Central Bank Independence, Democracy, and Dollarization

Allan Drazen
University of Maryland and NBER

August 1999

Prepared for the Conference on Argentine Political Economy, August 19, 1999, sponsored by the Banco Central de la República Argentina and the Universidad Torcuato Di Tella. I wish to thank, without implicating, Alberto Ades, Federico Sturzenegger, and P. Andrés Neumeyer for helpful discussions about Argentinean monetary and fiscal policy.

1. Introduction

Arguments for alternative exchange rate or international monetary arrangements are generally framed in terms of economic efficiency, namely, what arrangements will help a country better achieve certain macroeconomic objectives. With regard to the objective of low inflation, it is usually argued that this goal will be more likely achieved if monetary policymaking is significantly insulated from political pressures. In fact, in the design of policy institutions, central bank independence is widely accepted as a feature of good policymaking. Independence means not only the freedom of the central bank to decide how to pursue its targets, but also that its decisions are very hard for another branch of government to reverse.

Though central bank independence is widely accepted on economic grounds, its political status is more problematic, for it is often argued that there is a fundamental conflict between central bank independence and democracy. This is the conflict between making policy responsive to the popular will, seen as fundamental to democracy, and insulating policy from the popular will, seen as essential to good monetary policy as argued above. Many see central bank independence as co-existing uneasily with democracy. Hence, one is led to ask a basic question -- to what extent is central bank independence consistent with basic democratic principles? The purpose of this paper is to examine the conflict between responsiveness and insulation, that is, to examine whether or not central bank independence is inconsistent with principles of democratic policymaking. Our basic argument is that once one reflects on the process of policymaking in a democracy, strongly independent monetary policy is not inconsistent with democratic control of policymaking. We further argue that the conflict between popular sovereignty and policymaker independence is not unique to monetary policy, but actually characterizes most policymaking in a democracy. Moreover, institutions we associate with democracies have been created specifically to address this conflict.

Given the Argentinean experience and current debates, I am especially interested in extreme forms of policy commitment, such as currency boards or dollarization, from the perspective of their consistency with democratic principles. In such arrangements there appears to be no domestic sovereignty over monetary policy. What exactly is the relation between dollarization, for example, and principles of popular sovereignty or democratic control over policy? Are they simply disjoint, with such arrangements having sacrificed popular control in order to achieve price and exchange rate stability? Here, I argue that this is *not* the case; dollarization is in a sense fully consistent with democratic policymaking once one understands the role of constitutionalism in a democracy.

Before getting into the details, I want to make clear one argument that I am not making. It has been argued (I will purposely not cite any examples) that there is no real conflict between central bank independence and democracy if the central bank is "accountable," that is, answerable for its actions and decisions. That is, countries, especially emerging democracies, are urged to set up institutions that are seen as strongly democratic, as well as highly independent central banks that are held strictly accountable for their actions. These desirable objectives are prescribed simultaneously without giving a real sense of tradeoffs or possible inconsistencies between them. It sounds good, but is too simplistic. Accountability is important for addressing the tension between responsiveness and insulation, but full accountability means that the central bank is not really independent and insulated from political pressures. Simple multifaceted prescriptions ignore the reality that is the subject of this paper.

2. The Generality of the Question

The same question of whether there is a conflict between insulation and responsiveness can be asked for other policies and the associated institutional arrangements. Consider defense policy or, on a more economic level, fiscal policy. The generality of the question alerts one to a key point. *In modern democracies, most policies are chosen by institutions with some degree of independence, that is, insulation from popular pressures.* Basically no decisions are made by direct democracy. Thus, the question of the tension between central bank independence and democratic control is not unique to monetary policy, but brings up a basic issue in policymaking in a democracy. What distinguishes monetary policy, if anything, is therefore not the relevance of the question here, but not elsewhere, but the degree to which monetary policymaking is "independent" relative to other types of policy.

A number of points may be useful in understanding the general issue of policymaking independence. First, one wants to distinguish between independence in choosing the broad outlines of policy and independence in more operational decisions to implement these goals. For monetary policy, independence is often divided into two parts, as in Debelle and Fischer (1995): *goal* independence, meaning the central bank sets its own goals, rather than their being set by another agency; and *instrument* independence, meaning the central bank has control over the instruments of monetary policy, and is allowed to use them. In arguing for the optimality of central bank independence, it is instrument independence which is meant, with there being agreement that the central bank should not independently choose the overall goals of monetary policy. Central bank independence means not only the freedom to decide how to pursue its goals, but also that other government bodies cannot easily reverse the central bank's decisions.

Second, even in discussing decisions on overall goals, one should not equate democratic control with direct, “unfiltered” expressions of the popular will. Saying that there should be popular sovereignty in policymaking in a democracy is different than saying what form this should take. No one argues that decisions are truly consistent with democracy only if they are made via direct democracy. Representative democracy and delegation are the norm in modern democracies, and the argument that representative democracy is “undemocratic” is rare..

3. What Makes Monetary Policy Different?

All this having been said, there does seem to be a difference between the independence of institutions for monetary policymaking, such as a central bank with explicit or implicit legal independence, and institutions for, let’s say, fiscal policymaking. Monetary policymaking appears to be far more insulated and less subject to popular will. What is the case for independence of the monetary authority? How does this case differ, if at all, from the case for an independent fiscal authority? We begin with the former question.

In his recent book on central banking in theory and practice, Alan Blinder (1998), former vice-chairman of the Federal Reserve and continuing scholar of monetary policy hits the essential point. He argues that a key reason for independence is that monetary policy, by its nature, requires a very long time horizon. As he puts it (p. 55-6):

> But politicians in democratic -- and even undemocratic -- countries are not known for either patience or long time horizons. Neither is the mass media or the public. And none of these constituencies have much understanding of the long lags of monetary policy. So, if politicians made monetary policy on a day-to-day basis, the temptation to reach for short-term gains at the expense of the future (that is, to inflate too much) would be hard to resist. Knowing this, many governments wisely try to depoliticize monetary policy by, for example, putting it

> in the hands of unelected technocrats with long terms of office and insulation from the hurly-burly of politics.

To rephrase his point, monetary policy is like an investment, but an investment with two crucial characteristics: first, its gestation period is longer than politicians' time horizons; and, second, the "technology" of this investment is not well understood by politicians or the public. These characteristics of monetary policy as an investment imply that better outcomes may be achieved by putting decisionmaking control in the hands of an independent monetary authority. The argument for independence stresses the risks of *too much* popular control, that is, monetary policy too responsive to the popular will.

Blinder's argument hits the essential issue, though it is raises a basic issue. It is not only monetary policy that is a long-horizon investment whose nature is not fully understood by politicians; *many* types of policy can be seen as investments with the same characteristics. Politicians' horizons are similarly short for other types of policy; nor is it obvious that their understanding of the technical nature of these policies is greater. Hence we are lead to the second point raised at the beginning of this section, namely, how does the case for an independent monetary authority differ from the case for, let's say, an independent fiscal authority?

One answer is that there really isn't a difference in the need to insulate policy, and that, in practice, other policymaking institutions are similarly insulated. Hence differences between monetary policy and other types of policy are more apparent than real. Defense policy provides an example. In all but the overall objectives, it is made by authorities who, to use our earlier terminology, are given a large degree of instrument independence. This is motivated partly by technical considerations, but like monetary policy, there is also the desire to insulate decisions from political pressures. In the case of fiscal policy, however, there are clear differences. There is no independent fiscal authority comparable to the central bank, nor does it seem there would be much support for such an institutional arrangement. The details of fiscal policy are worked out in treasury ministries and legislative committees (that is, bodies with some insulation), but their decisions must ratified by representative legislatures. (As will become relevant below, governments do put restrictions on fiscal policymaking in order to insulate it from the popular will.) In short, there is a difference between monetary policy and other types of economic policy.

One explanation of this difference is the technical characteristics of monetary policy. Though many policies can be thought of as investment, the “technology” of monetary policy makes it especially subject to abuse. More specifically, one may think of the ease of expanding the money supply, the seemingly costless short-run term gains that often result, and, the long and uncertain lags till the costs become apparent. Hence, the benefits of expansionary monetary policy provide an especially strong temptation, while the costs of irresponsible short-run monetary policy may be less obvious than the costs of irresponsible tax policy. It is therefore more necessary to insulate monetary policy than fiscal policy from popular pressures. This line of argument is suggested in the quotation from Blinder.

There is much truth in this argument and it is clearly part of the answer to what makes monetary policy different, but it is incomplete. The reason it is incomplete is that part of the “technology” of monetary or fiscal policy concerns the institutional structure for making policy changes. If a society so desired, the flow of transfer payments, for example, could be changed with the same ease, quickly increased or decreased by the decision of a committee similar to the Federal Open Market Committee (in the United States) and rapid implementation of those decisions.[1] Monetary policy is easy to manipulate not only because of its economic characteristics, but also because of the policymaking structure that is in place. To make the same point in reverse, the technology of fiscal policy that makes it more difficult to abuse it in part reflects decisions on the nature of policymaking. Hence, an argument focussing on the ease of changing monetary policy is only part of the answer; more precisely, it is part of the question.

In my opinion the answer to the question of what makes monetary policy different is the temptation to inflate in the short run (reflecting the specific investment nature of monetary policy) *combined* with the ability of different interest groups to agree on what monetary policy that is *not* short-sighted would look like. It is this second aspect, the ease of concurring on "disinterested" monetary policy, that is special. If policymakers were somehow able to constrain themselves to choose monetary policy always for the common good, there would be agreement on: the problem of inflationary bias; on what to do in the medium and long run (policy aimed at low or zero inflation with no attempt to affect real variables); and, on how to implement this policy. It is this characteristic, I argue, which explains why societies are willing to turn over monetary policy to an independent authority, but are less willing to turn over fiscal policy (or at lest some aspects of it) to an analogous fiscal authority.

To better understand the point, let us contrast monetary policy with fiscal policy.

---

[1] Imagine changing the fourth line of the above passage from Blinder to, "So, if politicians made *transfer payment* policy on a day-to-day basis, the temptation to reach for short-term gains at the expense of the future (that is, to *hand out* too much) would be hard to resist." It would be an accurate description of both the possibilities and the temptations.

Consider the structure of tax rates or the distribution of transfer payments. Suppose that society chose to remove these aspects of fiscal policy from short-run political pressures by constraining itself to a long-run tax-transfer policy. Would there be an agreement on the structure of taxes or transfers similar to that for monetary policy? Almost definitely not, because of the distributional implications of these policies. That is, there is a clear conflict of interest over who bears the burden of taxation and/or who benefits from transfer payments. It is the clear distributional nature of these fiscal policies that makes it impossible to agree on what "good" long-run tax-transfer policy is. The conflict of interests over fiscal policy are different than monetary policy, and it is this aspect that is crucial in understanding the political status of independent authorities. Put very roughly, the conflict of interests in fiscal policy is both across time (the investment aspect) and across groups with very divergent interests even in a long-run equilibrium, while the conflict of interests in monetary policy is primarily across time, as set out in previous paragraphs, with there being far more agreement about optimal policy in a long-run equilibrium.[2] Hence, both knowing the temptation to follow bad policies and agreeing on the outlines of good policy, we are more comfortable giving policy over to an independent authority. This is what makes monetary policy different than some other sorts of economic policy.

This point may be strengthened by considering aspects of fiscal policy where there is far more agreement about both about the dangers of unconstrained policy and about the structure of optimal constrained policy. The leading example is fiscal deficits and unbalanced government budgets. The analogy to monetary policy has several dimensions. There is the temptation to

[2] One should however note Faust (1996), who argues that the inflationary bias of monetary policy reflects a conflict of interests between the old, who prefer low unanticipated inflation, and the young, who prefer high unanticipated inflation, with the latter outnumbering the former.

increase government spending and finance it by issuing debt, as the short run benefits are high while the current costs often appear low. There is a clear intertemporal aspect to this decision, deficit spending like inflation having the characteristic of disinvestment, with the costs of the policy only coming later. And, there is agreement that if society were to forgo the short-run temptation and focus on optimal policy in the long-run, society would want to constrain itself to budgets that were generally in balance.

Given the similarity of fiscal deficits to inflationary monetary policy, it is not surprising that we see similar institutions as applied to this specific fiscal problem. Societies often try to enact some sort of restriction constraining the ability of the government to run deficits or issue debt, including balanced budget laws; expenditure ceilings; numerical targets for fiscal variables; and, restrictions on the issuance of debt. There is strong interest in this specific issue currently in Argentina, with discussion of forms of a Fiscal Convertibility Law. Forty-nine out of fifty states in the U.S. have some sort of balanced budget restriction, and many state constitutions have restrictions on the amount of debt a state may issue. In contrast, on the national level in the U.S., the attempt to control budget deficits by a legislated balanced budget restriction has been unsuccessful. Given that balanced budget laws are tangential to our main concern, we do not discuss them here; references include Gramlich (1995), Poterba (1996) for state level restrictions, von Hagen (1991) for debt restrictions, and chapter 14 of Drazen (forthcoming) for an overview of both theoretical and empirical work. Our interest is more to illustrate the general argument about what are the sorts of policies on which governments are willing to choose to constrain themselves.[3]

[3] Restrictions on capital levies are another example.

Though there is a theoretical case for constraining monetary policy to be non-inflationary or for restricting the ability of governments to run deficits, both prescriptions have a strong empirical flavor, by which one means that we have observed that monetary policy (or deficit policy) works better when governments are so constrained. Having observed the costs of politicizing certain types of policies, societies have opted (in Blinder's words) for insulation from "day-to-day ... temptation to reach for short-term gains at the expense of the future," that is, "from the hurly-burly of politics." By the nature of monetary policy, we don't want decisions subject to the daily legislative struggle and the political pressures this implies. We want policy not subject to "second-guessing" and easy reversal.

Viewed in this light, the correct conceptual framework to understand monetary policy is *constitutionalism*, one key aspect of which is removing decisions from the influence of everyday political pressures. We now turn to this issue.

4. Constitutionalism in Monetary Policy

There are four characteristics that we associate with constitutional laws.[4] First, they are laws that *restrict the government's use of authority*. Second, they set out the *basic processes of policymaking*, that is, they are laws about how collective choices should be made. Third, constitutions often treat issues that are more *fundamental* than others, such as basic rights or liberties. Fourth, constitutional laws have more *stringent amendment procedures* than other

[4] This discussion draws on Drazen (forthcoming), especially chapters 3 and 5. Insightful discussions of constitutions that are accessible without a background in legal or political theory are Elster (1995) and the collection of essays in Elster and Slagstad (1988), especially the introductory essay.

laws, this characteristic reflecting in part the previous two characteristics, in that certain types of laws are meant to be more permanent.[5] All four of these characteristics of constitutional laws are relevant for understanding institutional arrangements for monetary policy, but especially the last one. We consider the importance of three of these characteristics in this section, the fourth in the next section.

The most straightforward application of constitutionalism to monetary policy is the characteristic of laws that restrict government's use of authority. This has an obvious application to a discussion of how monetary policymaking institutions can be designed to limit the ability of government to manipulate monetary policy. It says, in short, that such a limitations are a well accepted part of a democratic system. This characteristic does not in itself say what form these limitations should take.

The conceptually most relevant characteristic of constitutional laws for our discussion is that they have more stringent amendment procedures than other laws. I argue that in a basic conceptual way, this is central to understanding the role of central bank independence in a democracy and, even more so, institutions such as dollarization. Let's begin with a general discussion. Stringent amendment procedures may be thought of as a concrete approach to engendering the expectation that a law will not be changed whenever it is tempting. Such restrictions are often seen as "protecting the electorate against itself," so that important decisions

[5] Note that constitutions need not be written documents, nor does the constitutional nature of a written (or unwritten) law depend on whether it is in a document called the "constitution." Even though it is not part of a formal law, independence of the Federal Reserve has the permanence of a constitutional law, because it is generally agreed upon and thus hard to break.

will not be changed or undone whenever the majority feel current circumstances may warrant it.[6] This is the literal application of “stringent amendment procedures,” that is the decision that once made, certain laws or policies are difficult to undo and cannot be reversed by ordinary legislative or electoral procedures.

More generally, “stringent amendment procedures” refers to mechanisms that a society erects to make it difficult to undo decisions, or, in our earlier terminology, to insulate decisions (or decisionmaking bodies) from the “momentary temptation” to change these decisions. Put another way, a society decides to remove an issue from public debate that would lead to undesirable political pressures. A society decides not to continually redecide and constructs institutions that enable it to do this. When policies cannot be determined once and for all, stringent amendment procedures to an existing law cannot be literally applied; instead, a society can choose to remove the decisionmaking *procedure* from short-sighted political pressures. Hence, the second constitutional characteristic, namely, laws about the process of policymaking becomes relevant. This should be seen in the context of “stringent amendment procedures,” for this tells us conceptually what kind of process is chosen.

Note further that in applying the notion of “stringent amendment procedures,” either literally or conceptually, we should think not simply in terms of whether a law is or is not constitutional, but as a matter of degree. That is, in practice a society makes a constitutional decision of just how difficult it should be to revisit decisions, that is, just how insulated

[6] “Constitutionalism then stands for the rare moments in a nation’s history when deep, principled discussion transcends the logrolling and horse-trading of everyday majority politics, the object of these debates being the principles which are to constrain future majority decisions.”(Elster [1988], p. 6)

policymaking should be from political pressures.

The temptations associated with monetary policy that we discussed in the previous section make it a strong candidate for being constitutionalized, not in the literal sense of being written into a formal document called the "constitution," but in the sense of insulated from the temptation to adjust policy for short-run gain at the expense of longer-run considerations. Once one understands the role of constitutionalism in a democracy, one sees that central bank independence is in no sense inconsistent with democratic principles. The nature of monetary policy means that a society makes a conscious decision to remove it from short-sighted political pressures in exactly the way that other policy choices have been removed. Having made the decision to insulate policy from political pressures, the question is how to do so.

5. Dollarization -- Conclusions on Democracy and Policy Insulation

We can now consider the status of currency boards or dollarization in a democracy. By this point, the basic arguments have been made and we simply bring them together. A careful reader of the paper could make the arguments himself. Especially strong forms of commitment to price stability or fixed exchange rates can be seen as simply clear examples of constitutionalism, especially when seen as an application, at least conceptually of "stringent amendment procedures." The argument that removing policy from domestic control (or domestic sovereignty, defined as the formal ability of a country to choose policy on its own rather than under instruction from another country) is undemocratic misses the whole point, both in terms of the tensions that are inherent in democracy and in terms of the solutions, such as constitutionalism, that democracies have found to address these tensions.

One may argue that dollarization is conceptually different than giving the central bank independence, for the latter is insulating policies from pressures, while the former is abandoning all decision power over monetary policy. A review of the previous section indicates that this difference simply parallels the literal versus more conceptual application of "stringent amendment procedures." Appointing an independent central bank corresponds, as already indicated in the previous section, to the more conceptual application of the constitutional characteristic. Dollarization, seen as making the difficult-to-reverse decision to adopt U.S. monetary policy, is simply the literal application of the principle of "stringent amendment procedures." Is it really conceptually different than laws restricting property seizure or length or number of terms of elected officials. All are examples of constitutional laws.

One should carefully note that the argument that has been made so far is *not* that dollarization is a "good" economic policy *per se*. The argument is simply that there is no fundamental inconsistency with democracy, or, more exactly, the democratic principle of popular control. Having made the case for this in previous sections of the paper, in this section I consider two further constitutional issues here: whether dollarization or some other monetary arrangement should be constitutionalized in the literal sense of writing it into the constitution; and, very briefly, the argument against policy insulation in an emerging democracy.

The argument of whether a dollarization law, for example, should be formally put in the constitution turns on whether doing so makes it harder to reverse. Two constitutional characteristics come into play. "Stringent amendment procedures" is important in its most literal sense, in that laws that are written in the document called the "constitution" are, by the process of making laws, more difficult to undo. As already indicated, a law that is very difficult to reverse need not be in the "constitution," but in a mechanical sense it is harder to reverse if it is.

A more subtle argument concerns the importance of the constitutional characteristic not yet discussed, namely that constitutional laws often treat issues that are more *fundamental* than others, such as basic rights or liberties. This seems out of place when discussing technical arrangements like central bank operating procedures or, even more so, dollarization. What is fundamental about low inflation or a fixed exchange rate?[7] We suggest the following argument.

When a law is generally perceived as treating a fundamental issue, this perception, by its nature, will strengthen the expectation that the law won't be quickly changed. That is, there is a close connection between the view that a law is fundamental and that it is permanent. To the extent that a law is seen as regulating a basic right, basic in the sense that it is seen as holding across a wide range of circumstances, there is, by definition, the expectation that the law is permanent. In this sense, independent of any implied legal restrictions on changing the law, "constitutionalizing" a law sends the signal that a society sees the law as one not to be tampered with.

While some restrictions (such as freedom of speech) are obviously fundamental and hence permanent, others are not so obviously fundamental, so that constitutionalizing them invests them with an importance they would not otherwise have. For example, zero deficits is not a "fundamental right"; a balanced budget restriction in the constitution sends the signal that a society attaches fundamental importance to it. The same argument could be made about price

---

[7] What is "basic" about the prohibition in the U.S. Constitution against a state using anything other than gold or silver coin as legal tender (Article 1, section 10, clause 1)? See, however, *The Federalist*, No. 44 for a discussion suggesting what may be "basic" about this provision.

stability or restrictions on devaluation.

Finally, are there any special issues concerning an emerging democracy, that is, one in which there may be a need to strengthen (or at least reconfirm) democratic principles or the democratic process itself? The argument that has been made is that insulation of some aspect of policymaking from popular pressure tends to weaken the overall commitment to democracy, which may be risky if this commitment is not as firmly in place as in a more established democratic system.

The short answer is that this argument is flawed in at least three dimensions. The first is the general point made in this paper, namely that insulation is not only not inconsistent with democracy, but an essential part of the democratic process. The second way in which the argument is too simplistic is a continuation of the first. To the extent that independent policy authorities characterize democracies, the creation of such bodies should help cement, rather than undermine the democratic process in an emerging democracy. This argument, however, applies less to dollarization than to an independent central bank.

The final argument is more empirical and applies to any sort of independent monetary institution or arrangement. Even if one believed that an independent central bank (or a currency board, *et cetera*) was undemocratic, a focus on this issue is misplaced in most emerging democracies. Put simply, in an emerging democracy there are so many other, more problematic institutions, that the central bank should not be in the forefront of our attention. The democratic nature of political parties, elections, the bureaucracy, or an independent judiciary, to take some examples, are all generally more important. Singling out the central bank makes little sense if one is really concerned about cementing the commitment to democracy. In fact, it is often demagoguery meant to appeal to naive populist sentiments or to divert attention from more important issues.

REFERENCES

Blinder, A. (1998), *Central Banking in Theory and Practice*, Cambridge, MA.: MIT Press

Debelle, G. and S. Fischer (1995), "How Independent Should A Central Bank Be?," in J. Fuhrer, ed., *Goals, Guidelines, and Constraints Facing Monetary Policymakers*, Federal Reserve Bank of Boston Conference Series, no. 38, Boston: Federal Reserve Bank of Boston.

Drazen, A. (forthcoming), *Political Economy in Macroeconomics*, Princeton, NJ: Princeton University Press

Elster, J. (1988), "Introduction" in J. Elster and R. Slagstad, eds., *Constitutionalism and Democracy*, Cambridge: Cambridge University Press.

_______ (1995), "The Impact of Constitutions on Economic Performance," *Proceedings of the 1994 World Bank Annual Conference on Development Economics*, 209-39.

Elster, J. and R. Slagstad, eds. (1988), *Constitutionalism and Democracy*, Cambridge: Cambridge University Press.

Faust, J. (1996), "Whom Can We Trust to Run the Fed? Theoretical Support for the Founders' Views," *Journal of Monetary Economics* 37, 267-83.

Gramlich, E. (1995), The Politics and Economics of Budget Deficit Control: Policy Questions and Research Questions," in J. Banks and E. Hanushek, eds., *Modern Political Economy: Old Topics, New Directions*, Cambridge: Cambridge University Press.

Poterba, J. (1996), "Budget Institutions and Fiscal Policy in the U.S. States" *American Economic Review Papers and Proceedings* 86, 395-400.

Von Hagen, J. (1991), "A Note on the Empirical Effectiveness of Formal Fiscal Restraints," *Journal of Public Economics* 44, 199-210.