaning actors, at least under certain circumstances.

Of these, growth is the most benign case. Most empirical studies have found that a higher degree of central bank independence is generally not associated with greater variation of economic growth, thus confirming the view that independent central banks are less likely to engage in stop-and-go cycles (Alesina and Summers 1993; Eijffinger and Schaling 1993; Walsh 1994). But while it may be tempting to further assume that—because of its related effects on inflation—Independence should also lead to higher long-term growth rates, the empirical evidence seems to show that it is not associated with either higher costs or greater benefits in terms of economic growth (cf. Grilli, Masciandaro, and Tabellini 1991; De Haan and Sturm 1992; Alesina and Summers 1993).14 Although far from an indictment of autonomy, the lack of a significant positive relationship between central bank independence and growth is likely to leave most left-leaning politicians indifferent, rendering their views of autonomy much more contingent on how it impinges upon other important macroeconomic variables.

In this regard, a far more compelling case about autonomy’s potential real costs can be made in the realm of unemployment. While Alesina and Summers (1993) have argued that central bank independence has no adverse unemployment effects, their evidence is statistically quite rudimentary, based solely on correlations among a handful of industrial nations. More sophisticated empirical studies reveal that even where central bank autonomy has been shown to have a positive relationship with low unemployment over time, this has not been due exclusively to the independence of the central bank. It instead hinges on the interaction of central bank independence with other variables such as government partisanship (Way 2000), the sectoral employment structure (Franzese 1994), and/or the structure of coordinated wage bargaining in a given country (cf. Hall 1994; Hall and Franzese 1998; Iversen 1998). While the theoretical specifications and empirical conclusions

14. There are two exceptions. De Long and Summers (1992) find evidence in favor of a positive relationship between central bank autonomy and growth, while Cukierman et al. (1993) come to the same conclusion for LDCs when the relationship is measured with behavioral indicators.
differ across these models, all concur that central bank independence does not necessarily come free of adverse employment effects—a result that cannot be overlooked in the context of redistributive struggles over the economy.

If left-leaning governments have reason to be suspicious of central bank autonomy with respect to its impact on growth and unemployment, this is all the more true of budget deficits. For to the extent that an independent central bank can credibly threaten to make issuing government debt more costly (Franzese 1996) this would seem reason alone to bias left-leaning governments against autonomy. While it is difficult to pull anything systematic out of the empirical research to date, it does seem to be the case that while an independent central bank cannot prevent a government from creating a budget deficit, it may have some restraining influence on fiscal policy (Eijffinger and De Haan 1996, 40). At the very least, its ambiguity on this front is likely to engender caution.15

Finally, in addition to the uncertainty surrounding the long-term real effects of central bank reform, there is also the possibility that increased autonomy may actually yield short-term output losses. This is at least the thrust of a growing body of literature on the so-called sacrifice ratio, which suggests that changes in the degree of central bank independence affect the Phillips curve in a manner that exacerbates the short-term trade-off between output and inflation (Ball, Mankiw, and Romer 1988; Ball 1994; Walsh 1995a).16 Recent work on the European Community (EC) has confirmed that those EC countries with greater central bank independence have also experienced higher short-run costs of disinflation (Debelle and Fischer 1994; Walsh 1995a; Jordan 1997b). This distinction between the short run and the long run is not trivial, since while most economic arguments are about the long run, politics is about the short run. Knowing that central bank autonomy brings with it the promise of output penalties, left-leaning politicians may not wish to endure these short-term political costs of an independent central bank.

15. For example, Parkin (1987) and Masciandaro and Tabellini (1988) find some tentative correlational evidence for a negative relationship between central bank autonomy and the level of budget deficits in the advanced industrial countries, but Grilli, Masciandaro, and Tabellini (1991) find no such relationship when they include political variables in their regression equation. Pollard (1994) finds no significant relationship between independence and the level of government deficits but does find a significant negative relationship between independence and variance of budget deficits as a percentage of GDP.

16. The sacrifice ratio can be defined as output loss because of inflation reduction. It is generally thought to be affected by the degree of wage rigidity in the economy (higher levels of wage rigidity lead to a slower adjustment of wages, thus raising the costs of disinflation) and by the average inflation rate (at lower levels of inflation, less frequent price and wage adjustments induce a higher output loss per percentage point disinflation).
In light of these theoretical and empirical considerations, we see how central bank autonomy shifts from being an issue of valence to one of positions (Butler and Stokes 1974). Rather than being something that all actors welcome equally, central bank autonomy might instead be perceived as benefiting those actors who prefer low inflation and disadvantaging those who favor more political control of the economy. Once we accept this more differentiated view of politicians’ inflationary motives, our expectations about the incentives to undertake central bank reform shift accordingly. Instead of reflecting some sort of preelectoral compromise between parties with divergent ideologies—as Alesina and Gatti (1995) suggest—central bank autonomy may instead serve as a means through which incumbent politicians with conservative policy preferences seek to limit the policy choices of future governments.17

Central Bank Reform Reconsidered: The Logic of Imposition

The notion that the tenure security of officeholders might affect their propensity to undertake central bank reform is not new to the literature on central bank autonomy. Goodman (1991, 1992), for example, argues that the more incumbent leaders fear that their grip on government is vulnerable, the greater the incentive to increase the independence of the central bank and thereby institutionalize a bias toward monetary restriction in the future. Cukierman (1994) has also argued that incumbent politicians may seek to impose a higher level of central bank independence as a means of limiting the opposition’s ability to spend on public goods that the incumbent does not prioritize. The implication behind both of these arguments, as with my own, is that politicians are more likely to cede control over monetary policy when their time in office is limited.18

17. Alesina and Tabellini (1990) make this sort of argument to explain how a conflict between opposing parties over spending priorities induces incumbents to use public debt as a device for restricting the composition of future government spending, while Persson and Svensson (1989) develop a similar model to explain the level of such spending. These so-called replacement risk models (Franzese 1996) analyze the case where more conservative governments engage in a behavior that is otherwise anathema to their policy goals—that is, inflation—in order to force successor governments to bring debt back to the socially optimal level. In contrast, I suggest that conservative incumbents will use a policy instrument that is otherwise consistent with their policy preferences to affect the policy choices of future rulers. See the subsequent discussion.

18. Both Posen (1993) and De Haan and Van’t Hag (1995) reject the importance of government instability on central bank independence in empirical tests on the advanced industrial countries. But since they do not examine the interactive effects between partisanship and government turnover, it is unclear how their results impinge upon the present argument.
Where I part company with these authors is in their assumption that such an argument should hold regardless of the macroeconomic preferences of the party in power.\(^{19}\) Such a claim implies that facing an imminent loss of power, politicians attach the same price to being denied such flexibility through an autonomous central bank. But precisely for the reasons outlined earlier, parties of different ideological stripes should not value the trade-off between rules versus discretion equally. Rather, governments can be expected to differ systematically in their relative willingness to incur the costs of creating an autonomous central bank.\(^ {20}\)

Consider the case of right-leaning parties. In normal times, it seems unlikely that they would need to create an autonomous bank in order to secure their preferred policies. After all, they already share a natural bias toward monetary conservatism. But once we add political turnover to the equation, their decision-making calculus should change. Aware of the left’s ability to generate short-term expansionary cycles, right-leaning politicians might begin to worry about the prospect of such inflationary bouts in the future. Fearing the use of monetary policy for political ends, they are likely to view central bank autonomy as a welcome opportunity to safeguard a set of outcomes associated with macroeconomic stability.\(^ {21}\)

In contrast, parties of the left facing the same threat of “replacement risk” should have less incentive to insulate the central bank or perhaps no incentive at all. They are instead likely to view autonomy as a liability to the extent that it is likely to augment the costs of generating short-term expansionary cycles and in that it may also have other adverse long-term real effects on the economy. The best they can do is to try to maintain perfect discretion and hope that left-leaning governments are elected to office from time to time.\(^ {22}\)

\(^{19}\) It is true that Goodman (1991, 1992) also emphasizes the importance of a conservative societal coalition in explaining the likelihood of central bank reform. But he fails to link the presence of such interests to the policy preferences of incumbent politicians.

\(^{20}\) For a similar line of reasoning, see Zielinsky 1995. Clark (1994a) also notes the importance of both party competition and incumbent party preferences for the creation of an autonomous central bank. But since he fails to specify whether or not the politicians in his model are Downsian vote maximizers or are differentiated along more traditional left/right lines, it is difficult to interpret his results. An interesting adaptation of this sort of approach that emphasizes how informational asymmetries between parties of divergent ideological stripes may condition central bank reform can be found in Bernhard 1998.

\(^{21}\) Franzese (1999, 32–33) has speculated that a similar fear may have driven the recent spate of central bank reforms in Europe by governments that do not otherwise seem to suffer from a credibility shortage.

\(^{22}\) To be sure, one might argue that precisely because of their tendency to privilege electoral and constituency considerations over low inflation, left-leaning governments are most in need of the credibility boost supplied by an autonomous central bank (Simmons 1996). I address this point in the next chapter.
Viewing the situation from this more political perspective, we can at least cast doubt on the credibility literature’s claim that governments choose central bank autonomy exclusively to tie their own hands. Rather, it seems at least plausible that they may also seek to tie the hands of their successors. In keeping with Moe (1990a, 1990b), then, right-leaning governments might use the power of office in order to impose their inflationary preferences on their successors. And future governments would have no choice but to reluctantly accept this set of economic outcomes.  

Central Bank Autonomy: The Developing Countries

Old Wine, New Bottles: Credibility Arguments in the Developing World

If the literature on macropolitical economy lends plausibility to this more conflictual view of central banks in the advanced industrial democracies, a similar argument should also hold true for the developing world. Unfortunately, the redistributive perspective has yet to take hold. While there has been comparatively little research on the politics of central bank reform in developing countries to date, what does exist largely echoes the themes of the literature in the developed world.

One twist is that there is more emphasis given to the international environment (Siklos 1995; Maxfield 1997). Maxfield (1997), for example, argues that developing countries are likely to undergo central bank reform in order to shore up credibility with foreign creditors and investors. According to this logic, the amount of independence afforded the central bank should vary with governments’ perceptions of their need for international finance. Maxfield thus offers a slight modification to the conventional credibility literature in that the economic audience to whom governments signal is no longer domestic but international. When all is said and done, however, the basic intuition is exactly the same: governments choose central bank autonomy to signal a credible commitment to low inflation.

The influence of the credibility literature has been equally strong among those arguments privileging domestic variables. Maxfield (1997, 46–47) argues that where national leaders are insecure in office, they have incentives to wrest control from the central bank in order to buy political support, even when this may militate against their ordinary creditworthiness objectives. And regime change is only thought to exacerbate this dynamic by providing

23. Chapter 3 explains why such reforms should be difficult to undo.
incentives for elites to stay in power as long as possible by manipulating the central bank (Cukierman 1992, 445–47; De Haan and Siermann 1994; Cukierman and Webb 1995). Whether the relevant political event is an election or a transition, then, the conventional wisdom thus suggests that central bank autonomy should be less likely to occur in the prior period. Like many of their counterparts in the literature on the advanced industrial countries, such arguments are predicated on the notion that all politicians have the same incentives to inflate when confronted with the prospect of political turnover.

Despite efforts to tailor explanations for central bank reform to the distinctive contours of the developing world, the familiar adage “old wine, new bottles” seems all too apt. The principal motivating force is still one of signaling a commitment to low inflation, albeit to an international audience. And when pressed to explain exactly how domestic factors come to bear on central bank reform, authors simply revert to the opportunistic business cycle logic characteristic of much of the credibility literature.

An Alternative Approach: Distributional Conflicts in the Developing World

There are several reasons to find this credibility-based reasoning suspect in a developing country context. Let us examine first the empirical evidence. It is difficult to argue with the fact that developing countries face severe external constraints that make them vulnerable to the whims of the international economy. In the last two decades, the third world has witnessed a debt crisis of massive proportions and an unprecedented movement of capital and goods across borders. If LDC governments are to attract foreign capital and reap the rewards of a liberalized trade regime, they can ill afford to ignore demands by powerful economic actors for institutional guarantees of price stability (Dornbusch and Marcus 1991; Stallings 1992). Maxfield’s point is thus well taken: credibility arguments are persuasive when applied to the LDCs.

But if these international economic pressures were the sole determinant of central bank autonomy, then virtually all developing countries would have autonomous central banks.24 When the empirical data are examined, how-

24. This assumes that these pressures have been more or less constant across countries. This is clearly not always the case, and we can expect that some countries—such as those that have experienced bouts of hyperinflation—have been more vulnerable to outside pressures than others. Such exceptions notwithstanding, it seems reasonable to posit that at least since the onset of the debt crisis in 1982, international economic forces have played an increasingly strong and more or less uniform role in encouraging pro-market economic reforms in developing countries.
ever, it is clear that they do not. As is the case with the advanced industrial countries, we observe instead tremendous variation. As table 2.1 shows, this variation is readily apparent whether one chooses to employ formal/legal or behavioral measures of central bank independence.25

Consider the case of four of the most commonly studied Latin American countries—Brazil, Chile, Mexico, and Peru—all of which faced strong international economic pressures at various times since the early 1980s. While both Chile and Mexico increased the autonomy of their central banks in the last decade, Brazil and Peru continue to have highly dependent central banks. Nor does Maxfield’s (1997, 50–70) cross-national empirical chapter provide convincing support that international credibility motives are the sole factor driving what variation does exist. The treatment of data is highly sketchy, and there is no evidence for a causal link between the extent of international integration and the move toward increased autonomy across continents. At best, the chapter serves to confirm the fact that central bank reforms in LDCs have increased considerably in recent years, concurrent with an international economic environment in which developing countries are in greater need of creditworthiness. While an important contribution, Maxfield’s work should serve as the starting point—and not the denouement—for further research on this subject.26

In short, while international credibility is surely part of the story in explaining the recent trend toward increased autonomy in LDCs, the empirical data do not bear out the thesis that international credibility alone can explain variation across countries. What the evidence instead suggests is that some developing country governments must find it preferable to maintain political control over the central bank. A second reason to question the conventional credibility-based wisdom, then, is that it is also guilty of the efficiency logic noted earlier. Whether the context is a fully established democracy or a fledgling neo-democracy, it is questionable that central bank independence will have the same appeal for all politicians.27

25. Formal measures of independence involve the legal relationship between central bank decision makers and the government, while behavioral indicators attempt to capture the less visible aspects of the central bank’s actual behavior. See chapter 3.

26. The same can be said for arguments that might attribute central bank reform in developing countries to the force of international ideas. According to this line of reasoning, powerful international institutions—such as the World Bank and IMF—foster and fund the spread of market-oriented ideas (such as central bank autonomy) to decision leaders in developing countries (Sikkink 1991; Dominguez 1996). Like the international credibility argument, however, an international ideas argument also fails to account for the cross-national variation we observe. International support for a conservative monetary regime dates back to well before 1980 (Drake 1990) and has only increased subsequently. And yet some countries have changed the legal status of their central banks while others have not.

27. Clark and Maxfield (1996) have developed an international signaling model that
<table>
<thead>
<tr>
<th>Country</th>
<th>Behavioral</th>
<th>Formal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>0.8</td>
<td>0.55</td>
</tr>
<tr>
<td>Egypt</td>
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<td>0.43</td>
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<tr>
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</tr>
<tr>
<td>Peru</td>
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<tr>
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<tr>
<td>Argentina</td>
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<td>0.40</td>
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<tr>
<td>Israel</td>
<td>0.8</td>
<td>0.39</td>
</tr>
<tr>
<td>Uganda</td>
<td>0.8</td>
<td>0.38</td>
</tr>
<tr>
<td>Nigeria</td>
<td>0.9</td>
<td>0.37</td>
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<tr>
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<td>0.36</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.7</td>
<td>0.34</td>
</tr>
<tr>
<td>India</td>
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</tr>
<tr>
<td>Botswana</td>
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<tr>
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</tr>
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<td>0.10</td>
</tr>
</tbody>
</table>


Note: Formal measures are based on the index presented in Cukierman 1992. Behavioral measures are based on central bank governor turnover rates. Note that in order to facilitate comparison between the two measures, the behavioral measures have been transformed so that higher numbers indicate greater central bank independence.
To be sure, the redistributive game surrounding autonomy should look somewhat different in the developing world. For starters, the central inflationary motive is likely to shift from increasing employment to generating revenue so as to redistribute wealth and/or stimulate demand (Cukierman 1992, 47–82). Because LDC governments lack well-functioning capital markets and/or an effective system of taxation, they tend to rely more heavily on the central bank’s ability to print money as their primary source of revenue. By printing money, the central bank is able to extract real purchasing power from the public (seignorage). And the way the government collects this hidden source of revenue is through deficit financing via the central bank, which constitutes the main source of inflation in the developing world (Fry 1997). At a first cut, then, the political struggle in LDCs is likely to center around who wins and loses when the central bank is no longer able to freely monetize government debts.

But it is also the case that central banks have traditionally served as a sort of “development bank” in the third world. Through the use of targeted credits, interest rate ceilings, and other forms of financial repression, central banks have historically been used to prop up certain firms, sectors, and industries favored by the state (Haggard and Lee 1993). The creation of an autonomous central bank typically does away with such practices. On the one hand, it allows interest rates to be freely determined by the market (Haggard and Maxfield 1993, 305). On the other hand, it also puts an end to the deficit spending that has often financed such subsidies, whether directly (through budgetary transfers) or indirectly (through the rediscounting operations of the central bank in which seignorage gains are passed on to favored borrowers through the commercial banking system) (Haggard and Maxfield 1993, 315). A second dimension to the political struggle in LDCs is thus likely to take shape around the financial liberalization that tends to accompany autonomy and around who stands to win or lose when the central bank terminates its role as a vehicle of preferential credit.

Once we account for these adjustments, however, there is no reason to think that the potential for conflict over central bank autonomy should be any different in the developing world. And once we incorporate this redistributive dimension into the study of central bank reform in LDCs, we can also consider the plausibility of the sorts of insulation arguments advanced earlier in this chapter as an explanation for its occurrence. At the very least, recognizes that states may differ in the relative weight they attach to price stability (and, as such, the desirability of having an independent central bank). But the overall thrust of the paper is still one of trying to determine the conditions under which signaling to international investors by either type of state is likely to result in a foreign capital inflow, rather than the prior—and arguably more fundamental—question of why some LDC states are willing to forego central bank autonomy entirely.
the “tying successor hands” logic ought to be relevant in one political context of considerable importance in the developing world: democracies in transition from authoritarian rule.

Returning to the delegation literature with which we began this chapter, the key issue on the table is turnover of power. Normally, we associate turnover with democratic societies, where the existence of regularly scheduled elections provides the mechanism for the turnover of power between opposing forces. We do not think much (by definition) about turnover in the context of authoritarian societies. But there is a moment in authoritarian rule where turnover does become relevant, and that moment is the transition to a more democratic polity. For it is at this point when authoritarians need to begin to think about the possibility of change and what this change will mean for how their preferred policies are likely to fare in the future.

For a variety of reasons enumerated in the following chapter, I will argue that democratization brings with it the prospect of a more interventionist economic future. To the extent that this proves threatening to the interests of certain authoritarian elites, the exaggerated nature of turnover entailed in a regime change ought to increase autonomy’s value as a strategic instrument. Rather than focusing on the short-term support they can buy through the manipulation of the economy—as the existing literature suggests—those elites who fear losing power permanently might well seek to tighten their control over monetary policy. In this way, central bank autonomy may serve as a means of insuring against the threat and uncertainty of democracy itself.

28. Lohmann (1997) makes an analogous argument to suggest why Japan was likely to create an autonomous central bank post-1993, after the end of nearly forty years of single-party rule in Japan.

29. As noted earlier, what little empirical work has been carried out on the relationship between political instability and central bank independence in the developing world would seem to lend provisional support to the opposite conclusion: that greater political instability leads to less independence on average (e.g., Cukierman 1992; De Haan and Siermann 1994; Cukierman and Webb 1995). But this work is far from conclusive, relying as it does on different groups of countries, divergent measures of central bank independence, and various proxies for political instability. And, more important, none of these works controls for the policy preferences of the regime in power.