

CHAPTER 5

Explaining Divergence in the Policy Mix

In the preceding chapters, I have shown that monetary policy divergence, linked to the phenomenon of fiscal policy divergence, best describes the post-Bretton Woods era. A second research question must now be addressed. How can we explain these related patterns of policy divergence among the OECD countries after 1973? Restated, using the language of the Mundell-Fleming framework, what factors led many national governments to choose domestic policy autonomy, accepting the loss of exchange rate stability? Similarly, what factors led other governments to choose exchange rate stability, sacrificing the benefits of domestic policy autonomy?

These questions are important and have not been satisfactorily answered. Pauly (1995, 386) once wrote: “under what conditions do powerful and potentially dominant states voluntarily relinquish policy autonomy? This remains a key question for future research in this area.” Cohen (1996, 283–84) similarly stated: “The interesting question . . . is not whether financial globalization imposes a constraint on sovereign states; it most clearly does. Rather, we should now be asking how the discipline works and under what conditions.” He continued: “The number of conditions that might influence the preferred trade-off between policy autonomy and exchange rate stability is quite large. What is needed is more careful and applied investigation of how each works in today’s financially integrated world” (285).

To begin this investigation, it is useful to take one step back and briefly review. Chapter 4 demonstrated how OECD governments have moved their fiscal and monetary policy instruments in opposite directions in the post-Bretton Woods era. Consequently, these governments have moved onto the policy mix continuum defined by more government spending with a higher interest rate at one end and less government spending with a lower interest rate at the other end. Chapter 4 also showed how domestic policy autonomy in the

post-Bretton Woods era has been defined by movement toward the first end: more government spending led to higher national interest rates and larger interest rate differentials, resulting in greater exchange rate variability (see fig. 15). Conversely, governments who desired external policy convergence for exchange rate stability moved toward the other end: less government spending permitted a lower national interest rate, which, in turn, facilitated a smaller interest rate differential and reduced external currency variability.

Understanding a government's preferred trade-off between domestic policy autonomy and exchange rate stability thus requires an explanation of its policy mix choice. This chapter will proceed on that basis. Although the number of conditions that might influence the policy mix choice and, therefore, the trade-off between domestic policy autonomy and external currency stability is certainly large, the analysis here will focus primarily on the role of government partisanship.

I focus on government partisanship because it is a factor posited as relatively unimportant by different convergence theories. As discussed in chapter 2, the first wave of macroeconomic policy convergence theory argued that international capital mobility and, more broadly, economic globalization constrained partisan economic policy differences in the post-Bretton Woods era (see, e.g., Garrett and Lange 1991; Kurzer 1993). While Garrett (1995, 1998b) and other scholars later demonstrated growing fiscal policy divergence with greater capital and trade openness, their results have recently been challenged by a new partisan convergence thesis offered by Clark (2003). According to Clark's argument, it is not economic globalization that constrains partisan policy differences; instead, partisan economic policy convergence simply emerges from democratic capitalism (hence, Clark titled his 2003 book *Capitalism, Not Globalism*).

Thus, the ball has been solidly hit back to the partisan divergence side of the court. For scholars still positing partisan economic policy differences in the post-Bretton Woods era, it has now become especially important to establish more precisely why and where one should expect to see them. It is also important to establish where partisan policy divergence would not be expected to occur in the post-Bretton Woods era. Partisan differences in terms of main economic policy instruments do not necessarily imply partisan divergence in terms of dominant economic policy goals, just as partisan convergence in terms of policy goals does not force partisan convergence with regard to policy instruments.

While I focus on the role of government partisanship in explaining economic policy divergence, I also consider the role of two other factors: political

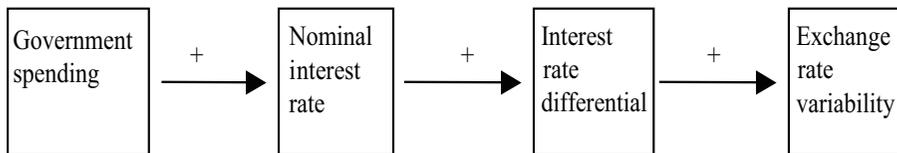


Fig. 15. Linking Fiscal Policy, Monetary Policy, and Exchange Rate Stability

power-sharing and central bank independence. This chapter thus proceeds in five sections. The first three sections examine the domestic political factors (government partisanship, political power-sharing, and central bank independence) in order, making a series of hypotheses. The fourth section tests the hypotheses about how these factors influence government spending, national interest rates, the extent of domestic monetary autonomy, and the stability of the national currency's value. The strongest statistical results emerge for government partisanship. Thus, the fifth section discusses how these results lead us toward a new and more nuanced theory of partisan economic policy-making in the post-Bretton Woods era.

I. Government Partisanship

As presented in chapter 4, the policy mix choice was motivated solely by the need to satisfy simultaneously the two domestic macroeconomic goals of economic growth and low inflation. But partisan governments have other economic policy objectives to varying degrees, including the provision of public goods, income redistribution, and exchange rate stability. The strategic game modeled in figure 11 in chapter 4 suggested that governments would be largely indifferent—at least in terms of economic growth and low inflation policy outcomes—in choosing between the policy mix of more government spending with a higher nominal interest rate, on the one hand, and the alternative mix of less government spending with a lower nominal interest rate. However, partisan governments are likely not so indifferent in actual practice, because they must try to meet other economic priorities using one of these two fiscal and monetary combinations. In general, I expect that leftist governments have been more likely to choose the policy mix associated with domestic policy autonomy, while rightist governments have moved toward the alternative for external policy convergence with exchange rate stability.

This hypothesis begins with the understanding that monetary and fiscal expansion do not serve as perfect substitutes. While both may promote aggre-

gate economic growth, fiscal expansion is better suited than monetary expansion for income redistribution and public goods provision. With regard to income redistribution, this is true because monetary adjustments tend to affect the economy as a whole (see Gowa 1988); thus, targeting particular societal groups may be difficult to achieve with a cut in interest rates. While cheaper money may eventually produce more jobs for and raise the wages of lower-income groups, the initial impact of a monetary expansion is likely to benefit higher-income groups, those qualifying most easily to borrow money for their business ventures. Indeed, monetary expansion may even increase income inequality in the short run, before its benefits trickle down to lower-income groups.

However, fiscal expansion is well suited for income redistribution, as it can be targeted to benefit lower-income societal groups (see Hallerberg 2002, 782). Fiscal expansion may also be necessary for increasing public goods. Additional government spending can fund better public schools, improvements in the national infrastructure, and greater research and development for public purposes. Conversely, while monetary expansion facilitates private investment, most of the goods created through private investment are unlikely ever to become available on a purely public basis. With this understanding in mind, we can now consider the fiscal and monetary policy pressures that various societal interest groups apply on different political parties.

Interest Group Pressures on Political Parties

Scholars studying partisan politics in the advanced industrial economies have long been comfortable in identifying leftist parties as agents for labor interests in society (see, e.g., Garrett 1995) and identifying rightist parties as agents for capital interests, following cleavages along factors of production (or classes). While some scholars have suggested a decline in class-based partisan politics, various studies presented by Evans (1999) demonstrate how socioeconomic position remains a significant predictor of party support in the advanced industrial democracies. With this understanding, what might be labor's interest with regard to the policy mix?

As it is more fixed in the domestic economy than is mobile capital,¹ relatively immobile labor can be expected to have stronger preferences for the local

1. On this point, see Schulze and Ursprung 1999, 298. Even in the European Union, where the movement of labor across national borders is permitted, labor mobility tends to be quite low, due especially to European cultural and linguistic differences. Most non-European states maintain controls on labor mobility, as do EU states with regard to non-EU labor.

public goods provided through greater government spending. As labor also stands to benefit from income redistribution, it can be expected to favor fiscal, over monetary, expansion. If more government spending becomes the dedicated instrument for economic growth to achieve greater public goods and income redistribution, monetary policy must be used for inflation control, resulting in higher nominal interest rates. Interestingly, high interest rates may benefit labor beyond simple domestic price stability. When interest rates are high, acquiring capital becomes more costly, and costly capital may lead certain businesses to substitute cheaper labor for the capital inputs to their production, thus creating jobs in the local economy.²

As discussed in chapter 4, the obvious cost of this policy mix is exchange rate instability, as national interest rates move farther away from the low world interest rate (i.e., domestic monetary autonomy as defined by a larger interest rate differential). On this point, however, it is interesting to note that currency variability may provide some unexpected benefits to labor. If exchange rate instability raises the cost of moving capital out of the domestic economy due to increased external investment risk and the expense of purchasing forward-exchange contracts to hedge against this risk, capital may be more likely to remain in the local economy, helping to provide jobs and income for labor.³

Perhaps not surprisingly, capital interests allied with the political right can be expected to favor the alternative policy mix of less government spending with a lower nominal interest rate for greater exchange rate stability. Since it is less tied to the domestic economy than immobile labor, mobile capital should be correspondingly less interested in local public goods, especially if taxes must be raised to pay for these public goods. Similarly, many capital holders can be expected to oppose increased government spending for the purposes of income redistribution toward labor. Thus, it is not hard to see how decreased government spending may be capital's preferred means of maintaining low inflation. Of course, capital is also interested in economic growth, but monetary expansion is likely to be its preferred policy instrument, especially as lower interest rates facilitate private investment opportunities. As the national interest rate falls, moving closer to the low world interest rate (i.e., external monetary convergence), capital will be further advantaged by reduced external currency vari-

2. On this point, see *Economist* 2004c.

3. This logic suggests how currency volatility may function as a de facto capital control, discouraging financial capital from exiting the domestic economy in search of potentially higher external returns, which might exist absent such costly currency volatility. Scholars have already demonstrated that leftist parties embraced de jure capital controls more willingly than did rightist parties (see Grilli and Milesi-Ferretti 1995; Quinn and Inclan 1997).

ability. As mentioned earlier, exchange rate instability potentially adds risk to making external investments. Of course, capital holders might purchase forward-exchange contracts to hedge against such currency risk, but these contracts are costly and erode capital's returns on its external investments.

Having just argued for partisan fiscal and monetary policy differences using a factor- and class-based Heckscher-Ohlin model, I can also make a similar hypothesis about partisan divergence using the Ricardo-Viner model, which presents a sectoral framework. There has been a tendency in the political economy literature to treat the Heckscher-Ohlin and the Ricardo-Viner models as substitutes (see, e.g., Alt et al. 1996). But as Fordham and McKeown (2003, 522) persuasively argued, these two models may be quite complementary: "The presence of sectoral effects is not inconsistent with the presence of factorial effects. The standard neoclassical theory holds that countries export goods that intensively employ their abundant factors. If so, in the United States [for example] the geographic distribution of skilled (unskilled) labor would be correlated with that of exporting (import-competing) sectors. If exporters employed no unskilled labor, and import-competing firms employed no skilled labor, the correlation would be perfect."⁴

On this basis, it is not at all surprising to observe sectoral-partisan affiliations. As Esping-Andersen (1999, 311) recently noted, traditional class-political cleavages "are being overlaid by new kinds of 'class' politics," with leftist parties drawing their support from the sheltered public sector and the middle-class white-collar service sector. Similarly, rightist parties in the advanced industrial democracies have relatively tight political links to banks and financial service firms, as well as to the large multinational corporations who conduct the bulk of international trade and foreign direct investment (see Silk and Vogel 1977; Jacobs 1999).

These sectoral-partisan affiliations have been particularly pronounced in the United States since the late 1970s, although they are certainly not limited to this political economy, as the case studies in chapter 6 will demonstrate. Dissatisfied with the Carter administration's autonomous policy stance, American banking and multinational firms withdrew what little support they had provided to the Democrats, helping the Republicans to regain the presidency in 1980 (see Ferguson and Rogers 1986, 113). Indeed, U.S. big business contributed significantly more to Republicans than to Democrats during the

4. On this point, one identifies such industries as steel and textiles in the developed world as part of the import-competing sector, rather than as part of the international exporting sector, because their heavy manual labor inputs render them almost noncompetitive in international markets dominated by lower-cost producers from the developing world.

1979–80 election cycle (Ryan, Swanson, and Buchholz 1987, 132). On this point, Himmelstein (1990, 129) wrote how American big business “moved to the right in the 1970s, emphasizing the pivotal role of ‘capital-intensive industries [exporters], investment banks, and internationally oriented commercial banks’ in shaping American politics.” Providing quantitative data to support the electoral connection between the Republican Party and internationally oriented voters, as well as that between the Democratic Party and domestically oriented voters, Hout, Manza, and Brooks (1999) showed that skilled manual workers (likely to be found in export-oriented industries, as U.S. companies export from a comparative advantage in skilled labor) have shifted their support toward the Republicans. Furthermore, they documented how professional and routine white-collar workers in the largely nontradable service sector increasingly support the Democrats, as do less-skilled manual workers (likely trapped in the import-competing manufacturing sector).

As Frieden (1991, 445) described, domestically oriented sectors of the national economy hold stronger preferences for domestic policy autonomy than for exchange rate stability. This is true because producers of import-competing goods and nontradable services conduct relatively little international business; thus, they receive few immediate benefits from currency stability. Inasmuch as domestic policy autonomy includes greater government spending (as discussed in chapter 4), these domestically oriented sectors stand to benefit from the local public goods provided through such fiscal policy expansion. Monetary expansion, as the alternative growth strategy, leaves such public goods either undersupplied or supplied in a private form inaccessible to many firms confined to the domestic economy.

Since inflation hurts almost all business activity, even import-competing manufacturing and those in the service sector have an interest in domestic price stability. But benefiting as they do from fiscal expansion, these domestically oriented sectors likely prefer inflation control through monetary, rather than fiscal, contraction. As Garrett and Lange (1995, 648) noted, the “combination of loose fiscal policies and tight monetary policies would greatly benefit the nontradables sector.” Furthermore, the exchange rate instability associated with this autonomous policy mix also benefits import-competing producers, as currency variability tends to increase the transaction costs of their import competition, thus raising the price of imported goods and making domestically produced goods appear less expensive in the home market.

Inasmuch as leftist parties may be pressured toward domestic policy autonomy through their representation of labor-intensive domestically oriented business sectors, rightist parties should be pushed toward external policy con-

vergence and exchange rate stability by capital-intensive internationally oriented sectors. As Frieden (1991, 445) described, exporters and international investors can be expected to favor exchange rate stability over domestic policy autonomy, since the currency risk associated with moving goods and money across international borders can be eliminated if exchange rates remain fixed over time.

The policy mix of less government spending with a lower nominal interest rate that is associated with greater exchange rate stability is also attractive for capital-intensive international businesses, as they have little interest in an economic growth strategy through fiscal expansion designed to reduce wealth inequalities and redistribute income. To the extent that international big business desires to get government out of the national economies, reduced public spending becomes a preferred policy instrument for inflation control. With regard to economic growth, internationally oriented sectors of the economy are likely to favor monetary expansion, since lower interest rates tend to increase their investment opportunities by reducing the costs of acquiring additional capital.

In short, whether one prefers to look at interest group preferences divided along either factoral or sectoral lines (or to look at preferences along both lines), leftist parties likely face greater interest group pressure for domestic policy autonomy, while rightist parties are pushed toward external policy convergence for exchange rate stability.⁵ However, we should not only expect to see certain partisan economic policy differences on the basis of interest group pressures. We should also expect to observe partisan divergence from differing policy ideas.

Policy Ideas and Political Parties

Few would dispute that leftist political parties began the post-Bretton Woods era as adherents of Keynesian economic ideas. Simply stated, Keynesian policy ideas advised governments to manage the demand side of their national economies, stimulating aggregate demand when economic growth began to stagnate (i.e., they were to use countercyclical demand management). In theory, demand stimulation could come from either fiscal or monetary policy expansion, but Keynesian practice during the Bretton Woods regime demon-

5. For more on how leftist parties act as the partisan agents for domestically oriented producer groups and how rightist parties act as the partisan agents for internationally oriented producer groups, see Bearce 2003.

strated the “asymmetry of monetary policy”: “it seemed far easier to restrain than to encourage demand” using interest rates and money supply (Thygesen 1982, 349). Consequently, fiscal, rather than monetary, expansion became the Left’s favored policy instrument for stimulating aggregate demand.

The stagflation experience beginning in the early 1970s meant that leftist governments needed a dedicated instrument for inflation control as the post-Bretton Woods era began. With increased government spending directed toward economic expansion, leftist governments predictably used monetary contraction to stabilize domestic prices.⁶ Indeed, it was not simply the case that leftist governments passively accepted higher interest rates to fight inflation, one can also find examples of Keynesian-oriented leftist governments actively pushing their central bank for monetary contraction.⁷ Kettl (1986, 170) wrote: “[Carter] administration officials had become convinced that OPEC oil price increases made tighter money necessary. They believed [Federal Reserve Board chairman] Miller erred by keeping monetary policy too loose. CEA Chairman Charles Schultze and Treasury Secretary W. Michael Blumenthal . . . began a calculated series of leaks and interviews to pressure the Fed to tighten.”⁸

Although Keynesian ideas may have influenced leftist political parties at the beginning of the post-Bretton Woods era, McNamara (1998) argued that the political left accepted a new conservative economic orthodoxy after their poor experience in combating stagflation in the 1970s. In the 1980s, “socialists and conservatives alike,” contended McNamara (1998, 10), adopted competitive neoliberal policy ideas, borrowing from monetarist economic theory. These ideas encouraged fiscal discipline, stable growth in the money supply, and even exchange rate stability.⁹ Indeed, as discussed in chapter 2, McNamara’s argument has become one of the leading explanations for the monetary policy con-

6. This use of monetary policy for inflation control might be termed “pragmatic Keynesianism,” consistent with McNamara’s distinction (1998, 67–69) between academic monetarism and pragmatic monetarism.

7. A similar example was provided by the Italian Communists’ endorsement of higher interest rates in Italy, provided that fiscal policy remained relatively expansionary. Goodman (1992, 159) wrote: “in September 1976, the Communists wholeheartedly endorsed the government’s decision to impose a series of restrictive monetary measures. Even more important, the Communists proved willing to accept and sell the new IMF program to the unions.”

8. Carter’s decision to replace Miller with Paul Volcker accords with this evidence. Karier (1997, 40) wrote on this subject: “the Carter administration well understood the risks posed by Volcker’s appointment. The commitment to Paul Volcker was a commitment to tight money.”

9. This last point is not obvious, since such monetarists as Milton Friedman were advocates of floating exchange rates (M. Friedman 1953). But McNamara (1998, 67–69) was careful to distinguish between monetarist academic theory, which prescribed floating rates, and pragmatic monetarist ideas, which viewed exchange rate stability as paramount.

vergence that supposedly occurred in Western Europe since the late 1970s: according to this argument, the political left adopted the economic policy ideas espoused by the political right, and this is why European governments of all party types now run very similar economic policy programs.

The problem with this argument is not that OECD governments failed to follow such neoliberal policy ideas in the 1980s. Clearly, many governments did—including the Christian Democrats in West Germany, the Conservatives in Britain, the U.S. Republicans, and the Japanese Liberal Democratic Party (LDP).¹⁰ The problem is that there were relatively few left-wing governments in power during the 1980s, and it is not particularly surprising that the right-wing governments already mentioned would follow such a conservative economic orthodoxy. Indeed, among the economies of the G-7 (the Group of Seven included France, West Germany, Italy, Japan, the United Kingdom, the United States, and Canada), only France was governed by a leftist party for a substantial portion of the 1980s. This fact helps to explain why certain convergence theorists invested so much effort in describing Mitterrand's economic policy as neoliberal in character, especially after the so-called U-turn of 1983.

But as I will demonstrate in much greater detail in chapter 6, this description of the French Socialists' economic policy is somewhat inaccurate, especially when we treat the policy mix of less government spending with a lower nominal interest rate as the more neoliberal policy mix. The 1983 U-turn did mark an important shift in the Socialist's policy mix, as they made inflation control a dominant economic policy objective. But the Socialist governments achieved lower inflation outcomes primarily through monetary, rather than fiscal, contraction. Indeed, French government consumption spending as a percent of GDP remained higher than the OECD average throughout the decade. Thus, the French Socialists moved toward the policy mix of more government spending with a higher nominal interest rate. This choice for domestic policy autonomy made exchange rate stability difficult to achieve, and the French government was forced to realign the franc within the EMS five times during the 1980s.

It seems clear that many leftist parties abandoned Keynesian ideas when they returned to power in certain advanced industrial democracies during the early 1990s. But this does not mean they adopted neoliberal ideas and accepted external policy convergence for exchange rate stability. As discussed in chapter

10. These last two examples were not discussed in McNamara's 1998 book, given her focus on events in Western Europe. On neoliberal policy ideas in the Japanese LDP, see Takenaka 1991, 129; Cargill, Hutchinson, and Ito 1997, 187.

2, new policy ideas had emerged by this time, ones that were more palatable to leftist interest groups and their ideological priorities than was monetarist economic theory. One very influential policy idea on the political left was endogenous growth—or new growth—theory (see Garrett and Lange 1991; Boix 1997, 1998). Much like Keynesian ideas, new growth strategies required government intervention in the national economy. But unlike Keynesian theory, which focused on demand-side intervention, new growth theory prescribed government intervention on the supply side. New growth theory held that government spending should be directed at public investment projects, notably those involving education, worker training, infrastructure, and research and development (see Aschauer 1990; Barro 1990; Romer 1990).

Perhaps supply-side fiscal expansion does not require such correspondingly high national interest rates and interest rate differentials as did demand-side fiscal expansion during the 1970s. But even government spending directed at the supply side of the national economy has demand-side implications. It can thus potentially increase inflationary expectations and raise prices in the national economy. For example, government spending on education and training boosts worker salaries, leading to greater private consumption and aggregate demand. Similarly, infrastructure projects employ large numbers of laborers, who use their wages largely for consumption purposes, rather than for investment. Consequently, increased government spending—even when it is directed at the supply side of the national economy—will require a higher interest rate for domestic price stability, thus translating into a larger national interest rate differential and greater exchange rate variability.

However, it is interesting to note that new growth theory says very little about the importance of exchange rate stability. Indeed, certain economists now question the link between fixed exchange rates, increased international trade, and a higher national income—both on an empirical basis (see, e.g., Edison and Melvin 1990; Levy-Yeyati and Sturzenegger 2003) and on a theoretical basis (see, e.g., Bacchetta and van Wincoop 2000). This is not to say that leftist governments have refused to make fixed exchange rate commitments in the post-Bretton Woods era. Many leftist governments joined the European Snake and, later, the exchange rate mechanism of the EMS. But both of these regimes were sufficiently flexible as to permit domestic policy autonomy, which such member states as France and Italy asserted to a very large degree (see Oatley 1997, chap. 5). Thus, reasoning from both opposing interest group pressures and different economic policy ideas, I expect to find partisan divergence with regard to the trade-off between domestic policy autonomy and exchange rate stability in the post-Bretton Woods era.

2. Political Power-Sharing

Scholars have recently focused their attention on how various electoral systems might influence national exchange rates. In one article in particular, Bernhard and Leblang (1999) showed that governments in high-opposition proportional representation (PR) electoral systems have been more likely to make formal fixed exchange rate commitments, perhaps to create a focal point for economic policy coordination. If one assumes that these fixed exchange rate commitments indicate greater external currency stability, then it would be natural to conclude that political power-sharing—the hallmark of PR regimes—leads national governments toward exchange rate stability and away from domestic policy autonomy.

This conclusion would seem to be strengthened by another article (Freeman, Hayes, and Stix 2000), which proposed that the consensual nature of PR electoral systems should help reduce the exchange rate variability resulting from political uncertainty. Comparing four bilateral exchange rates (between the United Kingdom and Ireland, the United States and Canada, Australia and New Zealand, and Germany and Sweden), the authors found that political factors had no effect on exchange rates in only the PR-PR dyad (Germany and Sweden). They thus concluded that other types of electoral systems “at worst exacerbate and at best do nothing to mitigate the effects of political (dis)equilibrium on currency markets” (*ibid.*, 465).

Yet the empirical base for the conclusion that political power-sharing leads to exchange rate stability is somewhat thin. With regard to the second paper (Freeman, Hayes, and Stix 2000), the conclusion is largely based on the noneffect of political factors with regard to a single exchange rate between two PR political economies. Indeed, the conclusion might differ if one looked at the exchange rate outcomes of the many other advanced industrial democracies with PR electoral systems. With regard to Bernhard and Leblang’s article (1999), I demonstrated in chapter 3 that commitments to OECD exchange rate regimes have been only weakly correlated with external currency stability in the post-Bretton Woods era. Thus, even if political power-sharing in PR systems leads coalition governments to make external monetary commitments, *de jure* fixed exchange rates will not translate into *de facto* exchange rate stability unless these governments also make domestic fiscal and monetary policy choices consistent with this external policy objective.

Given the empirical weakness of the proposition that political power-sharing leads to greater *de facto* exchange rate stability, I here consider a hypothesis in the opposite direction. My expectation is that political power-sharing will

make exchange rate stability harder, not easier, to achieve. To develop this argument, I begin by considering the fiscal policy choice of democratic governments engaged in political power-sharing.

Perhaps the central problem facing power-sharing governments is how to maintain their diverse governing coalition and their position of political power. Indeed, it is not particularly heroic to assume that governments, once in power, wish to remain so. The trick for parties engaged in political power-sharing is to meet the economic needs of their own political base without jeopardizing the demands of other governing parties representing different economic constituencies. To this end, a power-sharing government should have a greater need to engage in targeted economic growth than would a single-party government. Power-sharing governments may also find it politically expedient to engage in income redistribution toward the various economic constituencies represented by the governing coalition, even when that governing coalition includes rightist parties who would normally be ideologically opposed to such transfers of wealth and income.

As described earlier in this chapter, fiscal expansion is much better suited for targeted economic growth and income redistribution than is monetary expansion. Thus, political power-sharing may lead governments to engage in greater spending because the alternative growth strategy—monetary expansion—is insufficient for targeting key supporters and achieving redistributive policy goals. Clark and Hallerberg (2000, 342) concluded: “although an increase in the money supply may help certain groups . . . more than others, it is a blunt instrument for cultivating specific clienteles. Fiscal policy, in contrast, is more suited to targeted use, whether through greater spending, tax cuts, or both.” On this point, Roubini and Sachs (1989, 114) similarly concluded, “coalition governments will have a bias towards higher levels of government spending relative to majority party governments, as the various constituencies in the government undertake logrolling agreements to secure greater spending for their individual constituencies.”

What does greater government spending on the part of power-sharing governments imply for national interest rates and exchange rate outcomes? According to the policy mix framework presented in chapter 4, if governments use their fiscal policy instrument to pursue targeted economic growth, they must reserve monetary policy as their instrument for inflation control with international capital mobility. This choice typically means a higher national interest rate and greater domestic monetary autonomy, as the national interest rate can be expected to move away from the nominally low world interest rate. This choice also suggests that power-sharing governments should be associated

with greater exchange rate variability, despite any commitments that they might make to fix the value of the national currency.

The difficult experience of Italian governments within European monetary institutions suggests the plausibility of this hypothesis. Italian multiparty governments have traditionally held an expansionary fiscal policy, whether it is measured in terms of relative government spending, budget deficits, or even public debt. These facts suggest the “supremacy of fiscal policy over monetary policy” (Fratianni and Spinelli 1997, 212) for expanding the Italian economy. As the Italians assigned fiscal policy to the economic growth objective, monetary policy necessarily became the instrument for domestic price stability. As Posner (1978, 235) concluded early in the post-Bretton Woods era, Italian governments had to control domestic prices “largely by means of monetary policy,” resulting in high Italian interest rates and interest rate differentials beginning in the mid-1970s.¹¹

For the Italians, higher national interest rates were thus a deliberate policy choice to counterbalance greater government spending, especially since the Italian central bank has a relatively subordinate status, even after its so-called divorce in 1981.¹² The Italian governments’ choice for domestic policy autonomy arguably contributed to the country’s record number of realignments within the exchange rate mechanism of the EMS, despite the fact that Italy had wider bands (± 6 percent) than did the other member states (± 2.25 percent). Indeed, the cumulative currency adjustment for Italy was greater than that for any other EMS member state. Oatley (1997, 139) noted, “EMS flexibility granted the Italians a devaluation of about 7.5 percent approximately every six months and, thus, a fairly high degree of monetary autonomy.”

While political power-sharing often occurs due to a PR electoral system, it can also emerge in countries with majoritarian electoral systems. Thus, a second example in which political power-sharing potentially made exchange rate stability harder to achieve occurred in the United States during the early 1980s, when the Republicans took power in the executive branch, with the Democrats holding substantial political power in the legislative branch. Such political power-sharing arguably contributed to the mix of loose fiscal and tight mone-

11. On the political infeasibility of fiscal contraction for inflation control, Posner (1978, 235) continued: “Italian fiscal policy ‘is a resultant of bargaining among party factions. . . .’ It is therefore caught up in the immobility of . . . coalition politics.”

12. Consistent with the idea of deliberate monetary counterbalancing, Goodman (1992, 151–52) noted that when the Italian government asked the IMF for balance-of-payment financing in the early 1970s, the subordinate Bank of Italy raised interest rates well above the IMF’s requirements: “Once the Italian government had approved the IMF program, the Banca d’Italia moved quickly to tighten monetary policy . . . adopt[ing] an economic program which was more restrictive than that suggested by the [IMF’s] letter of intent.”

tary policies held by the first Reagan administration. This policy mix is often cited as a key factor leading to the U.S. dollar's instability in an appreciating direction during the first half of the 1980s.¹³

We have just discussed how political power-sharing may push democratic governments away from exchange rate stability even when they may desire to achieve this external policy goal. It is now important to consider a countervailing factor, one that may help governments to reduce positive interest rate differentials and better achieve external monetary policy convergence for exchange rate stability. That factor is central bank independence.

3. Central Bank Independence

The argument that central bank independence can reduce interest rate differentials builds from a relatively well-established fact in economics literature. More independent central banks have been associated with lower inflation policy outcomes, at least for the advanced industrial economies (see Alesina and Summers 1993; Grilli, Masciandaro, and Tabellini 1991)—although the relationship does not hold for developing economies (see Cukierman, Webb, and Neyapti 1992) and less democratic polities (see Broz 2002). Central bank independence theoretically leads to lower inflation because more independent monetary authorities have greater freedom to increase national interest rates and contract the money supply when they see signs of rising domestic prices. Central banks that are subordinate to the government in power may be constrained from raising interest rates, since monetary contraction can reduce economic growth, undermining the government's reelection prospects. Superficially, this logic would seem to suggest that more independent central banks would be associated with higher nominal interest rates and more positive interest rate differentials.

This quick story, however, ignores the role of central bank credibility and its

13. Consistent with leftist preferences for domestic policy autonomy, it can also be argued that high U.S. interest rates during the first Reagan administration were largely a legacy of the Carter administration's autonomous policy choices. Sterling-Folker (2002, 158) wrote: "The seeds for potential exchange rate chaos had been sown before Ronald Reagan took office in January 1981. The expansionary [fiscal] policies adopted at the 1978 Bonn summit collided with the [monetary] contractions caused by the 1979 oil shock." Thus, the fact that the first Reagan administration could not stabilize the dollar at a more competitive level does not mean that certain parts of the administration were not interested in doing so. Such a reading of the evidence tends to confuse *ex post* policy outcomes with *ex ante* policy preferences. During the presidential campaign, several Reagan advisors had advocated a return to a Bretton Woods-style fixed exchange rate system (see Ferguson and Rogers 1986, 118; Grubaugh and Sumner 1990, 257) and inserted language into the 1980 Republican party platform concerning the "overriding objective of maintaining a stable dollar value" (see Stockman 1986, 63).

effect on national interest rates. If international capital markets view independent central banks as more credible in achieving lower inflation outcomes than their subordinate counterparts,¹⁴ then independent monetary authorities may be able to hold lower interest rates—at least on a nominal basis—than subordinate central banks lacking such credibility. In other words, subordinate central banks must hold higher nominal interest rates to obtain the same amount of anti-inflation credibility as their independent counterparts.

This relationship between central bank independence and lower nominal interest rates does not mean that fiscal expansion will not lead to higher national interest rates as the central bank seeks to control inflation and reduce inflationary expectations (see fig. 11 in chap. 4). But it does suggest that at any given level of relative government spending, independent monetary authorities should be associated with lower rates and, thus, with lower interest rate differentials than subordinate central banks. If interest rate differentials can be reduced with more independent central banks, then this monetary commitment technology should also be associated with greater exchange rate stability, or reduced external currency variability.

This logic is potentially good news for both rightist and leftist governments. For rightist governments, the benefits of central bank independence are obvious. Independent central banks facilitate the rightist policy goals of external policy convergence with exchange rate stability, as discussed earlier in this chapter. Leftist governments tend to be more interested in the domestic benefits associated with increased government spending, but an independent central bank may allow them to achieve the necessary inflation control with lower corresponding nominal interest rates than could be achieved with a subordinate central bank. This possibility may help explain why leftist parties have supported moves to increase central bank independence since the early 1980s in several OECD countries, including Britain, France, Italy, Spain, Switzerland, and New Zealand.

4. Testing Hypotheses about Policy Divergence

The preceding theoretical discussion advanced a number of hypotheses concerning the relationship between the three independent variables of government partisanship, political power-sharing, and central bank independence, and the four different—but theoretically related—dependent variables of gov-

14. For a concise statement on the credibility of independent central banks, see Bernhard, Broz, and Clark 2002.

ernment spending, nominal interest rates, domestic monetary autonomy, and exchange rate variability. These hypotheses are concisely summarized in table 4. Leftist governments are expected to be associated with more government spending relative to GDP and higher nominal interest rates. Given this fiscal and monetary policy stance in the post-Bretton Woods era, leftist governments are also expected to be associated with greater domestic monetary policy autonomy and increased exchange rate variability.

A similar set of relationships is hypothesized for political power-sharing. Such power-sharing is expected to lead governments toward greater relative government spending, higher nominal interest rates, greater domestic monetary policy autonomy, and increased exchange rate variability. Conversely, central bank independence is expected to lower nominal interest rates in the domestic economy, thereby reducing the interest rate differential (the operational measure for domestic monetary policy autonomy) and exchange rate variability.

These hypotheses are tested on the same panel of twenty-three OECD countries that was examined in chapters 3 and 4. The temporal coverage is slightly reduced (1975–97), due to data limitations that will be discussed shortly; hence, $N = 529$. With four different dependent variables, I estimate four separate models, each of which takes the general form of equation (5.1).¹⁵

TABLE 4. Hypothesized Relationships between Domestic Political Factors and National Policy Instruments and Exchange Rate Variability

	Government spending/GDP	Nominal interest rates	Domestic monetary policy autonomy	Exchange rate variability
Leftist governments	+	+	+	+
Political power-sharing	+	+	+	+
Central bank independence		–	–	–

15. I used a common right-hand specification for these four models for theoretical reasons. As I argued in chapter 4, governments and their national monetary authorities choose a policy mix based on a common set of dominant policy goals. Thus, I needed to control for the same set of factors in each equation. Another reason I used a common specification was to avoid giving any readers the impression that my results for a particular model are due to an idiosyncratic model specification. In fact, the results of interest are robust with regard to other possible control variables, including unemployment, various trade measures, and different measures of de jure exchange rate regimes; for other model specifications, see Bearce 2003. Since the models presented in the current study include a full set of country- and year-specific fixed effects, concerns about omitted variable bias are greatly reduced.

$$\begin{aligned} DV_{it} = & \beta_0 + \beta_1 * GDPGROWTH_{it} + \beta_2 * INFLATION_{it} + \beta_3 * GDPPC_{it} \\ & + \beta_4 * KOPEN_{it} + \beta_5 * LEFTGOV_{it} + \beta_6 * SHARE_{it} + \beta_7 * CBI_{it} \\ & + \alpha_i * COUNTRY_i + \alpha_t * YEAR_t + e_{it} \end{aligned} \quad (5.1)$$

In equation (5.1), DV represents one of four dependent variables. The first is GOVCON, which measures the current level of government consumption expenditures as a percent of country i 's GDP in year t .¹⁶ The second dependent variable is INTRATE, which measures country i 's policy interest rate in year t . This variable was introduced in chapter 4, where a more comprehensive discussion of its construction and validity is provided. The third dependent variable is MONAUT, introduced in chapter 3. This variable captures the extent of domestic monetary policy autonomy in terms of country i 's nominal interest rate differential relative to the prevailing external interest rate in year t . Finally, the fourth dependent variable is EXRCV, also introduced in chapter 3. This variable measures the coefficient of nominal variation for country i 's national currency versus the SDR in year t . Higher (or lower) values indicate more (or less) exchange rate variability.

Equation (5.1) includes seven independent variables in addition to the country- and year-specific fixed effects. Considering that all governments can be expected to make some adjustments to monetary and fiscal policy in response to economic growth and inflation, I included the variables GDPGROWTH and INFLATION as controls.¹⁷ As shown in chapter 4, the level of economic development affects the national interest rate and possibly other related policy decisions as well, so I also included the per capita level of country i 's GDP in year t (GDPPC).¹⁸ The last economic control variable I included in this model is KOPEN, introduced in chapter 3. This variable measures country i 's financial openness in year t , updating the data from Quinn and Inclan (1997).

The remaining three independent variables in the model were included to test the various hypotheses specified in table 4. LEFTGOV measures the partisan character of the government in power for country i in year t , using a common five-point scale. LEFTGOV is coded as 4 for a left-dominant government, 3 for a left-center government, 2 for a balanced government, 1 for a right-center government, and 0 for a right-dominant government.¹⁹ SHARE measures

16. As discussed in chapter 4, government consumption is arguably the most valid way to capture a government's discretionary spending decisions. Total government spending includes other categories of expenditures, including interest payments, which are essentially obligatory in character. The data are provided by the OECD in *Annual National Accounts* (1975–97).

17. The data come from the World Bank's *World Development Indicators* (1975–97).

18. The data come from the World Bank's *World Development Indicators* (1975–97).

19. The data come from Woldendorp, Keman, and Budge 1993. I used their coding rules and data from Lane, McCay, and Newton 1997 to fill in the missing country panels.

the extent of political power-sharing for country i in year t , using a measure of government party fractionalization. This variable is continuous between 0 and 1, with higher values indicating greater power-sharing among different political parties.²⁰ Finally, CBI measures the independence of state i 's central bank in year t . This variable is also continuous between 0 and 1, with higher values indicating greater central bank independence from the government in power. Following Bernhard (1998), this measure uses a normalized mean score from three different sources (Alesina and Summers 1993; Cukierman, Webb, and Neyapti 1992; Grilli, Masciandro, and Tabellini 1991) to minimize the effect of coding disagreements.

The estimates for the four models are reported together in table 5. Of the eleven hypotheses summarized in table 4, eight receive statistical support, and three do not. The strongest results clearly emerged for the government partisanship variable (LEFTGOV), which is statistically significant with a positive sign in all four models. That leftist governments are associated with more government consumption spending and higher interest rates is consistent with Garrett's results (1995, 1998b), but the analysis here goes much further. The results in columns 3 and 4 also show how this policy mix moved leftist governments toward greater domestic monetary policy autonomy and exchange rate variability. While additional results are not reported here for space considerations, leftist governments were also associated with greater exchange rate variability when national currency instability was measured relative to the German mark and the U.S. dollar.²¹

Political power-sharing is also significantly associated with more government consumption spending. The SHARE variable is not, however, associated with higher interest rates or larger interest rate differentials. One possible explanation is that certain parties within the governing coalition—notably those on the political right preferring monetary over fiscal expansion—

20. The data come from the World Bank's "Database of Political Institutions" (Beck et al. 2001). The data coverage begins in 1975, thus restricting the temporal domain of my pooled time-series models in this chapter to the 1975–97 period. As discussed earlier, power-sharing has a different meaning depending on a country's electoral institution. For countries with high-opposition PR electoral systems (Germany, Italy, Netherlands, Belgium, Denmark, Austria, Sweden, Finland, Norway, and Switzerland), where power-sharing focuses on executive branch divisions, I used the World Bank's measure GOVFRAC. For countries with low-opposition PR electoral systems (Greece, Ireland, Spain, and Portugal) and majoritarian electoral systems (the United States, Japan, Britain, France, Canada, Australia, New Zealand, and Turkey), where power-sharing extends into the legislative branch, I used the World Bank's measure FRAC. On the importance of distinguishing between high- and low-opposition PR electoral systems, see Bernhard and Leblang 1999, 77.

21. For results showing leftist governments associated with greater exchange rate variability versus the German mark, see Bearce 2003, 406. Results showing that leftist governments are associated with greater variability versus the U.S. dollar are available from the author on request.

demanded lower interest rates as their part of the coalition's economic policy compromise. Another possibility is that many advanced industrial democracies with a long history of power-sharing governments have made their central banks more independent (Bernhard 1998, 2002). This fact should help reduce nominal interest rates and interest rate differentials, thus offsetting some of the contrary pressures associated with more government spending. But even so, political power-sharing is significantly associated with greater external currency variability, or exchange rate instability, as hypothesized earlier.

Also as hypothesized, more independent central banks are strongly associated with both lower nominal interest rates and smaller interest rate differentials. Central bank independence is not, however, significantly associated with a corresponding reduction in exchange rate variability. This weak result could emerge if central bank independence also leads governments to engage in greater government spending, a policy choice that is largely inconsistent with more stable exchange rates.²² Indeed, the result in the first column suggests a

TABLE 5. Estimates of Domestic Political Factors on National Policy Instruments and Exchange Rate Variability

Dependent variable	1 GOVCON	2 INTRATE	3 MONAUT	4 EXRCV
Constant	16.28*** (1.71)	23.44*** (6.62)	14.01** (6.17)	2.14 (2.93)
GDPGROWTH	-0.07*** (0.01)	-0.06 (0.11)	-0.10 (0.11)	-0.05 (0.05)
INFLATION	-0.04*** (0.01)	0.23** (0.09)	0.21** (0.09)	0.14*** (0.03)
GDPPC	-0.00009*** (0.00002)	-0.00056*** (0.00016)	-0.00046*** (0.00014)	-0.00004 (0.00004)
KOPEN	0.03 (0.04)	0.65*** (0.21)	0.77*** (0.21)	0.20** (0.09)
LEFTGOV	0.053** (0.027)	0.37** (0.16)	0.34** (0.16)	0.14** (0.06)
SHARE	0.47* (0.25)	-0.27 (1.66)	-0.65 (1.69)	1.33* (0.76)
CBI	2.52 (2.03)	-26.02*** (7.76)	-23.66*** (7.58)	-5.73 (3.94)
<i>N</i>	529	529	529	529
<i>R</i> ²	0.97	0.76	0.63	0.76

Note: Estimates are Prais-Winsten coefficients, including an AR1 correction, with panel-corrected standard errors in parentheses. Individual country and year dummies are not reported.

Two-tailed statistical significance is indicated as follows: ****p* < .01, ***p* < .05, **p* < .10.

22. For a more developed explanation of this result, see Bearce 2005.

weak, but positive, relationship between greater central bank independence and more government spending.²³

Beyond evaluating the main hypotheses for the domestic political factors, it is also important to consider how some of the economic control variables affect the policy mix and the resultant trade-off between domestic monetary autonomy and exchange rate stability. More developed capitalist economies (i.e., those with a larger GDPPC) naturally spend less on a relative basis and have lower nominal interest rates. Together, these results show that if governments are going to move toward the fiscal and monetary policies of the most developed states in the international system (i.e., external policy convergence), they must move toward the policy mix of less government spending with a lower nominal interest rate for reduced domestic monetary policy autonomy and exchange rate variability (see fig. 14 in chap. 4).

But such external policy convergence is harder, not easier, to achieve with international capital mobility. Larger values of KOPEN are associated with more government consumption spending²⁴ and higher nominal interest rates. These facts suggest that international capital mobility should also be associated with more domestic monetary policy autonomy and increased exchange rate variability. Indeed, these results are statistically significant in the third and fourth columns of table 5. Thus, international capital mobility does not lead OECD governments toward a more externally convergence policy stance. To the contrary, it appears to make external policy convergence harder to achieve, a result consistent with the proposition of macroeconomic policy divergence in the post-Bretton Woods era.

5. Toward a New Theory of Partisan Politics in the Post-Bretton Woods Era

The policy mix framework presented in chapter 4 and the government partisanship results presented in this chapter lead toward a new theory of partisan economic policy-making with international capital mobility. This point may not be obvious to many readers, so it is useful to compare the partisan policy mix framework with two other partisan theories. Table 6 summarizes their differing convergence and divergence predictions in terms of both economic policy goals and policy instruments.

23. Other model specifications produce a statistically significant positive result; see, for example, Bearce 2002, 213.

24. The result is not quite statistically significant in this model specification. For a model specification with a statistically significant result, see Bearce 2002, 213.

The traditional partisan-ideological thesis has several variations (see, e.g., Kirschen et al. 1964; Hibbs 1977; Alt 1985; Garrett 1995, 1998b; Oatley 1999). But in the broadest sense, traditional partisan theories argue for partisan divergence in terms of both dominant economic policy goals and the policy instruments used to achieve these goals. In terms of policy goals, leftist parties are expected to have stronger preferences for economic growth and fuller employment, caring somewhat less about domestic inflation. Conversely, rightist parties have stronger preferences for low inflation outcomes, with much weaker preferences for economic growth to increase employment.

Traditional partisan arguments were largely tested on economic policy outcomes, not on the use of policy instruments.²⁵ But the partisan-ideological thesis generally theorized that leftist governments would use all available policy instruments, both fiscal and monetary, to achieve economic growth with fuller employment.²⁶ Since inflation control was only a minor concern, no policy instrument needed to be reserved for this economic objective. Leftist governments were theoretically expected to move toward a policy mix defined by more government spending and lower interest rates (Garrett 1995, 670). Conversely, rightist governments were expected to move in the opposite direction (toward less government spending with a higher interest rate), with both policy instruments generally directed toward domestic price stability.

Perhaps such strong partisan divergence, in terms of both policy goals and policy instruments, was possible during the period of restricted international capital mobility after World War II. But this story becomes harder to defend

TABLE 6. Three Theories of Partisan Economic Policy Goals and Instruments

Theory	Prediction about policy goals	Prediction about policy instruments
Traditional partisan-ideological thesis	<i>Divergence</i>	<i>Divergence</i>
Macroeconomic convergence hypothesis	<i>Convergence</i>	<i>Convergence</i>
Partisan policy mix framework	<i>Convergence</i>	<i>Divergence</i>

25. For important exceptions, see Garrett 1995; Garrett 1998b, chap. 4; Oatley 1999.

26. Oatley (1999) amended the traditional partisan argument to fit open-economy models, where governments have only one effective policy instrument—either fiscal policy with fixed exchange rates or monetary policy with floating exchange rates.

with the financial market integration that began to reemerge at the end of the Bretton Woods system and that exploded in the post-Bretton Woods era. Much like the macroeconomic convergence hypothesis advanced in the early 1990s, the partisan policy mix framework presented here takes seriously the idea that international capital mobility constrains the economic policy goals of national governments. But unlike the macroeconomic convergence hypothesis, which focused almost exclusively on the need for governments to maintain low inflation, the policy mix framework also recognizes the need for governments to maintain a growing national economy. This means that partisan governments have been constrained to make inflation control and economic growth their two dominant macroeconomic policy objectives. The political left has certainly taken inflation control more seriously in the post-Bretton Woods era, but the political right has also learned the importance of sustained growth and the need to avoid economic recessions.²⁷

This logic about how international capital mobility constrains certain domestic economic policy goals accords with Clark's evidence (2003, chap. 5) that there are relatively few strong partisan differences with regard to such macroeconomic outcomes as GDP growth, actual inflation, and unemployment, although Clark used a different theoretical logic to get to these results.²⁸ But partisan convergence in terms of such economic policy goals does not mean that there should also be convergence in the use of policy instruments, as scholars advancing the macroeconomic convergence hypothesis have tended to assume.

With regard to the capital mobility constraint, Mosley (2000, 766) interviewed financial market participants and concluded: "provided governments achieve the desired outcomes, market actors do not worry about which means is employed. These choices . . . are well within the purview of domestic politics." With regard to Downsian theories of partisan convergence toward the median voter (see Downs 1957), while the median voter likely cares about such economic outcomes as growth and inflation, it is not at all clear that the median voter should care about the policy instruments used to reach these outcomes, provided that the preferred outcome is indeed achieved. Quinn and Shapiro (1991, 659) wrote: "one strong objection to the necessity of conver-

27. On how rightist economic policies have often permitted—even engineered—economic recessions during the Bretton Woods system, see Alesina and Rosenthal 1995, 180–81.

28. To the extent that we observe some limited partisan divergence in terms of these economic outcomes, it may have to do more with the effectiveness of the different policy mixes used by partisan governments than with different partisan economic policy objectives, or goals, in the post-Bretton Woods era.

gence to a mean among parties is that different strategies can yield similar rates of economic growth, thereby satisfying the convergent policy goal.”

Thus, partisan divergence in the use of policy instruments remains theoretically possible. But such partisan divergence should not take the form specified by traditional partisan-ideological theories. The Old Left policy mix, defined by more government spending with a lower nominal interest rate, is no longer feasible in the post-Bretton Woods era, as discussed in chapter 4. The results in the present chapter show how leftist governments have instead shifted toward a policy mix marked by more government spending with a higher nominal interest rate (see fig. 16). Likewise, the Old Right policy mix, with two policy instruments dedicated to inflation control, is no longer feasible with international capital mobility. To accommodate the need for low inflation with economic growth, rightist governments have effectively moved toward a policy mix defined by less government spending with a lower nominal interest rate. This New Right policy mix was labeled as the neoliberal alternative in chapter 4.

While Garrett’s work hinted at these new partisan policy mixes in the post-Bretton Woods era, the analysis here goes at least two steps further. First, it provides a model explicitly linking domestic fiscal and monetary policy choices, developing the logic of deliberate monetary counterbalancing in response to increased government spending.²⁹ This allows scholars to do more in the examination of the use of policy instruments than just test compensation versus efficiency hypotheses (see Garrett 1995, 671). The policy mix framework explains why partisan governments must be concerned about both compensation and economic efficiency but that differences with regard to who they compensate and how they obtain their economic efficiency should produce partisan divergence concerning government spending and nominal interest rates. Second, this analysis shows how partisan divergence in the use of such policy instruments has clear and important implications for the trade-off between domestic policy autonomy and exchange rate stability in the post-Bretton Woods era, a topic not considered in Garrett’s study of partisan politics with economic globalization.

The results in this chapter have demonstrated that we can find statistically significant partisan differences precisely where the partisan policy mix framework expected to find them—in terms of government consumption spending, nominal interest rates, interest rate differentials, and exchange rate variability. But can this evidence of partisan policy divergence be squared with Clark’s conclusion (2003, chap. 3) that just as there are no meaningful partisan differences concerning economic policy outcomes, there are also no significant par-

29. Garrett (1998b, 102) seemingly rejected the idea of deliberate monetary counterbalancing.

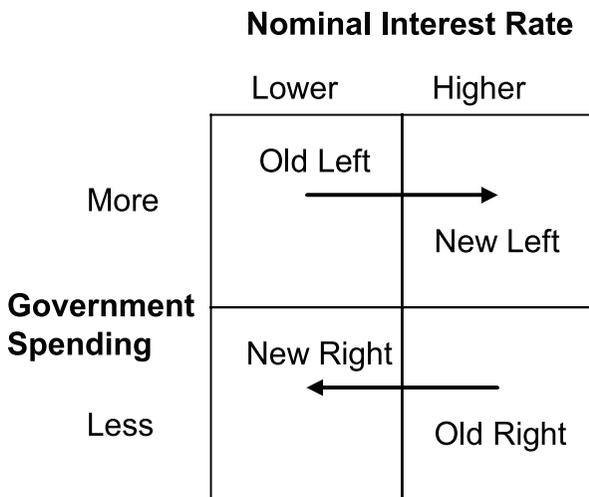


Fig. 16. Partisan Policy Mix Divergence

tisan differences concerning the use of fiscal and monetary instruments? I believe this is possible, because Clark, in fact, found some evidence of partisan divergence concerning the use of fiscal and monetary policy instruments.

With regard to fiscal policy, he reported some significant partisan differences in terms of government consumption but fewer such differences with regard to income transfers, total spending, and budget deficits. This set of results is not particularly surprising, since of the various possible spending measures, government consumption best captures the discretionary fiscal policy choices made by current governments. On this point, income transfer spending is effectively obligatory in character, being known as the so-called third rail in U.S. domestic politics, since any politician trying to cut such spending is likely to find his or her political life cut short. Partisan governments are not easily able to change this category of government spending, especially from year-to-year, the time frame investigated here. The same is true for total government spending, since it includes yet another category of obligatory expenditures, that of interest payments on debt. Interest payments largely reflect the spending decisions made by previous governments and then imposed on the current government. While total government spending includes discretionary consumption expenditures, the obligatory categories effectively add noise to the signal of a government's fiscal policy intentions, making expected relationships much harder to find in the data.

The lack of partisan differences with regard to budget deficits is also not

problematic for the partisan divergence argument advanced here. Since leftist governments tend to balance greater discretionary spending with more tax revenues (Garrett 1995, 674; Garrett 1998b, 90; Cusack 1999; Clark 2003, 66–67), we should not expect to see significant partisan differences with regard to either budget deficits or public debt. But these results do not mean that there are not important partisan differences concerning fiscal policy instruments. Although it may produce similar outcomes with regard to deficits and debt, the strategy of more spending with higher taxes has markedly different macroeconomic implications than the strategy defined by less spending with lower taxes.

On this point, Clark (2003, 70–72, 78, 81) also reported some significant partisan differences with regard to national interest rates, with leftist governments associated with high interest rates, much like they are in the results reported here. For Clark, this finding was problematic because it ran contrary to the expectations of traditional partisan-ideological theories, which posited the political left as more expansionary in terms of its monetary policy choices. But this result is not at all problematic for the policy mix framework, which expects the Left to hold higher interest rates to counterbalance its choice for greater government spending.

In short, what Clark (2003) viewed as only minor partisan fiscal and monetary policy divergence is identified as a major difference by the partisan policy mix framework. Policy divergence in terms of government consumption spending and nominal interest rates represents a major difference because it has important implications for the trade-off between domestic monetary autonomy and exchange rate stability, as the statistical results in this chapter demonstrate. Chapter 6 will further illustrate this partisan policy divergence, presenting contrasting case studies on the French Socialists and British Conservatives.