Goodhart, Charles A. E

**Article**

# The Political Economy of Monetary Policy Decisions

Kredit und Kapital

**Provided in Cooperation with:**
Duncker & Humblot, Berlin

*Suggested Citation:* Goodhart, Charles A. E (1988) : The Political Economy of Monetary Policy Decisions, Kredit und Kapital, ISSN 0023-4591, Duncker & Humblot, Berlin, Vol. 21, Iss. 1, pp. 1-7, https://doi.org/10.3790/ccm.21.1.1

This Version is available at:
https://hdl.handle.net/10419/293101

# The Political Economy of Monetary Policy Decisions*

By Charles A. E. Goodhart

*Mayer* (1987) seeks to bring the analysis of Central Bank decision-making within a political-economy framework. This is a worthwhile approach, if only because there is a difficult and important question to be resolved, which is why the Central Banks generally acquiesced in the continuation of inflation in the 1960s and 1970s. Mayer suggests four possible, though not mutually exclusive, reasons: political pressures, Central Bank self-interest, X-inefficiency due to the absence of a 'bottom line' and time-inconsistency problems.

Let me start by concentrating on *Mayer*'s treatment of political pressures. In this passage on "Relaxing the Keynesian Political Assumption", pages 286 - 7, Mayer treats political pressures as inherently liable to cause inefficiency and excessive expansion. Thus, he writes, page 286, "But once one drops the assumption that the central bank is efficient and that it is not affected by its own bureaucratic self-interest or by political pressures, then the monetarist case becomes much stronger that before. Suppose that, perhaps due to political pressures, the central bank wants to adopt a too expansionary policy." Indeed, Mayer appears to take the view that the public interest in having an efficient monetary policy and political pressures are in conflict with each other. This is, on the face of it, rather odd, however, since, in a democratic system, we elect politicians to act on our behalf in the public interest. How then can their interventions be systematically against the "public interest", when we elect them to represent our interests?

Having raised this question, I shall offer a number of possible answers, some of which *Mayer* also touched upon. The first line of argument that I shall explore is one that he did not discuss. This is that there are some fundamental differences between the distribution of resources that results from a free market system as compared with the distribution resulting from a political allocation. In the former, players use their inherited, and most definitely unequal, endowment of human and non-human capital to make freely chosen trades. No one can be coerced but the initial and final distributions

---

* See *Thomas Mayer:* "The Debate About Monetarist Policy Recommendations," Kredit und Kapital, 20, 1987, 281 - 302.

are unequal. In the political calculus, everyone has, or is supposed to have, an equally weighted vote; the majority can then coerce a minority, via taxation, to part with a proportion of their income or assets in a manner that the minority would not voluntarily choose to do. If the distribution of incomes or wealth is skewed, as is the case in reality, then unless the wealthy minority can persuade the poor majority that such redistribution will damage their own interest, eg by reducing supply side incentives to effort, risk-taking, etc., the rational political pressure will be for coercive redistribution. A combination of full employment, raising the bargaining power of labour, and high inflation, taxing the rentier to the point of euthanasia, might seem an excellent recipe for redistribution via the political system. In practice, inflation has probably occasioned a redistribution from the old, the pensioners, to the younger workers, rather than from the rich to the poor. But in either case the labour unions, who provide much of the support for redistributive governments, find their members benefiting.

There is nothing irrational, nor necessarily inefficient, about such a political process of redistribution. Yet I guess that, au fond, most monetarists dislike the political process because they believe that such potential redistribution based oncoercion is in some "moral" sense wrong and worse than the distributions arising from a free market outcome. Thus, they always suspect the politicians, elected on a one person-one vote basis, will be "excessively expansionary" because that policy will be expected to redistribute income or wealth to the poor majority from the rich minority.

*Mayer* does not address this first issue at any length. He claims in the opening Section that political pressures will lead to inefficiency and excessive expansion without giving any explanation why this might be so. Then, in the Section on "Policital Pressures as Explanations of the Fed's Errors", pages 292 - 4, he back-tracks: thus, he writes,

> "Whether or not the central bank should be more or less closely controlled by elected officials is a complex issue ... Perhaps independence is inconsistent with the democratic ethos."

A second set of reasons why political pressures may not be in the public interest, i.e. inefficient and excessively expansionary, may be due to faults inherent in the political system itself. We are a democracy only on election days; the voting public may be gullible and misled; there are too many issues being considered simultaneously; etc., etc. I am inclined to dismiss such arguments. Economists have found the concept of rational expectations useful in analysing markets; should we not then analogously assume that voters make efficient use of all available information to cast their own votes rationally? If we believe in a rational expectations market equilibrium,

should we not also assume a rational expectations democratic voting outcome?

The third reason that may be advanced to account for the adverse effect of "political pressures" is political myopia, with "The most dramatic example of this [being] the political business cycle". Essentially, the problem is that the subjective time rate of discount of politicians rises above that of the electorate as a whole as elections approach. For reasons set out in the time inconsistency literature, *Kydland* and *Prescott,* (1977), *Barro* and *Gordon,* (1983 a and b), *Barro* (1986), politicians are led to renege on their previous low monetary growth/low inflation promised rules to cause surprise monetary (and temporarily real) expansion. The public comes to expect this, however, and eventually a reputational equilibrium may be achieved where the penalties imposed by a somewhat unforgiving and unforgetting electorate in the form of lower future voting support following an inflationary burst just offsets the benefits foreseen by the politicians in the immediately forthcoming election from more surprise expansion now, see *Barro* and *Gordon* (1983).

An independent Central Bank will not be subject to the same political myopia and its own subjective rate of time discount will presumably be closer to that of the public. Its presence should then raise the cost to a government seeking to bring about a surprise monetary expansion: consider headlines such as "Governor of Bank Warns of Inflation: Chancellor Sacks Governor". In so far as the government voluntarily delegates some of its undoubted powers to determine monetary policy to a somewhat independent body (the Central Bank), it represents a public precommitment to a rule that the government will not manipulate policy to its own short-term benefit.

This view of a Central Bank, as trying to maintain the government's reputational credibility in a world full of political time inconsistency problems, may throw some light on issues of Central Bank independence. Some economists, eg *Parkin* and *Bade* (1978), also see *Frey* and *Schneider,* (1981), suggest that such independence may lead to better monetary/inflationary control; there is, however, more than a little simultaneity here. The greater the voting public's inherent dislike of inflation, the greater the cost to politicians of reneging on conservative sound policies, so the more they will delegate power to a Central Bank. Inflation is not low in West Germany because the Bundesbank is independent. Instead, both low inflation *and* Bundesbank independence are caused by the strongly anti-inflationary preferences of the West German electorate. As *Mayer* notes, the comparative strength and independence of the US Fed depends on the political constituency that the Fed can really behind itself. Whatever the formal constitutional position

of each Central Bank, its ability to undertake policies that will stabilize prices depends ultimately on the broad political support for such policies. Moreover, the comparative "success" of a Central Bank cannot really be assessed in terms of a single uni-dimensional measure such as monetary growth or inflation but has to be reckoned against the wider economic, social and political background that presents each Central Banker with the hand that he plays. Certainly, the Swiss National Bank and Deutsche Bundesbank have had the best results but were they dealt an easy hand full of "political and socio-economic" aces? It is, inmy view, arguable that the most remarkably successful Central Bank of recent years has been the Banca d'Italia, which has done wonders for maintaining financial and economic stability inthat country despite being dealt a poorish hand.

Reverting to the time-inconsistency problem, *Mayer* tends to be dismissive of its importance. I think that he is wrong in this respect. Thus, I have already argued that the political myopia (political business cycle) problem is basically one of time inconsistency. Also, my own experience in the Bank of England makes me tend to dismiss summarily most of the claims about Central Bank "self-interest" or inefficiency and to see practical validity in time-inconsistency problems.

For example, in the normal Keynesian forecasting format inthe UK, it has been generally difficult to forecast movements in wages, productivity, exchange rates and commodity prices other than on the basis of sluggish auto-regressive tendencies. Usually, these variables are forecast on the basis of some starting assumption, eg about the wage round, trend productivity, etc. Then, apart from productivity, it has been difficult to calculate how these variables would respond in the short run to demand-side changes. So, the assumption was generally made that the rate of inflation and price expectations would remain fairly stable in the short run. Against that background, the short run advantages of higher demand and output seemed obvious; the potential disadvantages offuture worse inflation hazy, distant and even in some case disputed.[1] So, the mode of Keynesian forecasting, as practiced in both the Treasury and the Bank of England in the 1960s and 70s, led to a standing temptation to give up any policy rule in favour of short-term expansion while, of course, continuing with the rhetoric about maintaining sound, non-inflationary policies.

The one example of time inconsistency that *Mayer* does find plausible is that proposed by *Poole* (1986). In this case, the public is myopic, placing

[1] E.g. higher demand causes higher investment, which raises productivity owing to greater, and more modern, capital per worker.

"undue" weight on current problems, whether these be inflation or unemployment. I have some difficulty, however, with this example. Is the supposed behaviour of the public consistent with rational expectations? Experience should make the public aware that monetary expansion to relieve unemployment today will cause inflation tomorrow, which they will then dislike just as much asthey dislike unemployment now.[2] So, this particular case would seem to imply some irrationality or failure to learn. It is, perhaps, possible that the majority of the electorate really do have such a high rate of subjective time discount that they do not care what is likely to happen in the future, even though their expectations about the future are rational. I find that very hard to believe but, if it were true, I do not quite see on what principles the authorities should seek to optimise conditional on their own (assumed lower) rate of time discount in place of the public's. If the electorate want some course of action initiated, in the rational expectation of what will follow from that, why should the political authorities not acceed to such wishes? Of course, rational expectations may not be such a sensible starting point either in economics or in politics, but that is a rather wider issue.

Where does all this get us? First, I think that *Mayer* should have noted that one cause of political pressure for more expansion can arise from a rational desire of the majority of the electorate to redistribute wealth from the rich rentier to the poor worker. Second, I would myself place the major responsibility for the authorities' apparent drift into stagflation in the 1970s on the time inconsistency problem, though this does take various guises. Third, my personal experience leads me to dismiss the "self-interest" or "X-inefficiency" theories as being far-fetched and without foundations.

One final point should be mentioned in passing. When discussing the problems for monetary targetry arising from variable and unpredictable velocity, *Mayer* page 291 suggests that "there exists a variant of the monetary rule that avoids most of the damage done by a change in the trend of velocity. This is a rule that adjusts the monetary growth rate in accordance with prior changes in velocity". This would only help if changes in velocity exhibit positive auto-regression, iethat in the equation,

$$dVt = a + bdVt - 1$$

$b > 0$. Although this is probably true, why not use an optimal forecast for future $V$, rather than a ramshackle forecast? Presumably, given the forecast

[2] And if experience does not lead to such awareness, perhaps economic commentators should do the job.

money stock, a nominal income target inherently incorporates an "optimal" forecast of *V*. So, once again, such a revised rule would seem to throw away potentially useful information with abandon.

## References

*Barro,* Robert: "Recent Developments in the Theory of Rules versus Discretion," Economic Journal, Supplement, 96, 1986, 23 - 27. – *Barro,* Robert and David *Gordon:* "Rules, discretion and regulation in a model of monetary policy," Journal of Monetary Economics, 12, July 1983, 101 - 102. – *Barro,* Robert and David *Gordon:* "A Positive Theory of Monetary Policy in a Natural Rate Model," Journal of Political Economy, 91, August 1983, 589 - 610. – *Frey,* Bruno and Friedrich *Schneider:* "Central Bank behavior: A positive empirical analysis," Journal of Monetary Economics, 7, May 1981, 291 - 316. – *Kydland,* Finn and Edward *Prescott:* "Rules rather than discretion: The inconsistency of optimal plans," Journal of Political Economy, 85, (June 1977), 473 - 91. – *Mayer,* Thomas: "The Debate About Monetarist Policy Recommendations," Kredit und Kapital, 20, 1987, 281 - 302. – *Parkin,* Michael and Robin *Bade:* "Central Bank laws and monetary policy", Paper presented at the Fifth Interlaken Conference on Analysis and Ideology, June 1978, unpublished. – *Poole,* William: "Monetary Control and the Political Business Cycle", Cato Journal, 5, Winter 1986, 685 - 700.

## Zusammenfassung

### Die politische Ökonomie geldpolitischer Entscheidungen

*Mayer* (1987) behauptet, daß eine Zentralnotenbank diskretionäre Geldpolitik nicht effizient durchführt, und zwar aufgrund „des politischen Drucks, des Eigeninteresses der Notenbank und des Potentials für X-Ineffizienz". Dieser polit-ökonomische Ansatz kann erhellend sein, aber Mayer setzt sich nicht eingehend genug mit der Art solcher politischen Zwänge auseinander. Eine Ursache für politischen Druck kann der Wille der Mehrheit (ärmerer Arbeiter) sein, Vermögen zu Lasten der Reichen umzuverteilen. Nach meiner persönlichen Erfahrung sind die Theorien des „Eigeninteresses" und der „X-Ineffizienz" zu verwerfen. Ich würde Problemen der Zeitinkonsistenz mehr Gewicht beimessen, als Mayer es tut.

## Summary

### The Political Economy of Monetary Policy Decisions

*Mayer* (1987) claims that the Central Bank does not operate discretionary monetary policy efficiently owing to "political pressures, the central bank's self-interest and the potential for X-inefficiency". While this politico-economic approach can be illuminating, Mayer does not specify in sufficient detail the nature of such political pressures. One cause of such pressures may be a desire of the majority, of poorer workers, to redistribute wealth away from the rich rentier. While my personal experi-

ence leads me to dismiss the "self-interest" and "X-inefficiency" theories, I would put more weight than Mayer on time-inconsistency problems.


## Résumé

### L'économie politique de décisions de politique monétaire

*Mayer* (1987) affirme que la banque centrale ne pratique pas une politique monétaire discrétionnaire de façon efficace, à cause de «pressions politiques, de l'intérêt propre de la banque centrale et du potentiel d'inefficacité». Alors que Mayer peut expliquer l'approche politico-économique, il ne spécifie pas de façon suffisamment détaillée la nature de telles pressions politiques. Celles-ci peuvent s'expliquer entre autres par le désir de la majorité des pauvres travailleurs, de redistribuer la richesse, loin du riche rentier. Mon expérience personnelle me faisant repousser les théories de «l'intérêt propre» et de «l'inefficacité», je mettrais plus de poids que Mayer sur des problèmes d'incompatibilité temporelle.