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Putting Monetary Policy in its Political Place[1]

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ABSTRACT

Even though a central bank has formal independence, the success of its actions are part of an interdependent system of policies in which elected governments have a role too. In the making of monetary policy, economists have technical expertise but politicians claim electoral legitimacy. This paper examines monetary policy from the perspective of elected officeholders who must balance non-economic pressures, both domestic and international, against concerns of central bankers with monetary constraint. It emphasizes divisions within national governments about how that balance should be struck, and differences in political priorities for economic policymaking between countries and across time. It concludes with a POP (Politically Optimal Policy), having flexibility between multiple and shifting policy goals rather than fixing on a single target, monetary or non-monetary.

> The big challenge to international and domestic monetary policies is to separate the economics from the politics. Often, unfortunately, the politics dominates.
> Gary Becker, Nobel laureate in economics

> No president has an economic policy; all his policies are political.
> Richard E. Neustadt, author of *Presidential Power*

In theory, monetary policies can be discussed in terms of a single criterion, such as an optimal currency area or a winning election strategy. In practice, monetary policies are part of a multi-dimensional matrix of issues reflecting political and economic pressures both domestic and international. The attention give to monetary policy issues is asymmetrical. For elected politicians it is one among many concerns, and often outside their knowledge or experience. Central bankers can welcome being ignored by politicians, insofar as it increases their scope for independent action on a daily basis. But from time to time the interdependence of political and monetary issues forces bankers and politicians to confront common problems from contrasting perspectives.

The outcome of confrontations between politicians and economic actors is contingent on circumstances. German Chancellor Helmut Kohl forced the German Bundesbank to accept an overvalued rate for the East German Mark as the price the Federal Republic would pay (and is still paying) for German reunification. However, in 1992 pressures from the foreign exchange market broke the credibility of a newly elected British Conservative government (Stephens, 1996).

Every year sees elections in several EMU member countries.

> It is a crude fact – not recognised in the solemn declarations around the creation of the euro – that at election time most politicians care more about voters in the street than disapproving number-crunchers in EU office blocks. (Parker and Swann, 2002).

While there may be a consensus among politicians and economists about the desirability of price stability, it does not follow that there is agreement about whether preventing inflation is an end in itself or a means to an end. As Richard Neustadt emphasizes, for politicians all economic policies are means to political ends. When price stability is put in its political place, this subordinates it to such goals as keeping government colleagues together, winning re-election, financing social policies and maintaining national defence. However, in an era of big government the achievement of many political goals requires money; therefore, no politician can be indifferent to the state of the national economy, including monetary policy. This is true whether a loose monetary policy is seen as a means to the end of winning a forthcoming election, or whether a tight monetary policy is seen as the means for dealing with the inflation that can follow a loose monetary policy. While a national leader can give monetary policy issues a low priority, as Lyndon Johnson did during the Vietnam War and Richard Nixon did in subsequent White House discussions about the Italian lira, the consequences of ignoring inflation cannot be ignored.

Monetary policy is thus a *meta-policy* concern, reflecting diverse pressures from different departments of government, party and interest groups, from domestic and international markets, and increasingly from intergovernmental and international financial institutions. In the words of the Danish government's spokesperson on EMU:

> It is difficult to narrow the public debate down to only dealing with the EMU. We have to discuss broader issues, because this is what our electorate wants. (quoted in Marcussen, 2002: 144).

Given diverse and often conflicting pressures, a prime minister must set priorities between competing goods and reconcile conflicting demands in ways that avoid the loss of political support.

The creation of the European Central Bank (ECB) has altered the way in which monetary policy is made, and the circulation of the euro gives public recognition to new forms of monetary interdependence. But these events have not made monetary policy a consensus policy. There are disagreements about economic priorities within every EU member state; between member-states of the European Monetary Union; and between member-states and non-member states about whether or not it is in a country's political interest to belong to the Eurozone.

The constitution of the European Central Bank gives it a formidable degree of independence of national parliaments and elected politicians (cf. Issing et al., 2001; Chang, 2002). But removing the ECB from a national setting does not remove it from politics; it simply substitutes one set of political arrangements for another. To claim that the ECB is now governed by Platonic guardians removed from politics is to practice the politics of the apolitical, asserting power by ignoring political feedback (cf. Deutsch, 1963).

I Political makers of economic decisions

While national governments are the units that created the ECB, it is misleading to think of each national government as having a uniform view of what monetary policy ought to be. Since member states of the European Union are democratic, in every country Opposition parties have the right to enunciate an alternative view about economic policy. Opposition parties can use election campaigns to press for more liberal spending policies that encourage a governing party to make electoral commitments that could undermine its fiscal commitments to the ECB, as happened in the French elections in Spring, 2002. Alternatively, a newly elected government can seek absolution for violating Stability Pact provisions by blaming its predecessor for breaching ECB rules about deficits, as centre-right Portuguese Prime Minister José Manuel Durão has done. If a government is a coalition, as is the norm for all 12 member countries of EMU, partisan differences are likely to be articulated within government too.

The multiple policies of a government are the responsibility of multiple departments with different priorities, such as spending vs. saving or pump-priming vs. fighting inflation. In contemporary European states, spending ministries, such as health, education and social security tend to be introverted, focusing on domestic concerns. This is even more true of departments concerned with local government spending. Extroverted ministries with relatively low claims on the public budget but significantly concerned with international relations include foreign affairs, trade, industry, finance, energy and agriculture. Each department is headed by a politician with personal political ambitions and goals.

Major economic issues must go to the top of government. Whether or not the prime minister or Cabinet is capable of determining the outcome, they must accept responsibility for the consequences of economic processes to which their decisions are inputs of limited rather than controlling impact. Constraints of time, organizational resources and departmental structures limit a prime minister's involvement in policymaking to a few issues. The prime minister is concerned with meta-policymaking as the focal point for pressures from multiple government departments, domestic pressure groups and international pressures. He or she is also concerned with political management, that is, maintaining office by minimizing friction with political colleagues, having good media relations and opinion poll ratings, and winning re-election.

A prime minister has two unique balancing roles. He or she must balance economic and political pressures within government, such as Ministry of Finance advice and electoral calculations; and foreign and domestic considerations. A prime minister is better qualified to listen to and make judgments on meta-issues than on monetary issues. It is unusual for a professional economist to become prime minister and an academic degree in economics is no proof of a grip on the intricacies of monetary policy, as illustrated by Ronald Reagan, the first American president to have an economics degree, and George W. Bush, the first MBA president. The immediate incentives of a prime minister are to engage in foreign affairs. A side effect of the terrorist attack on the United States a few months before the launch of the euro is that it raises the stakes of foreign policy for European as well as American leaders at a time when inflation appears to be under control.

The traditional view of the priority between domestic and international concerns was summed up by United States Congressman Tip O'Neill in the epigram, 'All politics is local', for Members of Congress depend on voters in their local district for re-election. But national governments have a national constituency. Moreover, in today's open international economy many issues that concern national governments are 'intermestic', conflating international and domestic concerns (cf. Rose, 2001). The introduction of the Single Europe Market has greatly augmented the scope for regulations of the European Union to apply to what were formerly viewed by politicians as strictly domestic matters, and agreements to deepen the EU since have increased the number, visibility and impact of intermestic policies on national governments. Hence, any politician who follows President Clinton's prescription for winning a national election – 'It's the economy, stupid' – must heed what happens in the international economy.

The European Central Bank is part of a complex of economic policymaking institutions, including national government as well as other European Union institutions. The 18-member governing council of the Bank consists of 12 members who are the heads of the central banks of member states, while 6 are executive board members based in the Bank's Frankfurt headquarters. While the ECB is meant to be "above" national political interests, the squabble over the nationality of the first ECB president was not a deviant case but the first example of a continuing concern of national governments with the nationality of the ECB's leaders.

The European Commission's supranational directorates collectively have broader terms of reference than the ECB and national central banks, and this is reflected in its statements on monetary policy. Pedro Solbes, the Monetary Affairs commissioner, has placed public pressure on the ECB to give greater priority to economic growth by being more flexible in stability policies that are only one of the two nominal goals of the Stability and Growth Pact. In advancing this view, Solbes is also promoting a claim for the Commission to have more influence on monetary policy. The European Parliament has the least power but it has a unique claim to legitimacy as long as it is the EU's only elected body.

National finance ministers can use Ecofin, the Council of Ministers committee of finance ministers, to advance national priorities that challenge rules laid down in Frankfurt. The Italian Finance Minister, Giulio Tremonti, has called for the ECB to 'reinterpret' its priorities as between stability and growth, yielding its former insistence on a completely balanced budget and excluding from its review of budget balance, at least for a period, government spending on economic reforms and investment.

> Balanced budgets were required in the first phase, when we were in the process of setting up the euro. Now we must try to move to another phase, one which maintains stability but also puts the emphasis on growth and flexibility (quoted in Blitz, 2002).

The European Commission has given France, Germany, Italy and Portugal more time to bring deficits into line with commitments entered into in the Stability and Growth Pact. Tremonti has welcomed this as moving 'from technocracy to democracy' (ibid.).

For member states of the European Union, major international financial institutions are less relevant for national policy. EU countries are ineligible for World Bank loans for economic development, and preparations for EMU were intended to prevent any European country from going to the International Monetary Fund for financial assistance, as Britain and Italy did in the 1970s. To date, the ECB has not become focus of attention from Non-Governmental Organizations (NGOs) that have protested and disrupted meetings of the World Bank, the IMF, G-7 and the World Trade Organization from Seattle to Gothenburg and Genoa, and placed on the agenda of international financial institutions issues very different than price stability. Yet logically, the ECB's monetarist policies are open to many of the criticisms that NGOs hurl at global financial institutions.

II Multiple, shifting and conflicting economic priorities

In reaction against the depression and unemployment of the 1930s, for more than a quarter century after the end of the Second World War the governments of Europe pursued policies that gave priority to economic growth and full employment. These priorities were relative, not absolute, for price stability and a favourable balance of payments were also valued. While governmental managers of the economy viewed Keynes' theory as making monetary policy instruments a means to economic growth and full employment, they were prepared to shift monetary policies when the pursuit of these goals threatened inflation or a balance of payments crisis.

In recognition of the interdependence between economic goals, most European countries developed formal or informal institutions intended to reduce conflicts or facilitate trade offs. In Austria, where a conservative-socialist coalition was the norm and posts in government were divided in proportion to party ties, the central bank, the spending and taxing departments of central government, the trade unions, and business interests could seek to coordinate policies in order to maintain a balance in pursuing a multiplicity of desirable goals. By contrast, the British government did this through "stop-go" policies involving increasingly large swings in interest rates. Many governments practised "one-eyed Keynesianism", that is, running a budget deficit when this was the appropriate Keynesian policy to promote full employment and continuing to do so when it was not. In the extreme, Italy ran a deficit for 25 consecutive years from 1951 to 1975, and over the years governments of both left and right more often had deficits than balanced budgets (Rose and Peters, 1978: 138ff).

The eruption of stagflation in the mid-1970s led to a major structural shift in the political priorities of economic policy. Double-digit inflation made price stability the primary political goal in societies where everyone was affected by high rates of inflation and fewer were directly or indirectly concerned about unemployment or low rates of economic growth. The revolution in economic priorities and paradigms was symbolized by the readiness of Margaret Thatcher to take responsibility for double-digit unemployment in the early 1980s in order to bring inflation down to a single digit number. It was confirmed by the failure of demand-stimulus policies pursued by François Mitterrand after his election as French president in 1981. The consistently low inflation rate of Germany became the beau ideal of economic policymakers. Given the monetarist bias of central bankers, an independent central bank on the German model became regarded as the best means of institutionalizing a strong commitment to price stability.

The European Central Bank was established in the 1990s by politicians who were reacting against the inflation of the previous decades. To say that the ECB was designed to fight the last war is an exaggeration, since money supply is an ongoing responsibility of government and global markets trade currencies around the clock. Yet its creation did reflect a rejection of earlier policies. Moreover, the establishment of the ECB was part of a process of strengthening European institutions against national institutions after the fall of the Berlin Wall and the re-unification of Germany in 1990, and it was consistent with goals of the Single Europe Market (cf. Dyson, 2002). When low rates of growth are evident in many Eurozone countries, growth can replace price stability as a political priority, but not as the priority of the ECB. Thus, there is a danger of one-eyed monetarism replacing one-eyed Keynesianism. Barry Eichengreen expresses 'a slight fear that the ECB looks at the world through a rear-view mirror' (quoted in Barber, 2001).

The creation of the ECB was the culmination of a sequence of events that have shifted political priorities greatly, but the shift has not meant the repudiation of such goals as economic growth and promoting employment. Preparations for entry to the European Monetary Union and, in the case of outsiders, debates about whether or not to join EMU focus attention on choices between competing priorities. The balance sheet of consequences invariably shows a mixture of costs and benefits – and in some cases the costs are short-term while the benefits are longer term. A mixture of consequences raises questions about the distribution of costs and benefits within as well as between countries. Interpretations can vary too. As Dodd (2001: 32) notes, 'Economic convergence is generally taken to refer to inflation in Germany but is more likely to mean income and growth in Portugal, Greece and Ireland'. Differences in interpretation are likely to expand with EU enlargement.

The clear and overriding priority of the ECB – price stability – strengthens the impact of its activities,[2] for '*organization is the mobilization of bias*. Some issues are organized into politics while others are organized out' (Schattschneider, 1961: 71; italics in the original). But the narrow focus of the ECB is a weakness when policymakers have multiple goals and institutions and shifting priorities.

III Priorities across space

The first priority of an elected government is to its national electorate, a point that can be overlooked by officials of institutions that do not depend on popular election for their authority and legitimacy. Yet it is a *reductio ad absurdum* to claim that election enables government to do 'what the people want'. Once in office, elected governors quickly learn that, as a British Treasury minister once said to me, 'The laws of economics that we studied in school haven't been suspended just because we are in office'. On the other hand, it is the height of arrogance to claim, as a very senior British civil servant has done, 'the Treasury stands for reality'. In political economy, there is more than one reality. The foreign exchange market is itself witness to this fact, for in any given day's trading there are buyers and sellers, and losers as well as winners.

Governors of small countries are under no illusion about power relationships. While entry to office depends on national election results, economic success depends on what happens in the economy of Europe and internationally. By entering EMU, small countries such as Austria are no longer on the outside when decisions are made in Frankfurt by the *Bundesbank* of the Federal Republic. They gain an insider's seat at the table in Frankfurt when the European Central Bank takes decisions. Visibly shifting the locus of decisionmaking to a foreign country can appear, at least to many Britons, as a political debit, a loss of "sovereignty" or at least of the appearance of sovereignty. But in small countries, such as Austria and Ireland, the opposite argument can be made: membership in the ECB gives national officials a chance to be present when monetary decisions with a major impact on national policies are made abroad. The foreign locus of decisionmaking also creates opportunities for displacing or at least sharing blame when politically unpopular decisions are taken. National officials can criticize ECB decisions in their national political arena whilst acquiescing privately in Frankfurt. For a coalition government, passing monetary decisions to an intergovernmental agency avoids disputes that can disrupt a national coalition.

Governments of a country with a big displacement in international financial markets may act like a hegemon, imposing their national policies in ways reaping national benefits and externalizing costs. After a group of Harvard and Yale economists offered advice to the United States Secretary of the Treasury about how to deal with the international implications of the dollar going off gold in 1971, John Connally explained, 'Gentlemen, I look at it this way. Either those foreigners are gonna screw us or we're gonna screw them, and I want to be sure that we screw them first' (quoted in Odell, 1982: 263). Europe, however, has no financial hegemon. While the *Bundesbank* may be an institutional paragon to monetarists, the debilitating effects of financing five East German lands, combined with the slowness to adapt of the German economy, has deprived the largest economy in Europe of the resources to act like a hegemon. And Britain and France demonstrate that governments of large European countries have differed in assessing the advantages and disadvantages of membership in EMU.

From a global perspective, the euro is a regional currency along with currencies issued by the United States Federal Reserve Bank and the Bank of Japan. Moreover, the economy of its member-states makes it much bigger than Japan and it is similar to the United States in population and wealth. The euro can offer intra-regional currency stability, but not global stability. Another way of describing the position is that the euro is now vulnerable on two sides, for its value can be unilaterally influenced by what happens to the dollar and/or to the Yen. For countries such as Britain, which have a substantial tie to the dollar as well as to the Eurozone, there is now the risk of being hit by negative changes in both currencies, or seeing gains in one currency offset by losses in another rather than producing a win-win outcome.

From a global perspective, fighting inflation is only one among a multiplicity of concerns. When military action occurs, then the dominant actor is not in Europe but in Washington. The Gulf War of 1991 and September 11, 2001 were events with an absolute priority for political decisionmakers. When international security is the issue, then the primary security reference point is NATO, whose membership and power structure is very different from that of the ECB, for the United States is the hegemon in NATO but outside the Euro zone.

IV Priorities across time

'A week in politics is a long time' was the motto of British Prime Minister Harold Wilson. By contrast, a treaty commitment to the European Monetary Union is a very long-term commitment. The adoption of the euro as a country's currency makes national currencies such as the Deutsche Mark and the French franc part of the historic past. Moreover, it creates a great obstacle to reversion to the *status quo ante*, because, if a member-state decided to withdraw from the euro it would not be able to revert at once to the national currency that it has abandoned.

The contrast between the time span of a politician such as Wilson and treaty commitments emphasizes that the duration of the span of time chosen in evaluating currency zones is critical. A comparison of year-on-year rates of inflation or growth is very vulnerable to short-term fluctuations in economic conditions. As Rollo's (2002) comparison of the economic performance of Britain and Germany shows, a very long-term comparison over several decades tends to favour Germany, while a short-term comparison over the past decade tends to favour Britain.

A half century ago the founders of the European Coal and Steel Community, the precursor of today's European Union, did not justify the Community by econometric calculations of pecuniary costs and benefits. Instead, the case rested on a comparison with an all too familiar past, in which two world wars had been fought and lost in one sense or another by both Germany and France. On that basis, the Schuman Plan was adopted to integrate the materials of war in the belief that this would prevent the outbreak of a Third World War.

As long as the European Central Bank was an idea, any evaluation of its consequences was necessarily prospective and speculative, for there was no historic record on which to base a judgment. Judgments could draw on historical analogies, simulations based on data from the past and/or theoretical deductions, each of which is necessarily contestable. The situation offered a field day for politicians who wanted to impose their political values, hopes and fears upon a fluid situation. It also offered great scope for theoretical economists who could deduce consequences from first principles without risk of evidence contradicting their conclusions.

Even after the euro has gone into general circulation, it is still too early to tell how much difference the new currency makes to national economic performance. Insofar as unexpected events have an impact, then after half a dozen years or more evaluations of the euro's impact will be qualified by a *ceteris paribus* clause that ignores the fact that all other conditions have not remained equal. Even after a period with no eventful interruptions, analysis of the effects of the ECB must involve comparison with a speculative notion of what national economic performances would have been in the absence of EMU.

The powers that the ECB was endowed with in order to give credibility to the euro at its launch have created a situation in which future developments are more likely to threaten than augment these powers. Incipient conflicts are already evident between the priorities and performance of national governments and standards for price stability. Differences between the German government in Berlin and the European Central Bank in Frankfurt are particularly striking, in view of the Germanic foundations of the EMU system.

The enlargement of the European Union will bring in Central and East European countries that have not had the experience of current

EMU members in balancing conflicting political and economic pressures in a democratic market system. Admitting up to ten or more countries will increase the size of ECB committees in which all member countries are represented (cf. Baldwin et al., 2001). The one populous enlargement country, Poland, cannot claim an impact on the European economy comparable to large EU member states (cf. Kokoszczynski, 2002). Even if the numerical representation of smaller countries becomes limited in executive committees, the greater the number of new members, the more difficult it will be to render them voiceless. Insofar as current discussions about institutional reform alter the European Union, whether making the Council of Ministers more powerful, strengthening the European Commission or creating an elected EU president, this will strengthen countervailing forces that can be brought to bear against independent decisionmaking by the ECB.

V What would a Politically Optimal Policy (POP) be like?

The readiness of economists to pronounce on the characteristics of an optimal currency area (OCA), whether that of a single country or a multi-national trading bloc, is encouragement to outline a Politically Optimum Policy (POP) for the government of an EU member-state. From the foregoing, it would:

- Deliver short-term benefits, whatever the long-term costs, for it is easier for politicians to get agreement about immediately visible benefits than to secure assent to paying immediate costs in return for hypothetical future benefits – especially if benefits accrue after rather than before a general election.
- Juggle multiple goals – political AND economic – for the priorities of politicians alter with the political situation, for example, the proximity to an election, as well as with the economic situation. From this perspective, an independent bank is *un*desirable, insofar as it avoids engagement in multilateral negotiations leading to trade offs that accommodate competing policy goals.
- Allow "fudging" the numbers by which a country's economic performance is evaluated so that when facing difficulties a national government can accommodate multiple political and economic priorities. This is already happening. In its February, 2002 *Monthly Bulletin*, the ECB expressed worry that national governments were succumbing to the 'temptation to improve artificially the current budgetary position by means of accounting measures that should be resisted'.

- Make incremental and reversible choices, with policymaking proceeding on a trial and error basis, in which measures showing signs of progress can be maintained and those that are not abandoned (cf. Braybrooke and Lindblom, 1963). An incremental approach to policymaking rejects commitments to a single goal and holistic plans without regard to feed back indicating progress or failure.

The hallmark of a politically optimal policy is *flexibility* in relation to the pursuit of multiple goals in an ever-changing political and economic environment. By contrast, the key characteristic of the monetary policy of the European Central Bank is a *fixed* commitment to price stability in all circumstances. This is shown, for example, in its inflation target being a ceiling which only tolerates undershooting rather than a symmetrical target permitting an equal amount of going above and below the target. In a larger context, a fixed commitment to a single economic goal fails to be politically optimal, when the aims of economic policy are multiple and, as Neustadt reminds us, public choices about the economy are above all political choices.

NOTES

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2 Compare the description of a British monetary economist as being like a 15-year-old who had invented the atom bomb and wanted to apply his new invention to everything in sight.

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