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Abstracts

The Political Economy of Monetary Institutions
by William Bernhard, J. Lawrence Broz, and William Roberts Clark

In recent decades, countries have experimented with a variety of monetary institutions, including alternative exchange-rate arrangements and different levels of central bank independence. Political economists have analyzed the choice of these institutions, emphasizing their role in resolving both the time-inconsistency problem and dilemmas created by an open economy. This "first-generation" work, however, suffers from a central limitation: it studies exchange-rate regimes and central bank institutions in isolation from one another without investigating how one monetary institution affects the costs and benefits of the other. By contrast, the contributors to this volume analyze the choice of exchange-rate regime and central bank independence together and, in so doing, present a "second generation" of research on the determinants of monetary institutions. The articles incorporate both economic and political factors in explaining the choice of monetary institutions, investigating how political institutions, democratic processes, political party competition, and interest group pressures affect the balance between economic and distributional policy objectives.

Partisan and Electoral Motivations and the Choice of Monetary Institutions Under Fully Mobile Capital
by William Roberts Clark

Central bank independence and pegged exchange rates have each been viewed as solutions to the inflationary bias resulting from the time inconsistency of discretionary monetary policy. While it is obvious that a benevolent social planner would opt for such an institutional solution, it is less obvious that a real-world incumbent facing short-term partisan or electoral pressures would do so. In this article, I model the choice of monetary institutions from the standpoint of a survival-maximizing incumbent. It turns out that a wide range of survival-maximizing incumbents do best by forfeiting control over monetary policy. While political pressures do not, in general, discourage monetary commitments, they can influence the choice between fixed exchange rates and central bank independence. I highlight the importance of viewing fiscal policy and monetary policy as substitutes and identify the conditions under which survival-maximizing incumbents will view fixed exchange rates and central bank independence as substitutes. In so doing, I provide a framework for integrating other contributions to this volume.

Checks and Balances, Private Information, and the Credibility of Monetary Commitments

by Philip Keefer and David Stasavage

In this article, we argue that the effectiveness of central bank independence and exchange-rate pegs in solving credibility problems is contingent on two factors: political institutions and information asymmetries. However, the impact of these two factors differs. We argue that the presence of one institution—multiple political veto players—should be crucial for the effectiveness of central bank independence, but should have no impact on the efficacy of exchange-rate pegs. In contrast, exchange-rate pegs should have a greater anti-inflationary impact when it is difficult for the public to distinguish between inflation generated by policy choice and inflation resulting from exogenous shocks to the economy. Such information asymmetries between the public and the government, however, do not increase the efficacy of central bank independence. Empirical tests using newly developed data on political institutions provide strong support for our hypotheses.

Veto Players and the Choice of Monetary Institutions

by Mark Hallerberg

I argue that two types of veto players matter in the choice of monetary institutions: party veto players and subnational governments, which are strong in federal systems but weak in unitary systems. A crucial issue is whether voters can readily identify the manipulation of the economy with party players. A second issue concerns the national party veto player's ability to control either fiscal or monetary policy. In one-party unitary governments identification and control are clear; parties where such governments are common prefer flexible exchange rates and dependent central banks. In multiparty coalition governments in unitary systems, identification is traditionally difficult, and the ability to target benefits to specific constituencies under fiscal policy makes fiscal policy autonomy more attractive for coalition governments. Such governments prefer central banks that are politically independent but that finance government debt. Under federalism, parties that constitute the central government have less control over fiscal policy and they prefer flexible exchange rates. Subnational governments do not support a dependent central bank that gives more power to the central government.

Political Parties and Monetary Commitments

by William Bernhard and David Leblang

Increased levels of economic openness in the industrial democracies have heightened the potential for intra-party and intra-coalition policy conflicts, hurting the ability of parties to win and retain office. We argue that politicians can use monetary commitments to help manage these conflicts and improve cabinet durability. To determine the political value of these commitments, we test the effect of fixed exchange rates and central bank independence on cabinet durability using a set of 193 cabinets in sixteen parliamentary democracies across the period 1972–98. The results indicate that monetary commitments are associated with higher cabinet durability, particularly for coalition governments. We then use the results of our statistical models to generate expected cabinet durability under alternative institutional configurations. By comparing these expected values, we show that actual monetary reforms in the industrial democracies have helped (or at least not hurt) the ability of political parties to remain in office.

Real Sources of European Currency Policy: Sectoral Interests and European Monetary Integration
by Jeffry A. Frieden

In the thirty years before Economic and Monetary Union was achieved, European currency policies varied widely among countries and over time. In this article, I argue that the sectoral impact of regional exchange-rate arrangements, in particular their expected real effects on European trade and investment, exerted a powerful influence on the course of European monetary integration. The principal benefit of fixing European exchange rates was facilitation of cross-border trade and investment within the European Union (EU); the principal cost of fixed rates was the loss of national governments' ability to use currency policy to improve their producers' competitive position. Empirical results indeed indicate that a stronger and more stable currency was associated with greater importance of manufactured exports to the EU's hard-currency core, while depreciations were associated with an increase in the net import competition faced by the country's producers. This suggests a powerful impact of real factors related to trade and investment, and of private interests concerned about these factors, in determining national currency policies.

Political System Transparency and Monetary Commitment Regimes
by J. Lawrence Broz

Central bank independence (CBI) and fixed exchange rates are alternative monetary commitments that differ in *transparency*. While CBI is opaque and difficult to monitor, a commitment to a fixed exchange rate is easily observed. Political systems also vary in terms of transparency. I argue that the transparency of monetary commitments and the transparency of political systems are *substitutes*. Where political decision making is opaque (autocracies), governments must look to a commitment that is more transparent and constrained (fixed exchange rates) than the government itself. The transparency of the monetary commitment substitutes for the transparency of the political system to engender low inflation. Where the political process is transparent (democracies), a formal commitment to CBI can produce lower inflation because private agents and the political opposition are free to detect and punish government interference with the central bank. Statistical results indicate that (1) autocracies are more likely to adopt exchange-rate pegs than democracies, and (2) CBI is effective in limiting inflation in nations with high levels of political transparency.

Competing Commitments: Technocracy and Democracy in the Design of Monetary Institutions
by John R. Freeman

In this article, I refine and expand the agenda for research on monetary institutions. First, I evaluate the analyses and research designs presented in this special issue of *International Organization.* Out of this evaluation, several ideas about how to produce a "third generation" of research on this topic emerge. Specific ideas include how to: create a better synthesis with certain branches of economics, such as information economics; broaden the welfare criteria on which institutional choices are made; deepen the analyses of coalitional and other political processes on which the choice of institutions are based; and strengthen the tests that are offered in support of these choices.

In the second part of this article, I explore questions of how popular sovereignty over economic policy and institutional choice are achieved. I show that the institutional regimes proposed in the special issue are, 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, there is genuine dissensus about policy and macroeconomic objectives, it is no longer clear that the regimes proposed in the special issue are democratic. In the conclusion, I briefly discuss a possible crisis of imagination in institutional design.