Competing Commitments: Technocracy and Democracy in the Design of Monetary Institutions

John R. Freeman *
University of Minnesota
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Some years ago, the noted economist Jan Tinbergen proposed his Theory of the Optimum Regime (1959, 1963, 1972). The Optimum Regime is a bundle of institutions designed to maximize social welfare. Politicians, according to Tinbergen, produce “doctrinal deviations” from this regime. Citizens therefore should defer to “economic thinkers,” social scientists who are “less emotional” and clearer headed than their elected officials. While the struggle between economists and politicians might take some time to resolve and the actual makeup of the optimal institutions may vary slightly from country to country, Tinbergen was confident that eventually all countries would converge on this regime. In the minds of some observers, the recent reforms in central bank institutions and current trend towards the liberalization of national economies show that this convergence is occurring. ¹

This special issue is, in a sense, an extension of this work, but an extension that treats politics much more seriously than Tinbergen. The authors are expressly concerned with institutional design, especially the design of two monetary institutions: the degrees of central bank independence and of exchange rate commitment. Their

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¹ For a presentation and critique of idea of convergence in institutional choice see such works as Ellman, 1980.

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analyses explicitly incorporate political variables. For them, the key to understanding the origins and consequences of today’s monetary institutions lies in the interplay of political and economic forces. Where their investigations differ, is in the extent to which the welfare implications of institutional designs are implicit or explicit. For some writers (Clark, Halleberg, and Bernhard and Leblang), the emphasis is more on the motivations of politicians and less on the macroeconomic consequences of their policies. For others (Broz and Keefer and Stasavage) the focus is on the impacts of alternative institutional designs on inflation, growth, and competitiveness. Together, the papers show not only that political institutions must be incorporated in any optimum regime, but also that this choice is best made on the basis of a careful analysis of the motives and strategies of both politicians and economic agents.

The special issue represents a significant advance over the more interpretive and heuristic studies of the 1970s and 1980s. Out of it emerge much deeper insights into the politics of institutional design. The papers offer an explanation not only of why elites choose a combination of central bank independence and exchange rate policy but also why certain political institutions are chosen along with these combinations. In this sense the special issue produces a much more complete and politically informed characterization of the optimal regime than Tinbergen and others could imagine. The pieces by Broz, Keefer and Stasavage, and Hallerberg are noteworthy because they explain the rationale for and design of democratic institutions that must accompany monetary commitments. In addition, the papers take a first step towards explaining some of the welfare consequences of regime choice especially with respect to prices.
The normative significance of the special issue lies in its results about the macroeconomic consequences of regime choice and also in the larger implications of the results for democratic politics. Contributions like those of Franzese are valuable additions to the debate about the “room to maneuver” that remains for the governments in advanced democracies—the degree to which officials in one country can choose a distinctive mix of welfare outcomes for their citizens relative to that which the officials in another country choose (e.g., Garrett, 1998; Rodrik, 1997, 2000). But the main purpose of the special issue is to inform the choice of monetary institutions. And, in this respect, the papers’ significance lie in their support for monetary technocracy. The special issue shows how democracy can be designed to create and protect monetary authority, authority based on benign technical expertise rather than malign, self-interested or “doctrinal” electoral manipulation. In this sense, the volume is a valuable extension of Tinbergen’s theory.

This essay refines and expands the agenda for this project. It first evaluates the analyses and research designs in the papers. Out of this evaluation emerge some ideas about how to produce a “third generation” of research on this topic, more specifically, about how to broaden the welfare criteria on which institutional choices are made, deepen the political analyses on which the choice of institutions is based, and strengthen the tests that are offered in support of these choices. The questions of how and if popular sovereignty over economic policy and institutional choice is achieved are explored in the second part of the essay. This part shows that the optimum regime proposed in the special issue is, in a sense, democratic as long as the public’s “perceived consensus” about economic policies and macroeconomic outcomes is real.
However, if, as new work suggests (e.g., Scheve, 2001), there, in fact, is genuine
dissensus about policy and macroeconomic objectives, it is no longer clear that the
optimum regime is a democratic one. This leads to a discussion of the possibility of a
crisis in imagination in institutional design in the conclusion to this essay.

Advancing The Research Program

The special issue is motivated by important facts and questions. Foremost among
these facts are recent episodes of central bank reform in such countries as the U.K.,
New Zealand, and Italy. Less emphasized is the fact that there have been few reversals
in central bank independence (Clark, p. 19). In fact, Keefer and Stasavage do not
discuss any episodes in which authorities have reneged on their decisions to make
central banks more independent. This suggests that the arrangements these authors
describe are designed to prevent reversals. To the believers in an optimum regime, this
is evidence of convergence on central bank independence.

But the questions that motivate the volume are more complex than this. The
authors seek to understand why central bank independence is chosen in combination
with (1) a particular kind of exchange rate commitment and (2) a set of expressly
political institutions—Institutions that help enforce the joint choice of monetary
commitment technologies (especially Broz, Hallerberg, Keefer and Stasavage). The
implication is that the political institutions are essential parts of the bundle of
institutions that make up the most preferred regime.

The papers are based on common understandings about the workings of the
economy and polity. The former include what in economics is called the neo-classical

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2 The investigations are clearly rooted in what in political science might be called a neo-liberal
perspective. The need for government intervention in markets and the existence of genuine
model of inflation and the time inconsistency of optimal plans. These essentially are the bases for seeking monetary commitment technologies (Bernhard, Broz, and Clark). Also important are the Mundell-Fleming conditions for open economies. The presumption is that capital mobility now is a given, so there are really only two choices available to countries: monetary autonomy or fixed exchange rates (Clark).\(^3\) Again, the question is which of these two alternatives is preferable and which political institutions best support this choice. As for democracy, the papers are rooted in conventional understandings about the workings of the respective institutions. The properties of majoritarian versus consensual government, federalism, interest group politics, the separation of powers and other political institutions are taken as axiomatic by the researchers. For example, Hallerberg (p. 4) invokes familiar spatial reasoning to explain the power that veto players exert. Among the ideas that bind the papers together in this regard is “transparency.” This is the notion that democratic politics is an inherently effective means of revealing information, especially about rent-seeking. Democracy’s virtue lies in its ability to reveal elected officials attempts to tamper with the authority of what are benign monetary authorities (Broz, Keefer and Stasavage). The challenge is to design democracy so that transparency is enhanced and, at the same time, the

\[^3\) The omission of capital controls is one reason the volume emphasizes choices for developed rather than emerging democracies.

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(intragenerational) distributional conflicts are taken as given. Politics is equated with struggles over the intragenerational distribution of wealth, struggles between among groups not classes (Bernhard, Broz, and Clark, pps. 1, 17; Hallerberg, p. 11). Politicians are motivated by the desire to remain in office and, in one case at least, enhance the growth rate of real income rather than (un)consciously serve any class interests (Bernhard and Leblang). The optimum regime is discovered by elites apparently through some dialogue with these self-interested politicians. An example of the tendency to equate politics with distributional struggles is Hallerberg’s argument that “an independent central bank is a device to assure that explicit political manipulation of the money supply does not occur” (p.11). My conception of liberal (classical and neo-liberal) approaches as distinct from so-called radical or critical approaches to political economy can be found in Democracy and Markets, (1989) Chap. 2. See also footnotes 8, 31 below.
defenders of central bank independence and of the chosen exchange rate policy have effective veto power over any attempts to renge on monetary commitments.

How can this research be advanced still further? On what questions and issues should the “third generation” of studies focus?

**Toward a Better Interdisciplinary Synthesis.** Work in this genre would benefit from incorporating additional ideas from economics. For example, studies of exchange rate politics should employ more explicitly what we know about the way exchange rates adjust to policy changes, e.g., the so-called J curve. Delays in adjustment can be exploited by politicians to produce cycles of overvaluation (van der Ploeg, 1989). Also, we know that the effects of fiscal policy are diminished in open versus closed economies. This is because some of increases in spending eventually “leak out” of the economy in the form of imports. This means that whereas, in some respects, fiscal policy may be a more effective electoral tool than monetary policy (Clark), its effectiveness in this regard may diminish as countries’ economies become more and more open to international trade and financial flows. These features of open economies should be incorporated in future analyses of institutional design.

Equally important is the economic research on expectational mechanisms and information processing. The special issue draws from the research on central bank behavior in only the most general sense. Few of the authors take up the challenge of analyzing the “expectational mechanisms” (Barro and Gordon, 1983a,b) that govern the relations between economic agents, political agents, and monetary policy makers. Yet, it is these mechanisms that lie at the heart of the causal relationships that determine the behavioral and welfare implications of regime choice. This includes the effectiveness of
central bank reforms vis-à-vis inflationary outcomes. We need to learn more about how politics is related to these expectational mechanisms and the reputational equilibria with which the mechanisms are associated. For instance, Barro and Gordon (1983a,b) show that the discount rate of the monetary authority is a key parameter in its decision rule and hence in determining the type of equilibrium that is established between the monetary authority and private agents. Future research should be devoted to analyzing how this discount rate depends on the workings of democratic institutions.  

New work in information economics potentially is quite important for the study of monetary institutions. This research addresses the question of if it is socially beneficial to have public institutions like central banks publish the results of their analyses (forecasts); if private agents have more precise information of the same kind, dissemination of public information, under some conditions, can be socially harmful (e.g., Morris and Shin, 2001). In a recent study, David Stasavage (2001) argues that, in fact, “central bank transparency”—the practice of central banks publishing their forecasts of money demand—reduces the costs of disinflation, especially if governments are left or center in their partnership. This practice helps private agents learn the disposition of central banks (as well as of what presumably are less-inflation averse politicians). This, in turn, makes it easier for these agents to make quicker and less costly adjustments to disinflationary policies. Smaller output and job losses

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4 Barro and Gordon’s work (1983a,b) looms large in the present volume (Keefer and Stasvage, pps. 4-5,15) as well as in parallel works (Iverson, 1998, 1999). Barro and Gordon offer rich models of the processes whereby expectations are formed by private agents about monetary policy, policymakers choose decision rules and reputational equilibria of various kinds emerge. On the importance of the discount rates of central banks and political actors in determining certain kinds of (reputational) equilibria, see Keefer and Stasavage, 2000: esp. p.2 and fn. 8.
therefore are observed. In this way, central bank transparency can be a beneficial complement to political transparency.

This line of research raises some interesting questions about political transparency, however. To be more specific, an important question is whether the results from information economics extend to political information. For example, is it beneficial for governments and (or) private firms to publish poll results in the run-ups to elections? Interestingly, because of its presumed impact on financial markets, the Taiwanese government recently placed restrictions on just this kind of public information (Lin and Roberts, 2001). This suggests that in some circumstances, this aspect of political transparency might not be desirable. Simply put, the welfare consequences of the dissemination of political information—especially information about the electoral prospects of parties—need to be addressed.  

Finally, economists have devoted much time and energy to studying the properties of financial time series like exchange rates. They have found, among other things, that these series exhibit nonstationary, episodes of volatility that tend to cluster together, and extreme events that occur much often than one would expect if the series are normally distributed (deVries, 1992). They also have found that these series display “break points;” the properties of exchange rate and other series vary across in different

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5 Morris and Shin (2001) argue that when they have (better) information than private agents, the dissemination of information by public institutions like central banks can be welfare enhancing. Unfortunately, they make no distinction between economic and political information. In relation to the arguments advanced by Morris and Shin (2001), Stasavage (personal communication) contends that private agents do not have good information about future money demand; the Federal Reserve and other central banks produce better forecasts of future money demand than private forecasters. Therefore, Morris and Shin’s results about the beneficial effects of public dissemination of information applies. The questions are a) Is the political information in electoral polls and public opinion surveys inherently more imprecise than information about such things as money demand? And, either way, b) Is there reason to believe that private pollsters have better information about future electoral outcomes than public sources of the same information?
eras (Corporale and Grier, 2000; Garcia and Perron, 1996). These essentially experimental results are the basis for the Efficient Market Hypothesis (EMH) and other important economic ideas.

Our empirical work needs to be better informed by this branch of economics. Our reduced forms should make provision for such things as autoregressive conditional heteroscedasticity (ARCH). This will ensure that our estimates are as efficient as possible and, in turn, that our hypothesis tests and counterfactual analyses (Franzese) are accurate. For the same reasons we should test for unit roots and include examinations of kurtosis in our diagnostics. This will help us avoid the problems associated with nonstationarity and illuminate regime switching in exchange rate and other series. Finally our interpretations of our results should acknowledge the EMH as it relates to the processing not just of economic information but also of political information.6

Analytics. The political analyses in the special issue should be strengthened several ways. First, multiparty systems looms large in the investigations of several authors. In fact, one of the main lessons of the volume is that multiparty systems produce veto players and government coalition partners who guard the independence of central banks (Keefer and Stasavage, Hallerberg, Bernhard and Leblang; see also Lohmann, 1998 a,b). The analyses of the workings and stability of multiparty systems is somewhat underdeveloped analytically, however. For example, the authors restrict

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6 Examples of works that are informed by veins of experimental economics include Bernhard and Leblang (forthcoming; 2001), Freeman, Hays and Stix (2001), Hays, Freeman, and Nesseth (2001), and Hays, Stix, and Freeman (2000). The Bernhard and Leblang work grapples with the way politics and political information affects conditional variance in exchange rates; the Freeman, Hays, Stix, and Nesseth studies analyze the impacts of politics and political information have on the probability of regime switching in currency and bond markets.
their investigations to a single policy dimension. As Laver and Shepsle (1996, 1998) have shown, multiparty government are better conceived in terms of multidimensional policy spaces. And, strategy and cabinet stability depend on a complex combination of four factors: the spatial location of parties preferences, policy salience weights, seat distributions, and legislative decision rules. For instance, sometimes parties, by virtue of occupying dimension-by-dimension policy medians, can ensure themselves of membership in a wide range of, if not all feasible, governments. In such circumstances it is not clear that such parties necessarily prefer to increase their vote share (popularity). Similarly, small parties may be more likely to become members of ruling coalitions if they modify their policy positions slightly or even lose seats. These features of coalition government need to be incorporated more fully in the study of veto players and other features of the optimum regime. 7

Second, international politics should be incorporated more fully into the analyses. To their credit a number of authors acknowledge the role which international political factors play in regime choice (Bernhard, Broz, and Clark; Hallerberg, Bernhard and Leblang). They suggest the decision to peg one’s currency to that of another country involves explicit consideration of that other country’s bundle of institutions. It also means that the previous point applies: the “strength” of inflation averse parties in the country to which one pegs is a key element of this decision. Illustrative is the power

7 Government durability may be a function of the four factors Laver and Shepsle analyze rather than of regime choice. Or regime choice may be a cause and a consequence of these same factors. Keefer and Stasavage emphasize the impact of the number veto players has on the tendency to reverse monetary commitments. They (p. 11) seem sensitive to the kinds of factors that Laver and Shepsle analyze. But they do not provide any demonstration in the present paper that the raw number of veto players necessarily captures the existence of very strong parties and other features of stable cabinets. (cf. Laver and Shepsle, 1996: Chapter 5). Although they cite Laver and Shepsle’s work, in fact, Bernhard and Leblang supply no such microfoundations for their analysis of cabinet durability.
which the CDU-CSU enjoyed in Germany—a country to whose currency several
European countries pegged—by virtue of its location at the dimension-by-dimension
median of the respective policy space (Laver and Shepsle, 1996: Chapter 10). There
also is the matter of central bank cooperation and coordination (Kapstein, 1992, 1989).
One suspects that the choice of monetary regime is both a cause and a consequence of
the activities of the epistemic community among central bankers. We need to learn
more about the understandings and political behavior of this community insofar as
regime choice is concerned. Finally, there is the question of regime choice for regional
and international institutions. Hallerberg’s results (p.30) help us understand certain
institutional features of the EU. But none of the papers teach us much about how the
existence of a regional political regime like that embodied in the EU changes the
calculus of the elites who design the regime of a single country. Presumably the
knowledge that political integration is underway and that alternative regional regimes
are being negotiated between a country and its neighbors changes the expected costs
and benefits of monetary commitment technologies. 8

Third, a more complete set of welfare criteria should be employed in evaluating
institutions. The special issue emphasizes the impacts of regime choice on inflation; it
bases the case for central bank independence and exchange rate commitment primarily
on this desideratum. But citizens also care about other macroeconomic objectives like
employment. And, as Bernhard, Broz, and Clark note in the Introduction, the choice of

8 On the institutional design of the EU in relation to that of national regimes see works such as Iversen
different view of why central banks, particularly the American Federal Reserve Bank, is insulated from
electoral forces and of the constellation of interests that central banks serve. See, for instance, Wade and
monetary institutions limits governments’ abilities to stabilize output and create jobs. Moreover, there is much evidence that in these respects, the choice of monetary institutions has different welfare consequences across sectors of the economy. Because of such things as differences in the ability to “pass through” price changes caused by currency movements, different industries suffer to differing degrees as a result of exchange rate policies (Frieden, 2000, 2001). The study of regime choice must be based on broader (welfare) considerations of these kinds.

This amendment will lead to evaluations of a larger set of institutional arrangements. For example, there is a well developed argument that job performance hinges on the design of wage bargaining arrangements. There also is evidence that the abilities of countries to “tie their hands” with exchange rate pegs (Clark, pps. 8, 11,16) depend on the existence of certain kinds of wage bargaining (Hochreiter and Winckler,1995). For these reasons wage bargaining institutions must be included in the optimum regime. Ostensibly this means there are three (Iverson, 1998,1999) or even six (Traxler and Kittel, 2001: Chapter 10) additional options for countries. In all there are (3x4=) 12 or (6x4=) 24 different regimes from which to choose. Unfortunately, because it focuses on only two of these choices, the special issue cannot yet teach us which is the most preferred of these regimes.9

9 Franzese puts the wage bargaining system in his reduced form model (pps. 9, 20, 31). But he does not explain , in the paper in this volume, how it constitutes another “hand on wheel.” Cf. Hall and Franzese, 1998. In his new paper on central bank transparency, Stasavage (2001) analyzes the “sacrifice ratio.” This is the number of percentage points of output (employment) lost per policy induced 1 point reduction in inflation. Again, he finds that this kind of transparency reduces the ratio, especially for left and center governments. Stasavage finds that wage bargaining institutions have no impact on this ratio. However, he
But one current theory argues that the optimum regime is clear. Iversen (1998, 1999, 2000) contends that the choice of wage bargaining institutions is inexorably tied to the choice of monetary institutions and that, in effect, the choice of the exchange rate institution is linked to wage bargaining arrangements. The most preferred regime is “decentralized monetarism” which provides for a hard currency policy, nonaccomodating monetary authority—viz., a high degree of central bank independence and monetary conservativism—and intermediate wage bargaining as distinct from the centralized wage bargaining in Scandinavia and elsewhere in the 1960s and 1970s (Table 1). According to Iversen, decentralized monetarism produces the best performance in terms of inflation and unemployment. The challenge is to show how the results of the present papers are (in) consistent with those of Iversen and, as explained below, how the special issue’s results about the design of democratic institutions complement decentralized monetarism.¹⁰

Research Design The special issue contains papers that employ both mathematical and statistical approaches to institutional design. The former are noteworthy for the multiple equilibria they illuminate. These demonstrations help explain the variety of regimes we observe today (Table 1). As suggested above, the mathematical analyses should be

¹⁰ Iversen equates wage bargaining institutions with currency policies—he maintains the two are highly correlated (1999, pps. 10-12, 168). He stresses convergence on one regime in particular, namely, that which provides for this kind of monetary commitment and intermediate wage bargaining. Using a somewhat different research design and Iversen—e.g., different measures for monetary policy and for temporal units—Traxler, Blaschke, and Kittel (2001: 259-274) find support for Iversen’s thesis but only for the growth in unit labor costs, not for employment or changes in employment. They find that there is some interactive effects of some of their six bargaining modes with monetary policy on these and other measures of economic performance.
extended in certain ways. Learning—Bayesian sequential updating—needs to be more fully incorporated in the set-ups. For example, the analyses could be enriched to allow citizens (voters) to learn over time about their parties’ commitments to certain regimes. Conceivably such an extension could provide insights into why certain “inflationary biases” in money growth (Goodhart, 2001) persist longer in some countries than in other (e.g., because of differences in the learning capabilities of the respective mass publics). Such learning also could be a source of multiple, reputational equilibria. In fact, Barro and Gordon (1983a, pps. 118-120) allude to the possibility that over time private agents learn about the preferences of policy makers. They also note that the length of time over which private agents punish policy makers for cheating may be longer than one period or, that such punishment might be meted out only “occasionally.” These two possibilities could be related: learning about the preferences of monetary authorities and political parties produces extended or sporadic punishment that, in turn, produces multiple, reputational equilibria. ¹¹

In many respects the statistical analyses in the special issue are sound. Illustrative is the care the authors take to analyze the impact of country outliers in particular and of heteroscedasticity in general on their estimates. These analyses could be improved in certain ways, however. To begin with, more attention should be paid to measurement issues. Gochal (2001) recently has shown, for instance, that, because of Berkson measurement error, the impact of central bank independence on inflation is weaker than previously thought. The use of trends or natural rates represents a second important measurement issue. Striving for deeper interdisciplinary syntheses will illuminate the

¹¹ Morris and Shin (2001) study binary action coordination games. The importance of multiple equilibria are stressed by both those authors (check) and by David Stasavage (2001:7)
need for temporal decomposition and the measurement of variables relative to natural
rates of growth and employment. Most of the present papers do not build such a
conceptual bridge to economics in their measures (but cf. Stasavage, 2001).\(^{12}\)

The decisions to employ annual or even multi-year averages of variables as well
as to pool country data are understandable. The focus in many papers is on long-term,
macro relationships. But these decisions have costs. The associated (reduced form)
statistical models provide insights only into the average effects of institutions among a
given sample of countries. The analyses of highly temporally economic and political time
series destroys information and mask break points and, more important, causal
relationships (Freeman, 1989). This is especially true where we analyze intermediate
variables like exchange rates and money supplies or welfare outcomes like prices. Just as
there is value in comparative, historical case studies of central bank creation and reform
(e.g., Goodman, 1992 and Bernhard, forthcoming), there is value in comparative
empirical analyses of individual countries at lower levels of temporal aggregation.
Carefully designed comparisons of political-economic processes in particular countries
can provide quasi-experimental insights into institutional design. When conducted at
lower levels of temporal aggregation, we gain better insights into the way expectational
mechanisms and reputational equilibria operate as well as about the short and medium
consequences of regime choice.\(^{13}\)

\(^{12}\) Also some of the seemingly contradictory evidence about the performance of decentralized monetarist
systems may be due to the use of different measures of central bank authority (cf. Traxler, Baschke, and
Kittel, pps. 259ff).

\(^{13}\) I am much less sanguine than Traxler, Baschke and Kittel about the use of multiperiod averages of
variables (Ibid., p. 25). My reading of the time series literature is that such practice mask causal
relationships (Freeman, 1989). Gochal (2001) makes similar arguments about the pitfalls of pooling. He
advocates the use of reduced form hierarchical models and a Bayesian monte carlo markov chain approach
The (reduced form) models in the special issue force economic and political structures of countries into a single, one-way causal functional form. For instance, none of the papers allow for causal relationships between variables within countries. Several of them use measures for the average value of variables among a set of countries as a shorthand for what are relationships between variables across national polities and economies (e.g., see Franzese). The first practice is indicative of the fact that none of the papers employs even a small scale (simultaneous equation) model of the political economy. The second practice might be adequate for small countries but it is likely to introduce biases of various kinds for large countries like the U.S. and Germany. In the “third generation” of work on this topic, we need to build and analyze more temporally disaggregated multiequation reduced form models for individual countries and/or for the interconnections between countries’ politics and economics. Such models will allow for a richer and more meaningful analysis of the origins and impacts of regime choice.

It also is important that the analytical connections between the mathematical and statistical set-ups in the papers be established. Stochastic elements need to be introduced in the mathematical analyses of commitment technologies and “microfoundations” need to be supplied for the reduced form models used to study this subject. Such amendments have the potential of yielding fresh insights into the nature and existence of game
to gauging (sampling) the coefficients in the respective equations; such a set-up is essentially the same as a complex random coefficients model.

14 Large countries political and economic processes might be exogenous to those of small countries, but small countries processes clearly are not exogenous to those of large countries. The second practice therefore probably creates simultaneity biases in the estimates of the respective models.

15 Keffer and Stasavage (present volume, p. 34) do address the simultaneity issue. However, it is not clear that there use of the Hausman test is adequate here. For example of the kinds of models I am referring to see Quinn (2000) and Ang and Bakaert (1998).
theoretic equilibria between central bankers and elected officials on the one hand, and of avoiding serious misspecification problems on the other. Thus, for example, in a related paper, Keefer and Stasavage (2000) suggest how Franzese’s idea of “multiple hands on the wheel” translates, in the context of a separation of powers, into an equilibrium inflation pattern on which central bankers, the executive, and the legislature agree.\textsuperscript{16}

Extending the mathematical and statistical analyses of monetary institutions in ways indicated above will pose challenges, of course. One of these is tractability; complex, multiequation models can be estimated with maximum likelihood and other familiar methods. But as the scale of the models increase the results often become less and less interpretable (see Freeman, Williams and Lin, 1989). The paucity of cases does make it difficult to study individual regimes. It is true that as the number of cells in Table 1 grows we have fewer and fewer countries we can study to gain insights into to the relative virtues of different institutional designs. Computational analyses of artificial political economies is one way to address this problem. This approach has proven useful in economics in such areas as real business cycle theory. Recently examples of similar investigations have appeared in the field of political economy (Freeman and Houser, 1998; Houser and Freeman, 2001; see also Richards, 2001). Less familiar approaches of this kind must be explored if we are to make progress sorting out the complex array of institutional choices we face.\textsuperscript{17}

\textsuperscript{16} Keefer and Stasavage (2000) study negotiations between central banks, the executive and the legislator. They show how inflations results from certain equilibria decisions among these three agents in a stylized version of consensual democracy. In this way they provide some microfoundations for Franzese’s work as well as for Broz’s argument about political transparency. On the importance of taking into account the biases that strategic decision making produces in statistical models see such works as Signorino, 1999, 2000.

\textsuperscript{17} For more temporally disaggregated experimental studies of relevant political economic processes see Leblang and Bernhard (2000) and Freeman, Hays and Stix (2001), Hays, Freeman and Nesseth (2001) and
Monetary Technocracy and Democracy

The special issue informs the debates about globalization. It helps us gauge the extent to which alternative institutional arrangements give governments more or less capacity to shape macroeconomic outcomes. In this sense the papers help us characterize one leg of the so-called “political trilemma” (Rodrik, 2000)\(^{18}\). But, is this capacity consistent with popular preferences? The fact that certain regimes afford authorities more “room to maneuver” does not mean that society’s most preferred blend of welfare—intragenerational and intergenerational—necessarily has been achieved, let alone that it has been achieved in a way that preserves democratic processes and values.

The special issue suggests explicitly or implicitly that this capacity is best achieved through monetary technocracy. The papers take as given the conventional wisdom that democracy is ill-suited to the making of monetary policy. The motivations of elected officials are such that they consistently “distort” what would otherwise be “optimal monetary policy” thereby creating unnecessary, harmful levels of inflation, reduced output, etc. For example, elected officials, create unnatural macroeconomic fluctuations (cycles) that are socially harmful (Franzese; see also Goodhart, 2000). As channels for the expression of popular sovereignty over monetary policy then,

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Hays, Stix, and Freeman (2000). What I am advocating is the study of small scale, structural models with rational agents and stochastic elements; calibration and simulation are the main methods used in such an approach (Freeman and Houser, 1998; Houser and Freeman, 2001). This is not the same case study approach discussed by Gochal (2001, p. 9).

\(^{18}\) Rodrik (2000) proposes a political trilemma akin to the Mundell-Flemming conditions. Rodrik argues that two of the following are possible: the nation-state, internationally integrated national economies, and mass politics (democracy). Since, like the authors of the special issue, Rodrik considers the second condition a given, the choice is between preserving the nation state and having limited “room to maneuver” and creating world federalism that with one political jurisdiction would allow mass politics to have greater impact on the making of economic policy and macroeconomic outcomes. Cf. fn 31 below.
legislatures and other representative institutions are of limited value: at best these
institutions provide a means by which the defenders of technocracy—or small groups
(veto players) who understand the virtues of technocracy—defend the independence of
monetary authorities (Broz).

How might this stand be reconciled with a commitment to democratic values and
popular sovereignty? One answer is through the idea of “expert democracy.”
Essentially, this holds that citizens are unable or unwilling to make judgments about
complex matters like central bank independence and exchange rate policy. Citizens
willingly defer to benign technocrats to make these decisions. If necessary, oversight is
exercised by a small, highly informed segment of the citizenry together with a select
group of legislators who periodically appoint and interact with monetary officials.

Unfortunately, as case for expert democracy, the special issue is underdeveloped.
To begin with, with respect to democracy, the conception of the monetary authority is not
adequately explained. The values and understandings of the respective technocrats are
taken as given or simply treated as a black box of some kind. For some time, political
scientists have studied the attitudes and dispositions of bureaucrats (e.g., Aberbach,
Putnam, and Rockman, 1981). It is time to do the same with central bankers. We need to
know more about how monetary authorities understand the expectational mechanisms
and other key features of the political economy, how they conceive of social welfare both

19 Popular sovereignty can be defined as citizens having the “undisputed right to determine the framework
of rules, regulations, and policies within a given territory and to govern accordingly” (Held, 1996a: 150).
Note that Held points out there are restrictions on popular sovereignty in all democracies including checks
and balances and guaranteed rights. Note also that his definition emphasizes the “input” dimension of
democratic legitimacy; cf. Schimmelfennig, 1996.

20 On the concept of expert democracy see such works as Hansen, 1996, esp. pps. 81-2.
in an intragenerational and intergenerational sense, and if and how they see themselves as trustees or guardians. Most important, we need to better understand how central bankers conceive of their role in a democracy, to whom and how they believe they are accountable politically. In this context it is important to address the debate about “representative bureaucracy:” whether the identities of central bankers must mirror those of society for monetary technocracy to be compatible with democracy. Studies of this kind may show that central bankers are not as benign as the contributors assume and that the absence of certain ethnic, racial, and gender identities within the ranks of central bankers translates into distributional injustices of various kinds within and between generations.21

The special issue offers limited insights into citizens’ dispositions toward monetary institutions. For instance, Broz argues that there is an “audience” monitoring regime choice. And Hallerberg emphasizes the importance of citizens being able to “identify” those responsible for making certain policy decisions. But neither author provides survey data about how citizens—or any highly informed and efficacious segment of the citizenry--comprehend and evaluate monetary institutions (or such things as the way international market constrain those institutions). Nor, surprisingly, do the

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21 The idea of representative bureaucracy is explored and evaluated in works like Krislov and Rosenbloom (1981). To my knowledge, no one has produced a thorough demographic profile of central bankers in relation to the ethnic, racial, gender and other makeup of their respective societies or, for Europe, for the European community. Representative bureaucracy presumably would yield more just distributions of such things as male and female unemployment (i.e., the distribution of the costs of disinflation.) This point is explained further in the text below.
contributors provide any evidence that citizens understand and support the central bank reforms that connote convergence to an optimum regime (Bernhard, Broz, and Clark). 22

In fact, some new studies suggest that a case for expert democracy might be sustainable. In a forthcoming book entitled Stealth Democracy, Hibbing and Theiss-Morse find that “perceived consensus” best characterizes Americans views of many issues. That is, citizens believe that with regards to inflation and other matters, they and their counterparts agree about what is desirable. Moreover, citizens are willing to defer to experts, because, in contrast to elected officials who emphasize what are perceived to be false (minor) differences in preferences, these experts are willing and able to choose the best means to achieve what are perceived to be mutually preferred ends. “The apparent desire to empower people often cohabits with the desire to empower entities virtually unconnected to the people” (Ibid., Chapter 6, p. 12). We need additional survey research of this kind, research that establishes more deeply and clearly the existence of such consensus and deference cross-nationally. Such evidence may move us closer to placing monetary technocracy on the footings of expert democracy. 23

22 One interesting idea is to probe citizens understanding of the nature of and potential impact of central bank reform. Bernhard (forthcoming, pps. 199-200) alludes to the need for this kind of research but, unfortunately, does not present any relevant survey data. See also Ibid., pps. 204, 211, 221.

23 An interesting, related argument is put forth by James Monroe (1990, p. 126) who argues that for Americans “direct democracy with scientific administration is a contradiction only when observed from liberal ground. If, instead of clashing interests, the people really did share an underlying communal goal, then both methodologies serve the same end” (quoted in Hibbing and Theiss-Morse, forthcoming, Chapter 6, p. 12). Hibbing and Theiss-Morse also point out that when at the Federal Reserve, Alan Blinder made a similar argument about the legitimacy of America’s monetary authority (Ibid., p. 13). In this sense, the Federal Reserve, may have a “political constituency”; cf. Bernhard, forthcoming, fn. 5 p. 78. Also germane here are Delli Carpini and Keeter’s (1996, pp. 70-1) finding that only 18% of Americans comprehend the nature of monetary policy and Hibbing and Theiss-Morse’s findings supporting the view that citizens lack meaningful policy preferences (forthcoming, Chapter 6, p. 21ff).
But, the problem is more complex than this. In a sophisticated study of the inflationary preferences of mass publics in O.E.C.D. countries, Scheve (2001) recently found, contrary to the perception of the American public, within and across countries there are significant differences in the importance citizens attach to inflation relative to other outcomes like employment. For instance, there are important differences in the weight British women attach to price stability relative to British men (Ibid., p. 27). As regards expert democracy, Hibbing and Theiss-Morse (forthcoming) present data that show more than two-thirds of the American electorate are uncomfortable with deference to non-elected experts (Table 2). Also, their data provide little popular support for the idea of public spirited, veto players who guard the independence of central banks (see especially Ibid, pps. 23ff). In addition, Hellwig (forthcoming) reports that openness of the economy tends to diminish citizens abilities and willingness to hold government responsible for economic outcomes. This is particularly true of more educated citizens and those who are employed in tertiary, private sector jobs. Together, these findings suggest that there is a role for representative democracy in sorting out what are real differences in preferences; consensus with respect to the goals of monetary institutions may be a false perception. Citizens may not understand the role of veto players in expert democracy and (or) how regime choice provides government with the capacity to choose different mixes of inflation and unemployment. On the other hand, a segment of the citizenry may understand that the monetary authority has been delegated to technocrats (hence their elected officials should not longer be held accountable for the economy).24

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24 Sheve (2001) finds that the distributional consequences of inflation and employment are key determinants of how individuals value these macroeconomic outcomes and also that inflation aversion depends on country-level factors that bear on the expected costs of inflation and unemployment. Unfortunately Hellwig’s data (personal communication) do not allow him to determine if the tendency to
This line of argument sees the special issue and related literatures in a somewhat different light. In addition to the important differences in the impact of monetary institutions on sectors of the economy (Frieden, 2000, 2001), there may be distributional consequences in terms of gender. Central banks therefore may be “unrepresentative bureaucracies” if their ranks do not include substantial numbers of women. Elected representatives have not so much delegated to monetary authorities (Bernhard, forthcoming) as they have abdicated their responsibilities to their constituents. Also, the reduced amplitude in political business cycles associated with the convergence on central bank independence actually is indicative of the decline of popular sovereignty. Legislative oversight and variations therein are critical elements of expert democracy (Leeper and Sterne, 2001; see also Bernhard, forthcoming, chapter 2, esp. pps. 39ff). However, legislative oversight of monetary institutions may not be understood and (or) supported by citizens. Worse such oversight may be a process by which certain interest groups ally with the technocrats to produce what are arbitrary (but real) redistributions of wealth. For example, it could be that constellations of interest groups—particularly

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25 To his credit, Bernhard (forthcoming, Chapter 9) treats very seriously the question of how central banks “fit” in democracy. However, this second line of argument essentially flips his conclusions on their heads. Cf. Ibid., esp. pps. 214, 229, 239.

26 The editors of the special issue stress that monetary commitments “limit opportunistic business cycles” (Bernhard, Broz, and Clark, p. 16). And there is much evidence, including my own (Freeman and Houser, 1998, esp. p. 651; Houser and Freeman, 2001, pps. 22-23.) that suggests the workings of democratic polities now have only marginal impacts on jobs, output, and other important variables. These findings need to be reexamined in light of the second argument in the text.
groups representing different sectors of the economy—strategically choose to lobby the legislative or executive branch of government in order to exploit the veto power of central banks. The link between “polarization” of the preferences of the legislative and executive branches and expected inflation (Kefer and Stasavage, 2000) actually is a proxy for distributional struggles between different coalitions of industries each with different “pass through” capabilities and preferences regarding exchange rate volatility. Finally, if it turns out that Hellwig’s results are not indicative of an understanding of how monetary policy has been delegated to technocrats, we may have the result that, despite the advent of mass education and information technology, ironically today’s citizens are less informed and efficacious with respect to economic policy making and institutional design than their predecessors of the late nineteenth century (cf. Frieden, 1994).

In sum, much work remains to be done before we can decide if the optimal regime sketched in this special issue is a democratic one. Sorting out these two competing arguments about monetary technocracy and extending it to the E.U. and other supranational institutions indeed will require a third generation of multi-faceted research. Yet, this perhaps is the most important of the challenges we face in institutional design.28

27 Keefer and Stasavage (2000) overlook the possible link between their work and Frieden’s (2000, 2001) focusing instead on ethnic diversity. Bernhard (forthcoming, Chapter 4) fails to discover any link between the presence and size of the financial industry and central bank independence. But he does not explore the possibility that it is through an alliance with certain industries that financial interests influence regime choice.

28 The special issue does not go into much detail about how the democratic features of EU institutions are related to those of the new European central bank. Needless to say, many of the points made in this section apply in this setting as well. For example, Frieden (2000, 2001) suggests that sectoral consequences of the creation and management of euro are present but transnational in nature. Hence one might conjecture that transnational coalitions of industries behave strategically toward the representative institutions that
A Crisis of Imagination?

Just as Tinbergen argued several decades ago, the papers in this volume suggest that countries will settle on a particular set of regimes. Convergence will produce the best possible inflation rates and perhaps the most desirable responses to shocks in national output. These regimes will be democratic to some degree, either because democracy is a better means of protecting and preserving monetary technocracy than authoritarianism (Broz, Keefer and Stasavage, Hallerberg) or, because politicians in democracies are able to devise ways to influence monetary policy or use fiscal policy to ensure their more selfish interests (Clark, Bernhard and Leblang). Wage bargaining institutions may be part of the optimum regime. In fact, Iversen (1999: Chapter 6) predicts convergence on a similar set of institutions, although he too is unclear about whether or how these institutions preserve democratic norms and values. Iversen suggests that supranational regimes eventually will embody the same choice of institutions (Iversen, 1998: p. 498).29

Only time will tell if these predictions are accurate or simply indicative of a crisis of imagination. There are serious questions about the capability of today’s citizens—even in the most advanced democracies—to comprehend and engage in monetary and other kinds of economic policy making. And, despite the information revolution, as yet, there have been few technological innovations in democracy, innovations that would

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29 While some students of wage bargaining allude to electoral politics within labor organizations (e.g., Hall and Franzese, 1998: 513), for the most part, these studies also fail to explain how (if) the regimes they analyze preserve popular sovereignty over economic policy.
enhance the capabilities of citizens. Finally, the visions of global governance associated with the other feasible leg of the “political trilemma”—world federalism (Rodrik, 2000; Held, 1991 a,b)—appears to be little more than “old wine in new bottles.” But it could be that in some respects the predictions of convergence are more a description and rationalization of what we are observing today than a refutation of some possible worlds. The hope is that these possible worlds include a regime in which there is markedly more popular sovereignty over the making and implementation of economic policy.

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30 I am thinking here of electronic means of popular deliberation or so-called “teledemocracy” (cf., for instance, Meyer, 1993). An illustration of the poverty of imagination with respect to modern democracy is The Economist’s Survey: The Future of Democracy (December, 21, 1996). It ends up speculating about the prospects for Swiss-type referenda in nation-states.

31 Rodrik (2000) points to the EU as a first step toward global federalism. Of course the EU employs a monetary technocracy and it has been criticized for its “democracy deficit.” Needless to say, world federalism is an old idea that can be traced to at least the 1950s, and probably a few hundred years prior to that. Critical theory seems a no better source for this imagination. It devotes most of its time and resources to simply criticizing rather than rationalizing the regimes on which the world seems to be converging.
### Table 1. Expanded Institutional Choices Associated with Optimum Regime Based on Iversen’s Studies (1998, 1999) of Wage Bargaining Systems

<table>
<thead>
<tr>
<th>Wage Bargaining System</th>
<th>Central Bank Dependence</th>
<th>Central Bank Independence</th>
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<tbody>
<tr>
<td></td>
<td>Hard Currency Policy</td>
<td>Soft Currency Policy</td>
</tr>
<tr>
<td></td>
<td>Hard Currency Policy</td>
<td>Soft Currency Policy</td>
</tr>
</tbody>
</table>

- Decentralized
- Intermediate

Iversen’s Optimum Regime

Centralized

**NB.** Traxler, Baschke, and Kittel (2001) suggest that there are actually six different wage bargaining systems that should be considered hence there are at least twenty four possible regimes.
REFERENCES
(Freeman, “Competing Commitments”)


<table>
<thead>
<tr>
<th></th>
<th>Leave Decisions To Successful Business People</th>
<th>Leave Decisions To Non-elected Experts</th>
<th>Run Government Like A Businesss</th>
</tr>
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<tbody>
<tr>
<td>Strongly Agree</td>
<td>4%</td>
<td>3%</td>
<td>10%</td>
</tr>
<tr>
<td>Agree</td>
<td>28</td>
<td>28</td>
<td>50</td>
</tr>
<tr>
<td>Disagree</td>
<td>59</td>
<td>60</td>
<td>37</td>
</tr>
<tr>
<td>Strongly Disagree</td>
<td>10</td>
<td>9</td>
<td>3</td>
</tr>
</tbody>
</table>

Table 2: Public Attitudes Toward Less Democratic Arrangements in the U.S.