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Distributional Politics and Central Bank Independence: Monetary Reform in the United Kingdom, Canada, Australia and New Zealand

A Thesis Submitted by
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Abstract

Why do politicians change the legislation governing the central bank to give this institution operational independence in the setting of monetary policy? This thesis examines the political debates over central bank independence in New Zealand, Canada, Australia and New Zealand during the 1980s and 1990s. These cases were selected due to the variation in their levels of central bank independence, while holding key institutional variables constant. Four hypotheses are suggested by the political economy literature to explain the timing of this legislative change: the need to signal creditworthiness to international financial markets, in response to lobbying by domestic interest groups opposed to inflation, in response to proposals from an epistemic community of monetary experts or based on the self-interest of politicians concerned with re-election. The case studies find that politicians delegate to the central bank when this reform has the consensus support of an epistemic community of monetary experts, and a key politician is willing to champion the legislation through parliament. This epistemic community has increased influence during periods of economic uncertainty, such as following a financial crisis. A key politician is motivated to support this reform due to ideological or electoral reasons. This reform was facilitated by political institutions characterised by few checks and balances that concentrated power in the hands of the executive and offered few obstacles to changing the central bank's statute. Central bank independence was rejected in the cases where the epistemic community did not hold a consensus on the need for reform, and politicians saw only electoral risks from changing the central bank's statute. This study finds that politicians retain room to manoeuvre despite the rise of financial globalisation.

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Ch. 1 Distributional Politics and Central Bank Independence

Why do politicians change the legislation governing the central bank to give this institution operational independence in the setting of monetary policy? Over the 1990s, more than thirty countries increased the legal independence of their central banks, as opposed to only three such changes during the 1980s (Maxfield 1997, p.3).¹ This trend in central bank independence was witnessed in industrial countries such as France, New Zealand and the United Kingdom as well as many developing countries, as seen in table 1.

1. Independence refers to the power of the central bank to set the instruments of monetary policy without the involvement of politicians. In other words, central banks have been given independence to take interest rate decisions (instrument independence), but not independence to determine the ultimate objectives of monetary policy (goal independence) (Debelle and Fischer 1994).

Table 1 Changes in Legislation of Central Banks, 1989-1999 (years of amendments)

Non-OECD	OECD & EMU members ¹	OECD Ex-EMU
Argentina	1992	Austria
Chile	1989	Belgium
Colombia	1992	France
Ecuador	1992	Finland
Egypt	1992	Germany
Honduras	1995	Ireland
Indonesia	1998	Italy
Pakistan	1994	Luxembourg
Peru	1992	Netherlands
Philippines	1993	Portugal
South Africa	1989	Spain
Uganda	1993	Total
Venezuela	<u>1992</u>	
Total	13	11

1. The European Central Bank was formed in 1999.

Source: Cottarelli and Giannini (1997); Cukierman et al (1992); Maxfield (1997); national central banks.

Political control of monetary policy was the norm in the post-war period, with many formerly independent central banks being nationalised. This institutional arrangement

was seen as consistent with democratic principles. As elected officials, politicians in the Ministry of Finance or Treasury took interest rate decisions and were held accountable in elections for their stewardship of the economy. Central bankers were civil servants, who gave advice on policy, but this advice was not made public and central bankers were not directly accountable for the outcome. During the 1990s, this division of responsibilities was changed dramatically. Independent central banks took on a higher public profile and were delegated considerable discretionary power to control inflation. Central bankers' judgement on monetary issues was not questioned and the decision making process by which interest rate decisions were taken lacked transparency. As a consequence, critics in opposition parties or the media have questioned the democratic accountability of this independent central banks. Critics are also opposed to having a single objective of price stability, as opposed to the pursuit of multiple objectives that include employment and output.

1.1 Central Bank Independence in the 1990s

The trend in central bank independence in the 1990s has been driven by three main forces: the founding of the European Central Bank ("ECB"); the desire of Latin American countries to secure the gains from the stabilisation programs of the 1980s; and the move by other countries to build the institutional structure for a market economy (Cukierman 1994a, p.1446). Preparations for the introduction of the single currency in Europe led to changes in the legislation of all eleven-member countries, which were required by Article 108 of the Maastricht Treaty of 1992 to bring their existing national legislation in line with the legislation for the ECB.² Countries on the periphery of the Euro-zone were also active in reforming their central banks, such as

¹ This figure does not take into account the independent central banks set up in Central and Eastern Europe following the collapse of the USSR.

² The ECB, formed in 1999, is the central bank for the Euro-zone, whose members are Austria, Belgium, France, Finland, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

Greece which failed to qualify for the first round; Sweden and the UK, who opted out of the single currency; the Czech Republic, Hungary and Poland, who are among the transition countries in the first wave to join the European Union; Turkey, which has formally requested to join the EU; and several members of European Free Trade Area which have remained outside the monetary union for domestic political reasons, namely Norway and Switzerland. Two other OECD members – Korea and Mexico – increased the independence of their central banks as part of the conditionality of IMF bailouts following financial crises in 1997 and 1994, respectively.³ Finally, Japan's government gave increased independence to the Bank of Japan following a political scandal that tainted the Ministry of Finance, which subsequently lost many of its powers.

Why Do Politicians Delegate?

The decision by politicians to give up control of interest rates is puzzling, as monetary policy is a powerful instrument for guiding the economy. Electoral studies have found that the public votes with their pocketbook and rewards politicians for positive economic performance, while punishing incumbents for poor management of the economy (Hibbs 1977; Tufte 1978). By giving up control of monetary policy, politicians have reduced the instruments at their disposal for managing the economy and put their fate in the hands of central banks. Politicians lose the ability to manipulate interest rates in the run up to elections in order to increase their electoral popularity, a strategy that leads to political business cycles (Alesina 1989; Alesina and Roubini 1994; Clark 1998; Nordhaus 1975). Even worse, delegation to an independent central bank may lead to conflict between fiscal and monetary policies, which could cause negative economic performance and damage the chances of re-election of incumbents. In other words, it is not obvious why short-sighted politicians in democracies would choose to undertake a reform that is designed to deliver predominantly long-term benefits.

When Do Politicians Delegate?

A second puzzle concerns the timing of this trend. The move towards central bank independence was a feature of the 1990s but absent in the 1980s. The timing does not appear to be closely related to any of the major structural changes in the international financial system over this period. The increase in this trend occurred long after the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, the elimination of capital controls during the late 1970s or the Third World debt crises of the early 1980s. Nor does the timing coincide with the rise of stagflation and the response of monetary targeting which took place during the late 1970s and early 1980s. One possibility may be that the trend in central bank independence results from financial interdependence or ‘globalisation’, which is forcing a convergence of economic institutions on one neo-liberal model. Such a view is contested.

Viewed from a historical context, this trend may be an effort by policymakers to regain the credibility achieved under previous monetary frameworks such as the Gold Standard or Bretton Woods. These frameworks relied on an external anchor to guide monetary policy, and were successful in delivering price stability. Credibility is a central concept for the study of monetary policy. A policy is said to be credible when private actors believe that policymakers will deliver on an announced policy. In other words, businesses, workers and financial markets become convinced that a policy will reduce inflation and adjust their expectations accordingly. Such behaviour becomes self-fulfilling, by guiding the inflationary expectations of private actors downward. With no consensus existing on the optimal external anchor, policymakers have sought to find a domestic anchor to provide monetary policy with credibility. Thus central bank independence is one such solution capable of delivering anti-inflationary credibility to

³ Indonesia also increased independence in its central bank due to IMF conditionality.

monetary policy by 'tying the hands' of politicians. Other possible solutions are establishing a currency board or joining a currency union.

This thesis does not suggest that central bank independence represent the ideal normative arrangement for monetary policy. Instead it studies the process of legislative change of the central bank in order to see how economic policy is influenced by international and domestic factors. A large literature in political economy stresses that economic choices are the result of a two-level game between the international system and domestic politics (Gourevitch 1978; Milner 1997; Putnam 1988). The legal status of the central bank results from different coalitions of domestic and international actors seeking to influence the policies adopted by politicians, which Milner terms "distributional politics" (Milner 1997, p.61). This interaction is conditioned by ideas concerning economic policy and constrained by existing institutions (Goldfinch 2000; Hall 1997). Institutions play a political role as they benefit some groups at the expense of others by distributing wealth to some groups while forcing the costs of adjustment on others. Domestic and international actors in this distributional game seek to put in place the institutions that will benefit them most. Monetary institutions are important in this distributional game as the welfare impact of monetary policy is so widespread.

Alternatives to Delegation

A third puzzle relates to the countries that chose not to legislate greater operational independence for their central banks. Within the OECD, politicians in seven out of 29 countries resisted pressure to change the legislation governing their central banks: Australia, Canada, Denmark, Iceland, Norway, Switzerland, and USA. While the US Federal Reserve, the Swiss National Bank and the National Bank of Denmark are seen as among the most independent central banks, the others generally fall into the category of central banks that are subject to political control (figure 2). For example, Eijffinger

and Schaling (1993) classify the Bank of Canada and the Reserve Bank of Australia as among the most politically controlled central banks based on the involvement of politicians in the determination of monetary policy. A large body of empirical research on central bank independence would suggest that these countries stood to gain the most from delegation. Instead, both these countries adopted alternative monetary frameworks based on inflation targets in order to increase the anti-inflationary credibility of their policymaking, which continues to involve politicians and targets a diverse set of objectives. This alternative strategy raises the question of whether politicians have alternatives to delegating to the central bank for making monetary policy credible.

Table 2: Legal Indices of Central Bank Independence during the 1980s¹

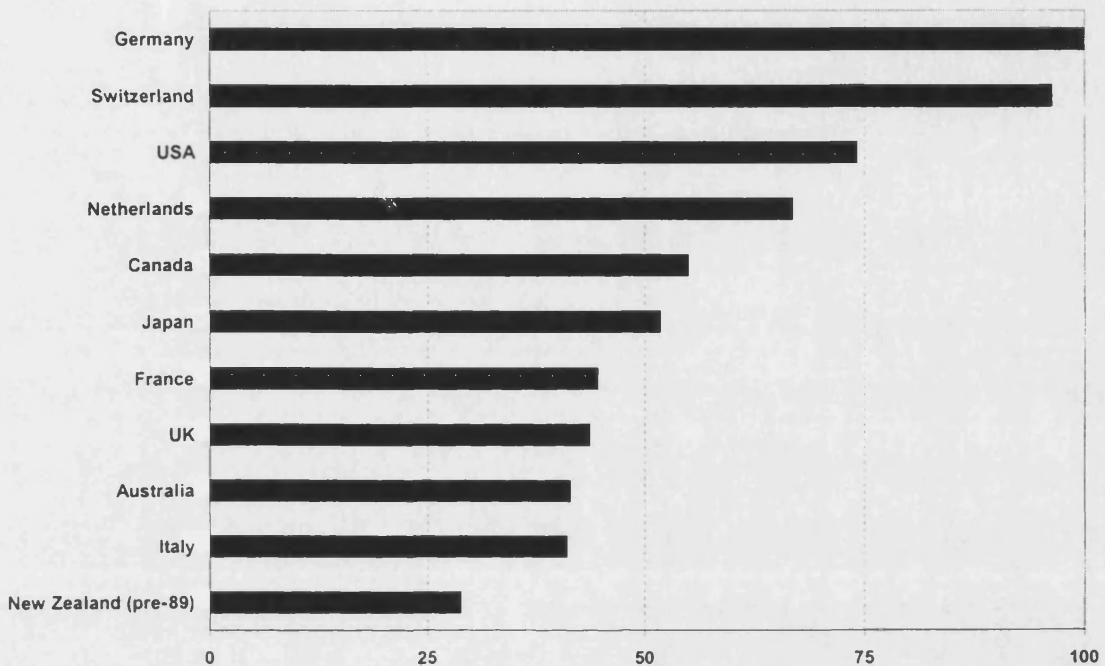
Country	Bade & Parkin (1987) ²	Grilli et al (1991)	Cukierman et al (1992)	Eijffinger and Schaling (1993)	Avg.	Stand. Dev.	Coef. of variation ³
Germany	100	100	100	100	100.0	0.0	0
Switzerland	100	92	93	100	96.3	4.3	4
USA	75	92	70	60	74.2	13.6	18
Netherlands	50	77	61	80	66.9	14.1	21
Canada	50	85	65	20	55.0	27.3	50
Japan	75	46	26	60	51.8	20.8	40
France	50	54	35	40	44.7	8.8	20
UK	50	46	39	40	43.8	5.2	12
Australia	25	69	52	20	41.6	23.2	56
New Zealand (pre-1989)	n.a.	23	35	n.a.	29.0	n.a.	n.a.

1. Re-scaled as percentage of the highest score, which in all cases was Germany.

2. Scores shown include additions made by Alesina (1989).

3. Standard deviation divided by average score.

Figure 1: Rankings of Central Bank Independence



This study proceeds in six sections. The first section has provided an overview of the trend in central bank independence. The second section discusses the role of central banks, providing important background information on the instruments and conduct of monetary policy. The third section looks more closely at inflation and its sources, contrasting an economic explanation with a political one. The fourth section reviews how the disciplines of economics, political science and political economy look at the trend in central bank independence in order to highlight the contribution made by a political economy approach. The fifth section outlines four hypotheses from political economy for explaining the trend in central bank independence during the 1990s, highlighting the role of international financial markets, ideas, interest groups and politicians. The sixth section summarises the findings from the study of four cases of monetary reform during the 1980s and 1990s in New Zealand, Canada, Australia and the United Kingdom. These case studies were selected due to the variation in their

degree of change of legal central bank independence over the past two decades, while holding key institutional and cultural variables constant.

1.2 The Role of Central Banks

Before continuing, it is important to be clear about the function and responsibilities of central banks. Central banks have a direct impact on the economy leading to wide-ranging distributional effects both domestically and – in the case of the Fed or the Bundesbank – internationally. Central banks first emerged during the 17th century, with the founding of the Swedish Riksbank in 1668 and the Bank of England in 1694. The modern central bank as currently conceived developed during the 19th century, which saw the widespread founding of central banks across Europe, the emergence of the Classical Gold Standard and the adoption by central banks of a greater role in the financial system (Capie, Goodhart, and Schnadt 1994, p.5). Following the First World War, central banks came to be considered an essential element of statehood along with the national currency and flag, leading to the founding of many central banks.⁴

Central banks are charged with the implementation of monetary policy, which together with fiscal policy are the twin instruments of macroeconomic policy. Central banks may set monetary policy independently or in consultation with politicians, generally the Ministry of Finance (or Treasury). Monetary policy is defined as the setting of monetary instruments to achieve some macroeconomic objective for the economy, usually defined in terms of price stability, output or the exchange rate. The main instrument of monetary policy is a short-term interest rate. Changes in this benchmark rate affect key economic variables indirectly such as the term structure of interest rates, the foreign exchange

⁴ The interwar years saw a worldwide trend towards establishing central banks in the newly independent countries and former British colonies, which increased the number of central banks from 22 at the outbreak of W.W.I, to 41 in 1940 (and ultimately 173 in 2000) (Capie, Goodhart, and Schnadt 1994; King 1999).

value of the currency and the rate of inflation.⁵ This ultimate target may be specified in the central bank's statute or may be left to the discretion of policymakers. Generally the ultimate target is to protect the value of the currency, which has been interpreted under a floating exchange rate regime to mean the pursuit of price stability. Central banks find it difficult to pursue their ultimate target directly due to the lag in the operation of monetary instruments, uncertainty about the accuracy of data on the economy, and disturbances caused by exogenous shocks. Central banks may therefore target an intermediate variable that is chosen based on its relationship with the long term objective, such as the money stock, short term interest rates, nominal GDP or the exchange rate.⁶ Progress towards the long-term objective may be checked periodically using other 'indicator' or 'information' variables, such as the growth of commodity prices or interest rate spreads, which are used to calibrate the setting of instruments.

Central banks perform a variety of other functions, such as managing the supply of currency, managing the payments system, acting as the government's fiscal agent, advising the government on the exchange rate or the public debt, supervising and regulating the domestic banking system, and stabilising the banking system by acting as lender of last resort (Economist 1999b; Swinburne et al. 1991, p.441).⁷ The central bank

⁵ The central bank conducts monetary policy by setting its instruments, such as open market operations, the reserve requirement and the discount rate. Indirect instruments are the use of capital controls, credit controls, or moral suasion (Downes and Goodman 1985). The central bank controls the money supply directly by adjusting the level of reserves which banks are required to hold against their liabilities (the "reserve requirement"), or by using the central bank's balance sheet to purchase or sell government securities in the open market ("open market operations"). Selling securities reduces the amount of money in circulation while buying securities increases it. This activity also changes interest rates. The central bank may 'print money' by buying new debt which is issued by the government, increasing the money supply and thus monetising the deficit. Short term interest rates can be targeted directly using open market operations, or indirectly by changing the rate at which the central bank lends overnight funds to the domestic banking system ("the discount rate") or the reserve requirement. Among the leading central banks, the interest rate is the primary instrument.

⁶ Bryant et al summarises research on different policy regimes (Bryant et al. 1993, p.30-31).

⁷ The central bank may have responsibility for controlling the money supply, but not always responsibility for issuing the currency. Some countries have a currency board for the later, and a central bank for the former such as Argentina, Estonia and Lithuania (Balino et al. 1997, p.2). In the OECD, 19

may be required to finance the government in the form of securitized loans, purchased directly in the primary market or indirectly through open market operations, or unsecuritized loans in the form of cash advances. Legal limits to government lending are considered important for preserving central bank independence, as government fiscal policy can unduly constrain monetary policy by forcing the central bank to fund budget deficits (Masciandaro et al. 1988; Sargent et al. 1981). The central bank may also play an international role, cooperating with other central banks through international organisations such as the International Monetary Fund (“IMF”) and the Bank for International Settlements (“BIS”), and taking part in international forums such as meetings of the G7 or the G30. The publications and statistics created by national central banks are the primary source of data for cross-national studies of monetary policy and the financial system. In some cases, the central bank is also the compiler of national statistics.

The central bank’s success in fulfilling its various roles is seen as a function of the clarity of its mandate, how it uses the instruments under its control, and the credibility it holds with private actors. The central bank’s ability to manoeuvre depends on the monetary framework in operation, and the degree of independence from politicians who might seek to control the central bank. In particular, the choice of exchange rate regime has fundamental implications for the scope of monetary policy. With fixed (or pegged) exchange rates, perfect asset substitutability and no exchange controls, a small country has no autonomy in monetary policy and must accept the inflation rate of its larger trading partners (Downes et al. 1991, p.47). Such was the case with non-US countries under the Bretton Woods system or the Exchange Rate Mechanism (“ERM”) of the European Union. Imperfect substitutability or exchange controls provides some

autonomy in the short run but not in the long run, as the currency will become overvalued, or undervalued, causing pressure through the balance of payments. With flexible exchange rates, monetary policy can be used autonomously to target domestic variables in the manner discussed above. Foreign exchange intervention may be 'sterilised', in which case the central bank offsets the effect on the domestic money supply, or unsterilised such that the money supply fluctuates.

1.3 Inflation Control

Inflation is defined as an increase in the price level of goods, services or assets. The rate of inflation can be measured using the consumer price index, the producer price index, the GDP deflator or the asset prices of securities and real estate. During the 1960s, policymakers believed in a trade-off between inflation and unemployment, where lower unemployment could be achieved at the cost of higher inflation, graphically represented by the Phillips curve. A decade later, two leading monetarists - Milton Friedman and Edmund Phelps - argued in separate papers that the trade-off implied by the Phillips curve did not exist and expansionary monetary policy would only create inflation (Economist 1991). Their view was given support by the rise of stagflation in the late 1970s, which discredited the reigning Keynesian paradigm and led to rising support for monetarism. While external shocks such as the OPEC oil shock combined with faulty economic analysis were partly to blame for the rise of inflation, the "interaction of Keynesian economics with democratic politics...was the real problem" (Willett et al. 1988, p.3).

Economics of Inflation

The following is a purely economic discussion of inflation. A more political view of inflation is provided below. Monetarists believe inflation is purely a monetary phenomenon that is due to excessive growth of the money supply (Friedman 1969a).

While monetary policy is a potent tool for stimulating the economy in the short run, due to the long and variable lags associated with fiscal policy, excessive stimulus only raises prices in the long run (18-24 months) without affecting real variables such as output or employment. Friedman therefore argued that monetary policy should be used to prevent money from being a major source of economic disturbance, to provide a stable background for the economy by reducing uncertainty and increasing business confidence, and to offset major external shocks (Friedman 1969a,p.106). There is little general disagreement with this view, or with the view that high and sustained inflation (“hyperinflation”) is damaging to the economy. The real disagreement concerns the costs arising from low to moderate inflation (inflation below 10 per cent), the cost-benefit trade-off during a disinflation and the benefits from accommodating inflation in the short run.⁸

Table 3: Theoretical Costs of Inflation

Anticipated Inflation	Unanticipated Inflation
<ul style="list-style-type: none"> • Tax on cash holdings • Shoe-leather costs to minimise cash holdings • Menu costs from revising prices • Decline in value of nominal income streams • Reduced value of nominal contracts • Erosion of subsidies & fixed grants • Distortions due to non-indexed tax systems & nominal accounting • Distortion of exchange rate affecting traded-sector • Costs of deflationary policies, in terms of lost output, increased cost of capital & increased unemployment 	<ul style="list-style-type: none"> • Money illusion • Redistribution of wealth • Intergenerational redistribution from old to young • Distortion in relative price signals • Loss of credibility by monetary authorities • Increased risk premium demanded by savers • Increased wage premium demanded by workers • Increased cost of capital for firms • Illusion of a real increase in company profits • Misallocation of capital • Risk of government intervention in economy • Increased search & information costs • Increased risk of bankruptcy

Source: Briault (1995), Fischer (1986, 1994)

Inflation represents a redistribution of wealth from those on fixed incomes to those on indexed incomes, from creditors to debtors, from savers to borrowers and from the private-sector to government when the government is a net debtor. The most obvious distributional costs of anticipated inflation are the decline in the purchasing power of cash holdings (referred to as the “inflation tax” or “seignorage”) and the menu costs associated with changing prices. Anticipated inflation also creates distributional costs when the tax system is unindexed, lowering the rate of capital accumulation, misallocating capital among sectors and affecting the labour supply.⁹ In a modern economy, inflation costs an estimated 2 to 5 per cent of GDP annually when inflation is running at 10 per cent (Fischer 1994c, p.276). This figure concerns the economic costs, but not the distributional costs among groups within society. Inflation below 5 per cent that is anticipated is seen as having moderate costs, a controversial view which lacks empirical support.

Inflation has more significant costs when it is not expected. Unanticipated inflation creates greater uncertainty, causing a misallocation of resources as investors shift from nominal assets into real assets, and investments are put off. For individuals, unanticipated inflation has significant wealth effects, with a redistribution from nominal creditors to nominal debtors and an intergenerational redistribution from the older generation to the younger.¹⁰ Finally, high inflation in the past has led governments to intervene in the economy, by imposing wage and price controls, or credit controls. This intervention produces distortions in the economy that are ultimately destabilising as they lead to disintermediation and misallocation of funds.

⁸ Inflation may be accommodated to ease the crowding out effect caused by rising deficits, to adjust to external shocks to the economy and to avoid raising interest rates.

⁹ While numerous, these tax distortions can be avoided by indexing the tax system (Fischer 1986).

¹⁰ The decline in value of government debt is a tax on the savings of the older generation, benefiting the next generation that face a lower tax bill.

Political View of Inflation

Orthodox economics treats inflation as an endogenous variable, resulting from increases in the money supply beyond the full employment level, or the result of rational behaviour by wage setters faced with politicians who cheat on their promises. Normatively, inflation above some level is viewed as a social bad as it distorts market signals, leading to an inefficient allocation of resources. Political economists contest this position, viewing the struggle over monetary policy as a political contest between interest groups where there are identifiable winners and losers (Burdekin et al. 1996).¹¹ Inflation leads to the redistribution of wealth within society, providing strong incentives for different interest groups to organise. In other words, inflation creates rents that provide the incentives for similarly affected groups to organise and lobby.

Domestic actors compete for a greater portion of the income available in an economy creating excess aggregate demand for income. This excess demand may then be accommodated by monetary authorities through increased money supply, or by the government through increased budget deficits. From a political standpoint, inflation is a politically inefficient tool for redistributing income as monetary instruments are dull and non-discriminatory and the costs of inflation are not hidden. “At a high level of abstraction, monetary policy actions can be viewed as reflecting the compromises reached by the political system between groups benefiting from the redistribution of income deriving from unanticipated inflation... and groups harmed by such income redistribution...” (Hetzel 1990,p.108). This ‘conflict inflation’ approach suggested by the public choice literature views monetary policy as a mechanism for redistributing

¹¹ Burdekin and Burkett are careful to stress that ‘conflict inflation’ does not propose an alternative model of how inflation originates, instead it provides an alternative framework for viewing inflation that complements existing economic theories. Viewing inflation as the outcome of conflict does not imply endorsing a particular conception of that conflict, say as a class struggle between workers and firms. However this view does emphasise that economic events do not occur in a “socio-economic vacuum” (Burdekin et al. 1996, p.17).

income between different interest groups in society, where the winners are the interest groups that organise and have the greatest political clout (Burdekin and Burkett 1996).

1.4 Different Perspectives on Central Bank Independence

This discussion has highlighted two views of inflation - an orthodox view that sees inflation as a problem to be solved through optimal control theory, and a more political view that sees inflation as the result of a distributional conflict between groups in society. In a similar fashion, different academic disciplines have focussed on different aspects of the debate over central bank independence. This section briefly summarises three views, one each from economics, political science and political economy. This discussion is intended to highlight the contribution that a political economy study of this topic can make to the already substantive literature on central bank independence.

Economic Rationale for Independence

For economists, the importance of the debate over central bank independence is a function of its perceived effects on economic performance. Empirical studies sought to provide statistical support for these theories by quantifying the degree of central bank independence and examining the links with economic variables such as inflation, output, employment and interest rates (Alesina 1989; Bade et al. 1978; Cukierman et al. 1992; Eijffinger et al. 1993b; Grilli et al. 1991). Chapter two discusses the economic findings relating to central bank independence in greater detail, while a brief summary of the theoretical and empirical work is provided below.

The main insight of the theoretical literature is that an independent central bank with a narrow mandate of price stability is seen as reducing inflationary expectations among domestic actors. Neo-classical economists used game theoretic reasoning to demonstrate the importance of credibility for monetary policy, modelling it as a repeated game

between rational, forward-looking actors (Persson et al. 1994a). Time inconsistency arguments were combined with rational expectations to show that discretionary monetary policy generated an inflationary bias among private actors (Barro et al. 1983). Time inconsistency reflects the fact that a policy stance that is best today will become undesirable to policymakers when that future arrives (Roll 1993, p.13).¹² An institutional mechanism was needed which made political promises to pursue price stability credible to private actors (Cottarelli et al. 1997). Central bank independence was one institutional solution to this problem. In other words, central bank independence solved the time-inconsistency problem of policy and provided anti-inflationary credibility in the eyes of key groups.

From this starting point, the empirical work advanced in three stages. First, researchers operationalised the concept of central bank independence, by creating legal indices based on the coding of central bank statutes. Next, these indices were regressed on different economic variables in the search for statistically significant relationships. Finally, researchers outlined the implications of their findings for institutional design, and the trade-off between credibility and flexibility in the use of policy instruments. The most significant finding was that independent central banks were associated with low inflation. In addition, no studies found a firm link between central bank independence and GDP growth or employment. This somewhat surprising finding led central bank independence to be portrayed as a ‘free lunch’ (Grilli et al 1991). It provides benefits in terms of reducing inflation, but does not come with any associated costs in terms of lost output or increased unemployment. The economics literature addressed the question of ‘why’ give independence to the central bank, but has not asked ‘how’ the process

¹² For example, politicians may promise today to control the money supply in some future period, in order to anchor inflation expectations, but may wish to loosen money supply when that time arrives due to a recession (Roll 1993, p.13).

happens or 'when' it occurs. These latter questions are political, and require an analysis of the distributional consequences of policy.

Democratic Accountability of Monetary Policy

For political scientists, delegation of interest rate policy to an independent central bank raises the issue of democratic accountability. In a democracy, politicians are elected by the public to manage the economy. Politicians are held accountable for their performance on a regular basis, either through the scrutiny of the press and the opposition, or through elections. By contrast, central bankers are unelected and are not directly accountable to the public. In some cases, the central bank may have a privileged status within the apparatus of government, operating apart from the broader bureaucracy, staffing itself independently from the civil service and controlling its own budget and salaries. While central bank officials must generally report on their monetary policy decisions to the legislature or the executive, this accountability is one step removed from the public eye. The deliberations of central bankers are notoriously secretive and the language they use to describe their decisions can be highly technical and elitist, adding to the public perception of a democratic deficit. This apparent autonomy from the political process and lack of transparency about decision-making raises questions of accountability which are difficult to refute.

Distributional Politics and Inflation Control

International political economy ("IPE") is concerned with answering the question, who wins and who loses from a given policy or a regime (Frieden and Lake 1991; Keohane 1989; Strange 1993). Economic policy is political because it affects the distribution of wealth among different groups in society and determines who pays the cost for public goods provided by the state. IPE studies of central bank independence start from the point of view of 'conflict inflation', discussed above. IPE seeks to identify which groups benefit from price stability and which groups bear the cost of adjustment during an

inflation or disinflation. “[This] struggle brings to light connections between politics and economics. It shows how the existing distribution of power among actors influences their ability to obtain the economic policies they desire and thereby affects the distribution of wealth.” (Milner 1988, p.3). An important consideration is how interdependence with the international system affects this outcome.

Who benefits and who loses from an independent central bank? And what incentives exist to cause different groups to lobby in favour or against this institutional reform? These questions can be answered by viewing the debate over central bank independence as a debate over inflation – its sources, its effects and institutional remedies for preventing it. To answer the question ‘who benefits?’ we first need to look at the distributional effects of inflation and the impact of policies adopted to control inflation. (Chapter 4 of this thesis provides a study of the distributional effects of central bank independence and highlights those actors who have an incentive to support or oppose this institutional reform). Second, we need to look at how these groups influence policymakers. The success of any anti-inflationary strategy adopted by monetary authorities hinges on accommodating or protecting key interest groups that are either making or resisting claims on income. The status of the central bank therefore becomes a crucial institutional variable for structuring the outcome of the monetary policy game in their favour, but one that can be changed when the power of different interest groups changes.

Domestically, inflation control through central bank independence causes a higher loss in output during disinflations, as measured by the sacrifice ratio. This loss results from an independent central bank raising interest rates and holding them at a high level for longer than a more politically controlled central bank. The costs of such a tight

monetary policy are unevenly distributed, and fall disproportionately on workers, the traded sector and manufacturers. Workers lose because the fall in output leads to a rise in unemployment, putting downward pressure on wages and potentially causing structurally higher levels of unemployment. Exporters are hurt because the currency appreciates, reducing the competitiveness of exports and making imports less attractive. Manufacturers are hurt because they typically operate in cyclical industries that rely heavily on debt or variable rate borrowings. A slowdown in the economy combined with a higher cost of debt leads to increased bankruptcies amid falling demand. Internationally, inflation is also destabilising as it can be exported through macroeconomic policy choices, trade links or exchange rate regimes. Witness the decline of the Bretton Woods system due to American exorbitant privilege or the policy of competitive devaluations during the interwar period (Simmons 1994; Walter 1991). It is no surprise that inflation is never far from the heart of debates over monetary frameworks.

A game-theoretic approach to this situation highlights the vital role played by information and institutions. Information affects the incentives facing different interest groups as they seek to predict the strategies of other parties in the game and try to structure the game in their favour (Burdekin and Burkett 1996, p.22). The outcome of the distributional conflict over central bank independence therefore may depend on the ability of different actors to control this institutional setting. This observation led Posen to argue that “there is no institutional ‘fix’ for the redistributive struggle over monetary policy,” (Posen 1993, p.53). The central bank can be seen as an intervening variable used by interest groups to structure monetary policy in their favour. A change in its status should be linked to shifts in the power of different interest groups that seek to change the institutions controlling economic policy in their favour.

1.5 Four Hypotheses Explaining Timing

The political economy literature offers four hypotheses for explaining when a central bank is likely to be given independence. These explanations are summarised below and are developed in greater length in chapter 3.

The first hypothesis is that politicians use central bank independence as a signalling mechanism to facilitate balance of payments financing (Maxfield 1997). Capital-poor governments with limited domestic sources of capital need to convince international financial markets of their anti-inflationary credentials in order to attract foreign capital and to reduce the interest-rate charged on their borrowing. The decision to delegate to the central bank signals this commitment to foreign investors, increasing their willingness to lend to these borrowers.

A second hypothesis is that politicians give independence to their central banks in response to the advice of an epistemic community of monetary experts. Histories of monetary institutions have shown how they are profoundly influenced by the development of academic theories about their proper role (Capie, Goodhart, and Schnadt 1994). In terms of the trend in central bank independence, greater uncertainty due to the rise of stagflation, the end of fixed exchange rates and the rise of international capital flows led to a breakdown in the existing monetary frameworks. Inspired by the time inconsistency literature, academics developed the view that central bank independence was a simple reform that could provide low inflation with no negative side-effects on growth or employment. An epistemic community of central bankers, academics and economists convinced key politicians in a few states to adopt this reform, which other states later emulated.

A third hypothesis argues that politicians adopt this reform in response to the lobbying of domestic interest groups opposed to inflation, led by the financial sector (Goodman 1991; Posen 1995b). A number of features put the financial sector in the best position to influence politicians in this area. The financial sector, it is argued, has the technical knowledge of monetary policy required in order to understand this issue. It has the organisational incentives required to lobby as price stability - while providing a public good - provides exclusive benefits to banks due to the impact it has on their balance sheets. This group has access to policymakers in this area and has the resources at its disposal to pay for these efforts. Other groups that are expected to oppose this reform are the trade unions, exporters and manufacturers.

The fourth hypothesis looks at the electoral incentives facing politicians to 'tie their hands' (Goodman 1991). In the past, politicians used their control of macroeconomic policy to increase their popularity around elections, despite the negative consequences for price stability, creating political (or partisan) business cycles (Alesina 1989; Nordhaus 1975). However, this behaviour is anticipated by the electorate and is no longer rewarded. Politicians may therefore be willing to 'tie their hands' and delegate control of interest rates to an independent central bank when this strategy provides electoral benefits. For example, right-wing politicians with an expected short time frame in office may grant independence to the central bank in order to reduce the room to manoeuvre of their left-wing successors. Alternatively, a left-wing government may give the central bank independence in order to reduce the interest-rate premium charged on its borrowing, as financial market actors are suspicious of left-wing governments' partisan preferences and expect an inflationary policy (Goodhart 1997). A third explanation is that politicians view central bank independence as a mechanism for

increasing cabinet stability and durability, by removing intra-party conflicts over monetary policy which are divisive and hard to monitor (Bernhard 1996).

These four explanations supporting central bank independence must be qualified by the institutional setting in which policy is made. Both political and economic institutions affect the likely outcome. The political institutions that are hypothesised to affect the outcome are the political regime type, the number of checks and balances in the political system, and the degree of party fractionalisation. A number of authors associate independence with federal political systems, where there is a greater tendency for politicians to delegate power (Banaian et al. 1983; Pollard 1993; Posen 1993). Other authors have suggested federalism is a proxy for the number of political checks and balances in the political system (Keefer et al. 1998). A larger number of veto players whose approval is required to pass legislation, such as in a federal system or with a bicameral legislature, affects the likelihood that the central bank will be given independence (Moser 1999).

The state of development of the domestic financial system and the access to private savings are important factors affecting both the need for foreign financing and the effectiveness of financial sector lobbying (Mas 1995; Posen 1995b). The existence of deep and liquid domestic capital markets may weaken the need to signal creditworthiness to international investors, reducing the need for delegation (Maxfield 1997). The central bank's role in regulating the banking system and the nature of labour market institutions are additional variables that are suggested to impact this trend in independence (Bleaney 1996; Hall et al. 1998; Posen 1993).¹³

¹³ The financial sector may face a conflict of interest when the central bank is responsible for banking supervision, which prevents the financial sector from lobbying for greater independence. When wage bargaining is coordinated, trade unions may prefer an independent central bank because inflation is kept

Methodology and Choice of Cases

These hypotheses provide a rich and varied group of variables for explaining the timing when politicians will reform the legislation governing the central bank. However, they also raise a number of questions, as they suggest a large variety of explanatory variables – some of which are predicted to have contradictory effects – such as the time frame of politicians, partisanship, the existence of domestic capital markets, or the number of checks and balances in the political system. Given the methodological weaknesses identified with the coding of central bank statutes, statistical studies employing the change in the status of the central bank as the dependent variable reached inconclusive results (Eijffinger et al. 1996).

Under these circumstances, an alternative methodology to a large-n statistical study is to employ comparative research of a limited number of cases to study the variation in the outcome (King et al. 1994; Peters 1998). To avoid omitted variable bias or an indeterminate research design, King et al (1994) recommend controlling the research situation by matching, that is choosing cases which are alike in as many ways as possible except for variation in the dependent variable. They also recommend increasing the number of observations, defined as one measure of one dependent variable on one unit, by measuring observations 'across space' or 'across time'.

This thesis employs a qualitative, case study approach of the central banks in the Australia, Canada, New Zealand and the UK. The period being studied is the 1980 to 2000, a timeframe that was chosen to take in the rapid rise in the trend in central bank independence during the 1990s in contrast to the relative absence of such a trend during the 1980s. The choice of cases was designed to hold key political and economic

institutional variables constant. These four English-speaking countries share a common history, a similar Anglo-Saxon culture and political institutions. All four are parliamentary democracies with the British sovereign as Head of State. Their parliaments are based on the Westminster model, where effective power resides with the Cabinet headed by the Prime Minister. During the 1980s and early 1990s, all of these countries elected representatives to the lower house based on either plurality or majority electoral rules.¹⁴

Ideationally, all four economies share similar higher-education systems, have the same exposure to the media (televised and printed), and exhibit a similar level of involvement of think tanks in the public debate. Policymakers, academics and central bankers are exposed to the same economic research spread through a transnational network centring around the Bretton Woods institutions, the OECD, the Bank for International Settlements and the World Economic Forum. Many academic and professional economists working in these countries have pursued their graduate studies in either the UK or the USA, where they would have been exposed to the debate between Keynesians and Monetarists, as well as the Rational Expectations revolution and the New Classical Economics. Finally, these relationships would be cemented through interaction at academic conferences, membership in affiliated educational associations, exposure to the main journals of their disciplines and subscriptions to the international financial magazines such as *The Banker*, *The Economist* and *Euromoney*.

Economically, all four are small or medium-sized, open economies which are members of the OECD. They are highly integrated into the global economy, and with a domestic

stable.

¹⁴ New Zealand changed the voting rules used to elect its Lower House, replacing its pluralitarian 'first-past-the-post' electoral rules with a mixed member proportional representation system from 1996.

financial system based on the capital-market. Over the 1990s, all four of these countries adopted inflation targets as the framework for monetary policy. However, only two of these countries reformed their legislation to give formal independence to the central bank, New Zealand in 1989 and the UK in 1997. Both Canada and Australia debated such a reform, but abandoned the proposals in favour of their so-called 'politically controlled' central banks.

Observations to test these hypotheses have been selected based on both variations across space and time. One observation within each case study occurs each time the legal status of the central bank is debated among politicians elected to the main legislative chamber. The evidence of a sustained political debate must appear in the published record of Parliamentary proceedings, either debates over bills to reform the central bank statute, government-appointed commissions which examine the central bank statute, or initiatives taken by the members of the Cabinet.

Table 4: Political debates concerning central bank independence, 1980-2000

COUNTRY	#	POLITICAL DEBATES OVER CENTRAL BANK INDEPENDENCE
Australia	3	1986-1989, 1991-1993, 1996
Canada	2	1991-1992, 1993-1994
New Zealand	1	1988-1990
United Kingdom	3	1989-1990, 1992-1994, 1997-1998

As part of this study, the author contacted and interviewed 84 officials in the four countries being studied. These individuals represented a mix of present and former politicians, central bankers, Treasury or Ministry of Finance officials, representatives from trade and business associations, and academics. These interviews were conducted face to face, over the telephone, or through an extensive correspondence by e-mail. The majority of these individuals agreed to have their contribution cited, in which case their

comments are attributed in the case studies. A full list of individuals is available upon request.

Road Map of Study

Chapters 2 through 4 of this thesis provide the theoretical framework. Chapter 2 reviews economic theories of central bank independence and summarises the empirical findings. By the early 1990s, a new paradigm had emerged that viewed central bank independence as the solution to the time inconsistency problem with policy. Central bank independence was a ‘free lunch’ which brought anti-inflationary gains without economic costs. This new paradigm provided the backdrop to political debates over this policy reform. Chapter 3 reviews the four hypotheses that explain the timing of this reform. The logic of these explanations and the importance of the institutional context are set out in greater detail. Chapter 4 sets the stage for the case studies, by providing important background material on the relevant economic and political institutions for each country case, as well as more specific detail on the interest groups that are expected to have been active on this issue. This chapter concludes by outlining what outcomes we should expect to find in the case studies based on the hypotheses in chapter 3 and the institutional and interest group variables outlined in chapter 4.

The second part of the study consists of chapters 5 through 9. Chapter 5 reviews the Reserve Bank of New Zealand, which was given independence in 1989 by the Labour government at the end of a comprehensive economic reform programme begun in 1984. Chapter 6 looks at the Bank of Canada, where politicians considered a proposal to reform the legislation governing the central bank but rejected it in favour of the status quo. Chapter 7 examines the debates in Australia, where close ties between Labor politicians and the central bank governor turned this debate into an election issue in 1993. Chapter 8 considers the UK, where the incoming New Labour government gave

operational independence to the Bank of England within a week of its election in 1997, despite the Conservatives rejecting this reform repeatedly over 18 years. Chapter 10 concludes by considering the four hypotheses for explaining why politicians delegate. It also considers the international sources of domestic institutional change as well as the partisan nature of international financial market.

1.6 Summary of Findings

The case studies found that politicians gave operational control over monetary policy to the central bank when this reform was promoted by an epistemic community of monetary experts, and was supported by a key politician who championed the legislation through parliament. Politicians had an incentive to tie their hands due to ideological or electoral reasons. In the case of New Zealand, the Finance Minister who introduced the legislation was convinced of the need to remove political interference in the setting of interest rates, an activity that was seen as responsible for leading to the country's dramatic economic underperformance over the previous two decades. In the UK, the Chancellor of the Exchequer used this reform to reduce the risk of a financial crisis in the short term and to lay the ground work for New Labour to get re-elected in the future. In both cases, central bank independence was used to signal the government's anti-inflationary credibility to a primarily domestic audience in the non-financial sector. This reform was facilitated by political institutions characterised by few checks and balances that concentrated power in the hands of the executive and offered few obstacles to changing the central bank's statute. Central bank independence in these two countries was not explained by domestic interest group lobbying. While interest groups took part in the political debates over central bank reform, their effectiveness at influencing politicians was mitigated by collective action problems.

Central bank independence did not occur in the cases where the epistemic community did not hold a consensus over this reform. In Canada and Australia, monetary authorities did not see the need to change the central bank's statute as the central bank operated with a high degree of *de facto* independence, as witnessed by its success in bringing down inflation. Narrowing the central bank's mandate to the pursuit of price stability was seen as inappropriate, as it reduced the government's flexibility to adjust monetary policy for external shocks or to pursue other objectives. In both cases, domestic academics were divided on the issue. A vocal group of opponents pointed to the benefits of having multiple objectives and expressed concern over the costs of narrowing the mandate. Supporters of the need to reform the monetary framework could not reach a consensus on a preferred alternative, but instead presented politicians with a confusing array of frameworks. Politicians in these cases saw only electoral risks from changing the central bank's statute. Central bank reform in Australia was opposed by key constituents among the trade unions. In Canada the reform was politically divisive and came at a bad time, when politicians were preoccupied with more pressing constitutional issues. British politicians opposed to reform saw delegation to an independence central bank as a politically damaging admission of failure that also restricted their ability to influence the timing of interest rate changes for electoral reasons. Finally, the bicameral and federal political institutions in Canada and Australia presented obstacles to passing legislation and provided an incentive to stick with the status quo. As a result of the lack of epistemic consensus and the electoral risks, politicians in these cases were unwilling to champion central bank independence.

Ch. 2 Central Banking and the Power of Economic Ideas

This chapter charts the rise of central banking and the accompanying emergence of a transnational epistemic community of monetary experts who have played an increasingly influential role in advising politicians on the conduct of monetary policy. This epistemic community consisted of professionally trained economists, most of them adherents to the tenets of monetarism or rational choice economics, who have dominated the debate over solutions to the control of inflation. It is hypothesised that this epistemic community has influenced policy by redefining how politicians perceive their interests, by controlling the agenda and by translating complex ideas into strategies for managing increased international interdependence. In particular, economists' theoretical and empirical work on central banking during the late 1980s and early 1990s led to a new paradigm that associated greater central bank independence with lower inflation, without necessarily creating higher costs in terms of unemployment or reduced growth. This apparent 'free lunch' was attractive to politicians from both the right and the left of the political spectrum, as it appeared to offer a solution to the high inflation experienced during the 1970s and 1980s. In addition, experts could point to the low inflation records of the independent Bundesbank, Federal Reserve and Swiss National Bank as institutional models that policymakers could emulate. This new paradigm, this chapter argues, was behind the trend towards central bank independence in the 1990s.

The first section provides a brief history of the rise of central banks and explains why central bank independence was not the norm prior to the 1990s. The second section reviews the policy failures that led to the collapse of the existing paradigm of monetary targeting during the 1980s, allowing the new paradigm of central bank independence to

emerge. The third section reviews the theoretical literature on central bank independence, which took off in 1983 following publication of a paper that applied the time inconsistency arguments to monetary policy. It also summarises the subsequent empirical work on central bank independence that uncovered a negative association between central bank independence and inflation, with no apparent relationship with GDP. The fourth section reviews the impact of the Bundesbank and the Federal Reserve on debates in the literature, with reference to how they acted as models to be emulated by other states. The final section summarises the status of the paradigm during the 1990s, and argues that central bank independence was presented to politicians as a relatively simple solution to the problem of inflation with no associated costs.

2.1 History of Central Banking

Classical Gold Standard and Interwar Reconstruction

A growing number of central banks were founded during the 1800s, during the era of the classical gold standard, which operated from roughly 1873 to 1914.¹ Under this monetary framework, gold flows theoretically responded to changes in trade and capital flows, generating automatic increases or decreases in the domestic money supply. During this period of laissez-faire, *de facto* central bank independence was the norm and central banks operated with relative independence within the constraints of the system, performing a technical function of maintaining the convertibility of currency for specie and controlling the money supply (Capie et al 1994, p.10). The gold standard is often described as a rule-based framework with changes in the gold stock acting as a de facto fixed money growth rule. In practice the success of gold standard owed much to the cooperation of the leading central banks, which placed operation of the international

¹ Britain had been *de facto* on gold since the early 1700s but the gold standard only became widely adopted in the 1870s.

gold standard above other domestic concerns (Eichengreen 1992).² The system's credibility led to stabilising private capital flows and meant the commitment to gold in the core countries was not tested.³

Table 5: Central Banks founded prior to 1914

Sweden	1668	Norway	1816	Russia	1860	Serbia	1883
UK	1694	Denmark	1818	Spain	1874	Italy	1893
France	1800	Indonesia	1828	Germany	1876	Switzerland	1905
Finland	1811	Nth. Antilles	1828	Bulgaria	1879	USA	1913
Netherlands	1814	Portugal	1846	Romania	1880		
Austria	1816	Belgium	1850	Japan	1882		

Source: Capie et al (1994)

The classical gold standard was suspended at the onset of the First World War.⁴ During this period central banks became subservient to their governments, with monetary policy implemented according to the exigencies of wartime finance. An attempt was made to reconstruct the gold standard during the interwar period but failed, as the political and economic conditions underpinning the pre-war gold standard had eroded (Eichengreen 1992). The operation of monetary policy became politicised with the creation of left-wing political parties, and the new emphasis on creating employment (Simmons 1994). International cooperation foundered as politicians abandoned balanced budgets and printed money to finance deficits, creating inflation. A monetary contraction originating in the USA was transmitted internationally by the gold standard, creating a deflationary spiral in the international economy. The spectre of currency devaluations in the absence of international cooperation led to destabilising private

² Central banks varied the discount rate in "order to avoid having to absorb gold flows directly onto their reserves" (Capie 1994, p.13). Monetary instruments were used to resist or attract inflows, in a pro-cyclical fashion, contrary to the 'rules of the game'.

³ Capital flows are not a new phenomenon in the post-war period, nor was there an absence of financial crises in the last century. By some accounts, the degree of integration in finance and trade was greater between 1900 to 1914. See: (Farkas 1998; Hirst et al. 1996)

⁴ In the UK, specie payments were suspended and a moratorium was declared on the repayment of bills of exchange. Central banks around the world took similar steps.(Capie 1994, p.16)

capital flows that caused the interwar gold standard to collapse (Eichengreen 1992, Simmons 1994).

Bretton Woods

Following the wars, the laissez-faire paradigm of classical economics was overthrown as Keynesian ideas spread, introducing a new paradigm of activist macroeconomic policy (Keynes 1936). Governments took control of the ‘commanding heights’ of the economy. In this atmosphere, the independence of central bank was questioned and many existing central banks were nationalised. The newly emerging states created over this period founded central banks that were politically dependent. Under the reigning Keynesian paradigm, monetary policy was ‘twice damned’ as it was considered impotent and it was tarred by association with the interwar period (Friedman 1969a, p.96). Therefore the instruments of monetary policy were not used (Cottarelli et al. 1997).

Table 6: Central Banks Nationalised following W.W.I

Year	Central Bank
1936	Danmarks Nationalbank Reserve Bank of New Zealand
1938	Bank of Canada
1945	Banque de France
1946	Bank of England
1948	Nederlandsche Bank Banque Nationale de Belgique
1949	Norges Bank Reserve Bank of India

Source: Capie et al (1994)

Led by the US and the UK, international monetary cooperation was restored after the war under the Bretton Woods regime (Walter 1991). Bretton Woods introduced a fiat monetary standard backed by gold, with pegged but adjustable exchange rates. Unlike the gold standard, this framework was discretionary and required the U.S. to maintain a fixed price for gold while member states maintained a fixed exchange rate with the U.S.

dollar. Under pegged exchange rates, central banks had little autonomy despite the existence of capital controls. Changes in interest rates generated offsetting capital flows which had to be sterilised in order to maintain external exchange rate pegs. In addition, domestic monetary instruments were initially limited, as credit and interest rate controls adopted during the war were slow to be abandoned (Capie, Goodhart, and Schnadt 1994, p.25). Central banks were left with the largely technical task of targeting the exchange rate. In this environment, the legal status of the central bank was not a political issue. The Bretton Woods system worked well for two decades, providing price stability with high economic growth rates for almost thirty years.

This view of the world lasted when monetary policy – which had lain dormant - became expansionary in the 1960s as governments responded to slowing growth (Cottarelli and Giannini 1997, p.3). US abuse of the key currency created a credibility crisis, as predicted by Triffin, as the number of dollars in circulation outstripped US gold reserves (Eichengreen 1996, p.116). Fearing rising gold losses, the Nixon administration closed the gold window in 1971 and broke the link with gold, signalling the end of the exchange rate regime. The arrival of stagflation in the 1970s signalled the breakdown of the ideological consensus underpinning the Keynesian paradigm (Cottarelli et al. 1997, p.4). The collapse of the Bretton Woods system of pegged exchange rates witnessed the end of a system-wide monetary framework.⁵ In its place there has emerged a patchwork of competing monetary frameworks, which vary based on the degree of discretion they allow in monetary policy. The majority of industrial countries opted for the status quo, adopting pegged exchange rates with the remainder allowing their currencies to float. Of the pegged exchange rate regimes, eight European countries launched ‘the Snake’ in 1972, while the others pegged to the US dollar, the

Pound Sterling, or a basket of currencies. In this environment, central bankers' specialised knowledge of monetary policy and financial markets provided them with increased responsibility and influence.

Monetarism

The ideological and operational breakdown of the Bretton Woods system opened the way for a monetarist counter-revolution. Monetarists, led by Milton Friedman, capitalised on the inflationary surge to expose the weaknesses in Keynesian views of monetary policy and the Phillips curve. The rise of inflation turned out to be the “revival of belief in the potency of monetary policy” (Friedman 1969a, p.96). It convinced practitioners and policymakers of Friedman’s claim that inflation was always and everywhere a monetary phenomenon leading to the conclusion that monetary policy should be directed towards the pursuit of price stability (Friedman 1969b). This paradigm shift towards monetarism was supported by empirical studies demonstrating a stable relationship between the velocity of money and long term rate of inflation (Capie, Goodhart, and Schnadt 1994). With monetary policy reinvigorated, central banks began focussing on ways to provide price stability through control of the money supply. As monetary policy moved to become the centrepiece of macroeconomic policy, central bankers moved to centre stage. Federal Reserve Chairman Volcker’s dramatic increase in U.S. interest rates in October 1979, which spurred the rise of interest rates worldwide, pushed central bankers out of the limelight and into the centre of a public debate (Economist 1999b, p.3).

⁵ The Smithsonian agreement, negotiated after the US closed the gold window in August 1971, collapsed in February 1973, marking the official end of the Bretton Woods system (Eichengreen 1996).

By 1980, the fashion in monetary frameworks was monetary targeting, following the example of Germany, which adopted monetary targets in 1974.⁶ Nine countries began using monetary targets as operational guides for monetary policy, including the US, Canada, Switzerland, and the UK (Cottarelli et al. 1997, p.26). Australia and France adopted internal monetary targets in support of an external exchange rate peg. A host of countries worldwide adopted a *de facto* monetary target by pegging their exchange rates to a currency where this framework was in place, such as the members of the Exchange Rate Mechanism (“ERM”) launched in 1979. Despite arguments in favour of floating exchange rates, few countries were attracted to this framework due to the rising volatility of foreign exchange markets and their tendency to overshoot their so-called equilibrium levels.

Monetarism may have increased the importance of central bankers, but it did not promote the trend in central bank independence. Friedman opposed central bank independence on the basis that discretion in monetary policy making was invariably inflationary. Friedman argued that the central bank could not control the price level, it could only control the stock of money (Wood 1994, p.68). The effects of monetary policy in the short run were highly unpredictable, and affected the economy with long and variable lags. Instead Friedman (1969) argued that the central bank and the monetary authorities should be tied down to clear, simple rules for monetary expansion (Capie et al 1994, p.83).⁷

⁶ Under monetary targeting, the central bank set its instruments to meet a short term target for a monetary aggregate (Cottarelli et al. 1997, p.26).

⁷ Friedman's position owed much to the thinking of the Currency School and their analysis of the determinants of monetary disturbances in the 1820s and 1830s (Capie et al 1994, p.81; Goodhart 1995, p.208).

2.2 Crisis of International Monetary Frameworks

The first stage in the development of a new macroeconomic paradigm is a process of policy failure, accompanied by a crisis, which creates the space for a new conception of economic policy (McNamara 1998, p.5). The stimulus for the rise of central bank independence was the collapse of monetary targeting during the 1980s, accompanied by the questioning of the monetarist orthodoxy underpinning targets. Ideologically, the view that expectations were forward-looking and rational, and that - once exploited - systemic relationships in the economy would break down, led policy rules in general to be discredited. This conclusion resolved the on-going economic debate between 'discretion and rules' in favour of discretionary policy.

Operationally, structural changes in the international monetary system caused by financial deregulation, the removal of capital controls and the rapid rise of international capital flows led to the breakdown of the relationships underlying monetary targeting. The Bundesbank and the Fed stopped placing as great importance on forecasts of monetary aggregates while many countries such as Canada and the UK abandoned monetary targets altogether. These changes left monetary policy without an anchor, and left the economics profession without any clear answers. Some countries adopted floating exchange rates, while others sought some form of external anchor by pegging to a basket of currencies. The uncertainty created by this change and the accompanying ideological shifts set the stage for the trend towards central bank independence in the 1990s.

The failure of monetary targeting is reflected in the failure of governments to control inflation or to combat rising unemployment over the 1970s and 1980s, as shown in table 4. In addition, the sharp increase in interest rates at the start of the 1980s was followed by a surprisingly painful slow-down and recession. While the industrial countries

exhibited relatively similar economic growth under the Bretton Woods era, they showed considerable variation in performance after its collapse. This variation in performance has been attributed to the different institutions in the respective countries, with central bank independence playing an important role for most explanations.

Table 7: Evolution of Monetary Frameworks, 1973-1995

	Exchange Rate Peg	Monetary Target	Floating Rate	Inflation Target
USA ¹		1979-1984	1970-1978 1985-2000	
Japan	1970-1971		1972-2000	
Germany ¹	1972 1999-2000	1975-1998	1970-1971 1973-1974	
France	1970-1971 1979-2000		1972-1978	
UK	1970-1971 1990-1992	1980-1983	1972-1979 1984-1989	1993-2000
Canada		1977-1982	1970-76 1983-1990	1991-2000
Australia ²	1970-1983	1976-1984	1984-1992	1993-2000
New Zealand	1970-1978 1982-1984		1985-1989	1990-2000

1. The USA is treated as being a floater from 1968, when the convertibility of dollar balances had been restricted to monetary authorities. Germany is treated as not having an exchange rate peg under the Snake and the EMS as it was the numeraire for the system.

2. Australia had both an exchange rate peg and monetary targets from 1976-84.

Source: Cottarelli and Giannini (1997), Edey (1997), Macfarlane (1998).

Table 8: Misery Index for Selected Countries ¹

Country	1950-72	1973-79	1980-89	1990-98
<i>OECD Average</i>	6.6	15.7	15.5	11.5
Australia	6.1	16.4	15.9	11.6
Canada	7.1	15.9	15.8	12.1
France	6.9	14.5	16.2	13.3
Germany	4.7	7.7	8.7	10.1
Italy	11.0	22.0	19.5	14.9
Japan	6.1	12.0	5.0	4.2
New Zealand	4.7	13.7	16.3	10.4
United Kingdom	6.6	19.4	17.2	12.4
USA	7.1	14.7	12.8	9.0

1. Misery index is the sum of the rate of inflation and the rate of unemployment, as developed by Okun.

Source: IMF International Financial Statistics

Figure 2: Inflation Record of Select Countries

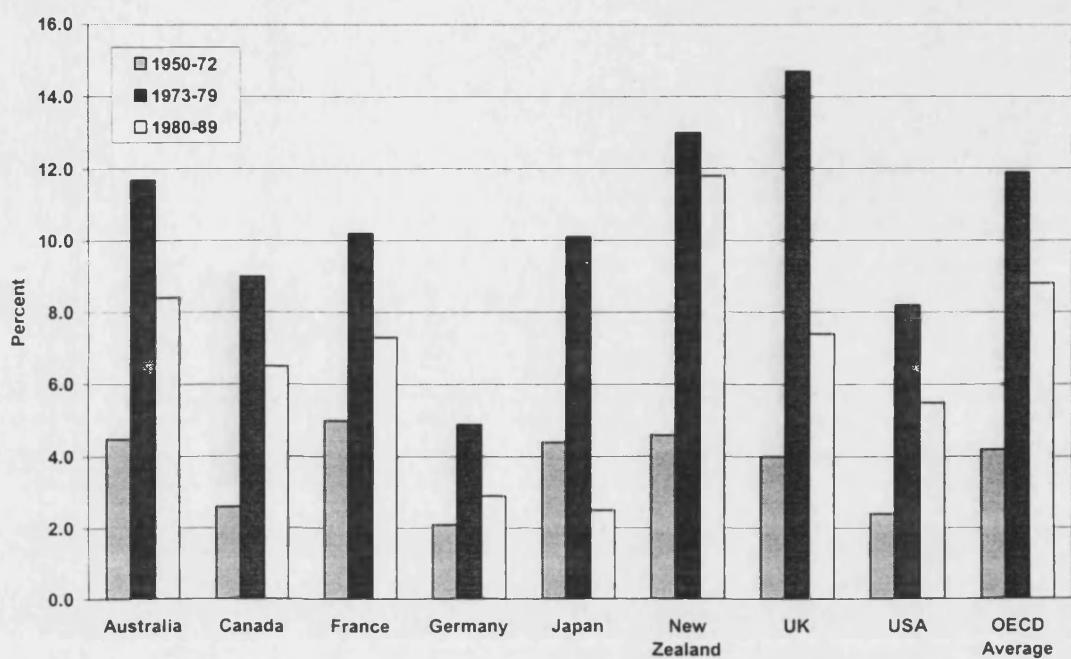
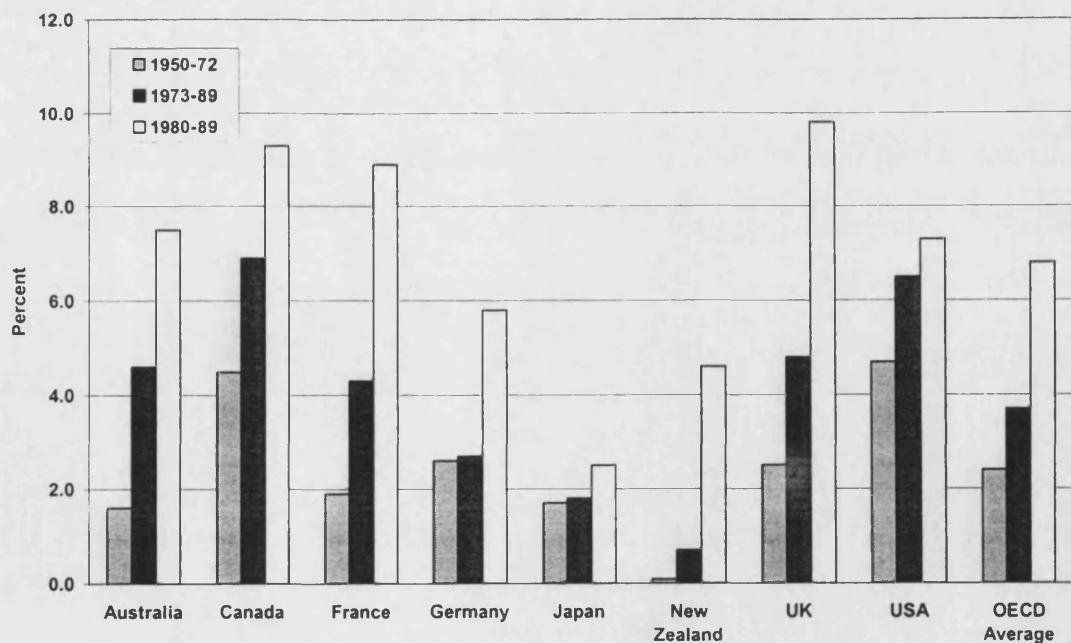


Figure 3: Unemployment Levels of Select Countries



2.3 Emergence of New Paradigm

The trend towards central bank independence during the 1990s has been underpinned by a new theoretical paradigm supported a large body of empirical work. This paradigm argues that the inflationary bias inherent in discretionary monetary policy can be overcome by putting in place an institutional framework that allows policymakers to credibly commit not to resort to surprise inflation. An independent central bank was one such institutional arrangement. This solution to the time inconsistency problem was supported by research that purported to show a negative relationship between independent central banks and inflation – a finding that has been used more than any other argument to support and legitimise giving independence to central banks. This link was established theoretically in the 1980s and then empirically in the first half of the 1990s by a number of scholars working under the paradigm of neo-classical economics. This paradigm was given greater visibility over this period due to the policy debates surrounding European Monetary Union, on one hand, and the creation of newly independent central banks in the former Soviet Union and Latin America, on the other.

Inflationary Bias, Game Theory and Credibility

The economics literature on central banking took a dramatic turn in the mid-1980s with the introduction of game theory to the analysis of monetary policy. Earlier literature had treated policy as a one-time, utility maximising ‘game against nature’, where policy makers optimised the setting of their instruments by solving a set of equations (Cottarelli et al. 1997). This view was overthrown by the rational expectations revolution which swept through the discipline in the 1970s. The new game theoretic literature viewed policymaking as a repeated game between rational, forward looking actors where policy is chosen to maximise some social welfare function, subject to well-defined constraints (Persson et al. 1994a, p.1). Whereas the traditional macroeconomics

approach – in its Keynesian, monetarist or Neo-classical variety – treated the money supply as exogenous, this literature treated money supply as endogenous to the game between fiscal and monetary authorities (Persson et al. 1993, p.54).⁸ Game theory highlighted the importance of credibility for policymaking. Credibility is defined as “the confidence invested by the public in the government’s commitment to a policy” (Eichengreen 1992, p.5).

The seminal article signalling this change of direction was Kydland and Prescott (1977) which introduced the notion of time inconsistency of policy. Kydland and Prescott argued that discretionary policy results in excessive rates of inflation without any reduction in unemployment, because rational economic agents anticipate and adjust for future policy behaviour. Governments may adopt the best policy to meet circumstances at the time, as suggested by optimal control theory, but past wage agreements have already discounted its inflationary effects, making the policy sub-optimal when it is time to be implemented. In other words, policy is time inconsistent “when the best plan currently made for some future period is no longer optimal when that period actually starts.” (Eijffinger 1997, p.xii). Barro and Gordon (1983) applied the concept of time inconsistency to the conduct of monetary policy to show how rational expectations make discretionary monetary policy ineffective for affecting real economic variables. Policymakers are viewed as non-cooperative actors who have an incentive to cheat on their commitments based on their loss function (Backus et al. 1985). In particular, monetary authorities have an incentive to engineer surprise inflation in the short run, expanding output beyond the natural rate of employment and reducing the real value of the public debt. Rational economic actors expect this systematic cheating behaviour,

⁸ Non-cooperative behaviour between actors can be modelled in two ways, as a Nash game where both parties make their choices simultaneously, or a game where one party leads and the other responds (Pollard 1993, p.32).

view public policy announcements from the government with scepticism, and factor inflation into their forward-looking expectations. Thus policy becomes ineffective for raising output and equilibrium in the economy occurs at a higher level of inflation. As a result, discretionary policy creates an inflationary bias in the economy.

Credibility Mechanisms

Kydland and Prescott (1977) and Barro and Gordon (1983) saw their demonstration of the inflationary bias of discretionary monetary policy as “making the case for a monetary rule, along Friedman lines.” (Fischer 1994c, p.288) But rule-based solutions suffered from a number of well-known disadvantages. First, they cured inflation by removing flexibility that was desired to deal with output shocks. This lesson had been learnt under the Bretton Woods system and was reinforced by the oil shocks of the 1970s. Second, rule-based frameworks were considered insufficient, as the announcement of a rule did not provide it with credibility. There remained incentives for policymakers to cheat given the existence of a short run Phillips curve. Third, a fixed money rule attained price stability at the cost of increased variability in output, creating ‘deadweight’ costs for the economy (Lohmann 1992). Finally, the Lucas critique and the failure of monetary targeting in the 1970s had shown how rational expectations prevented policymakers from exploiting systematic relationships in the economy.

By the mid-1980s, a view emerged that what was really missing was an institutional mechanism for convincing private agents that discretionary monetary policy would not be exploited to achieve short-run gains (Cottarelli et al. 1997, p.5). The evolving debate focused on how to overcome credibility problems through institutional mechanisms. Research suggested three solutions for enhancing policy credibility: establishing a reputation for price stability, which is tested at an early stage; devising a commitment

technology that removes the incentive to cheat; or increasing the transparency of the policy process (Cottarelli et al. 1997, p.6). These options are not mutually exclusive, but may be combined with one another. Over the 1980s, these solutions could be seen in the trend towards developing a reputation for conservativeness, the trend towards delegating to an independent central bank, and the trend towards contracting with an inflation-target to guide monetary policy. Reputation, delegation and contracting will be addressed in turn.

Reputation

Reputation is a substitute for a commitment technology in a discretionary policy environment. The logic of reputation is that policymakers will recognise that the future costs of inconsistent policy outweigh the benefits, so they will adopt the *ex post* optimal policy today which increases their credibility over time. (Persson et al. 1994a, p.8) One way to build a reputation is to appoint a conservative central banker who has a reputation within the financial community for defending price stability (Rogoff 1985). A second way is to develop a reputation for toughness that is tested early and often. But this appointment may not solve the credibility problem associated with cheating, as even hard-nosed, zero-inflation bankers have an incentive to cheat in the last period of a game (Backus et al. 1985).

While building a reputation sounds good in theory, in practice it suffers from a significant problem. Studies found that more independent central banks like the Bundesbank have paid a higher cost for achieving price stability (in terms of lost output) than more dependent banks (Debelle et al. 1994; Posen 1993). As seen in table 6, independent central banks have had a higher sacrifice ratio than more politically controlled central banks - a finding suggested by Rogoff (1985) who argued that a focus on inflation stabilisation comes at the cost of greater swings in output. Rather than

creating self-fulfilling expectations, building a reputation for credibility meant demonstrating the will to fight inflation over and over again.

Table 9: Sacrifice ratios during disinflations, 1960-1991

Country	Quarterly Data		Annual Data	
	Average	# Quarters	Average	# Years
High:	Germany	11.7%	51	10.1%
	USA	9.6%	34	9.2%
Medium:	Italy	7.0%	51	5.9%
	Switzerland	6.3%	25	3.4%
	Canada	6.0%	26	4.8%
Low:	Australia	4.0%	23	1.3%
	Japan	3.7%	57	-0.9%
	UK	3.1%	34	2.7%
	France	3.0%	33	0.9%

Source: Ball (1993)

Delegation

A second prescription for resolving the time inconsistency problem is delegation to an independent central bank with a mandate of price stability. Game theory argues that precommitment to a policy requires an external mechanism which ties the hands of the players in order to be credible. Alesina's studies of partisan politics and political business cycles led him to conclude that governments should adopt an institutional mechanism, such as an independent central bank, to provide the optimal trade-off between rules and discretion (Alesina 1989). Delegation is seen as a 'commitment technology' which increases the credibility of monetary policy by removing political control (Lohmann 1992). Making the central bank independent is a means of achieving credibility with wage-setters by pre-committing to an anti-inflationary policy (Neumann 1991). Lohmann (1992) argued for the inclusion of an escape clause into the agreement with an independent central banker, so that in extreme situations the policymaker can override the central banker, at some cost, to adapt policy to output shocks. She claimed

this arrangement – termed a partially independent conservative central banker - is superior to other institutional arrangements, as it preserves flexibility while maintaining credibility. The threat of overruling would make the central banker's reaction function non-linear during extreme circumstances, allowing the central bank to respond to output shocks while retaining credibility during normal periods.

A number of criticisms of delegation stand out.⁹ First, delegation does not resolve the operational debate on how best to implement monetary policy - it just shifts the problem from one set of decision-makers to another (McCallum 1995). Second, delegation to the central bank in itself does not solve the credibility problem, as bureaucrats may cheat on their commitments as easily as politicians. Third, there are limits to the degree of central bank independence that is desirable. Debelle and Fischer (1994) found that society is not better off if they have a completely independent central bank that is fixated on inflation, as this mandate may result in a deflationary bias and increased output variability. Instead, the central bank should be able to react to fluctuations in output as well as inflation. Fourth, society may not want to give up democratic control of policy to unelected bureaucrats who are unaccountable for their actions (Alesina 1989,p.62).

Contracts and Accountability

A central insight of the delegation literature was the need to change the incentives facing the central bank. The contracting approach was designed for this purpose. Walsh (1995) argued that designing a contract between the government and the central bank, which tied transfer payments (such as funding or salaries) to achieving an inflation target, was optimal for achieving the trade-off between flexibility and

⁹ Delegation to an independent authority is not feasible in countries with no rule of law, political regimes that render delegation ineffective, or an underdeveloped financial sector. In this case, a lack of domestic alternatives usually leads to adoption of an external constraint, such as IMF conditionality, to gain credibility (Cottarelli et al. 1997, p.16).

credibility.¹⁰ The central bank should have independence in the setting of monetary instruments but the inflation target should be set by elected officials. In other words, a central bank would have instrument independence but not goal independence (Debelle et al. 1994). The contracting approach underpins the trend in inflation targeting, which had been adopted by a growing number of states in the 1990s.

The contracting approach stresses accountability, which is a major normative issue in the field, particularly in the debate over the European Central Bank. States where the focus of the debate has been on accountability have adopted inflation targeting, such as the UK, Canada, Finland and Sweden. Accountability mechanisms differ across states. “The Fed is accountable to the Congress, and to public opinion. The Bank of England is accountable to the Treasury. The Governor of the Reserve Bank of New Zealand is accountable to the government for meeting his contract. The Bundesbank has very little accountability.” (Debelle et al. 1994, p.217) Giving control over monetary policy to unelected and independent bureaucrats creates concern within democracies, where public officials are held accountable through regular elections. To develop support for its independence, central bankers need to make policymaking more transparent, need to make regular, public reports on their decisions to elected officials, and need to educate the public on their role and the benefits of low inflation. Inflation targeting has thus been accompanied by an effort to increase the transparency of the monetary policy process, by the publication of regular inflation reports or the issuance of press releases around key events.

In summary, central bank independence is seen as only one of a number of solutions to the time inconsistency problem. Developing a reputation for conservativeness or

¹⁰ Rogoff (1985) and Persson and Tabellini (1993) also discuss contracting.

adopting a contracting framework are alternative strategies for gaining anti-inflationary credibility. These strategies are not mutually exclusive, but may be combined, as seen in the case of New Zealand, which has an independent central bank with a contract between the Governor and the government. Finally, theory suggests that central bank independence may come with associated costs, such as greater output variability.

Central Bank Independence and Economic Performance

The theoretical case in favour of central bank independence was reinforced by empirical research that tested its relationship with economic variables. Over the decade from 1985-1995, more than thirty economic papers regressed legal indices of central bank independence against economic variables ranging from inflation, economic growth, unemployment, interest rates, budget deficits and debt levels. These statistical tests were predominantly conducted for industrial countries, using legal measures of central bank independence developed by coding central bank statutes (Alesina 1989; Bade et al. 1978, 1988; Cukierman et al. 1992; Eijffinger et al. 1993a; Fair 1979; Grilli et al. 1991; Masciandaro et al. 1988).¹¹ The creators of these indices have focussed on factors hypothesised to affect the central bank's ability to operate independently, such as the government's role in appointments, the length of terms for the governor and senior staff, the government's involvement in determining monetary policy, the mandate of the central bank, its control over its main policy instruments, the central bank's responsibility to finance the government and the central bank's role in supervising the banking system. The creation of such an index is subjective, so researchers have

¹¹ Attempts to codify the degree of independence of central banks have employed two approaches: a legislative approach and a behavioural approach. The legislative approach is by far the most common and relies on a coding of the legal statutes of the central bank, without reference to working practice, the personalities staffing the bank or political influences.

focussed on different combination of variables and have therefore reached different rankings for the majority of central banks.

Table 10: Composition of Indices measuring legislative independence

Year Published	1978	1988	1991	1992	1993
Authors	Bade and Parkin (BP)	Masciandaro & Tabellini (MT)	Grilli et al (GMT) ¹	Cukierman et al (CWN)	Eijffinger & Schaling (ES)
Period studied	1972-86	1970-85	1950-89	1950-89	1972-91
# of countries in sample	12	5	18	72	23
# of factors considered	4	16	15	16	3
Weighting: ²					
Personnel appointments and terms	75%	44%	27%	20%	25%
Government role in mon. policy	25%	25%	20%	10%	75%
Lending to government ³		19%	33%	55%	
Explicit goal of price stability			7%	15%	
Control of instruments		13%	7%		
Supervision of banking system			7%		
Total	100%	13%	101%	100%	100%
Statistical studies employing index ⁴	7	1	8	7	1

1. GMT index is sum of political and economic indices.

2. Totals due not sum due to rounding.

3. CWN figure includes eight factors classified as limitations on lending, and one factor from policy formulation (role in government's budgetary process).

4. Studies through 1995, excluding original and subsequent studies by creators of index.

Source: Cukierman, Webb, and Neyapti (1992); Eijffinger and Schaling (1993); Grilli, Masciandaro and Tabellini (1991); Masciandaro and Tabellini (1988)

Table 6 summarises details of five legal indices measuring central bank independence, noting the time frame and sample size considered, the number of factors which were tabulated, and the relative weighting given to each issue area. The table also shows the number of empirical works known to this author that have used the respective index when testing for the effect of independence on economic variables. Several points stand out from this table. First, there is broad agreement that the two most important categories are personnel issues and the government's role in policy. The government's role in the appointment of key personnel, such as the Governor of the central bank, was

the most important factor considered for determining how the central bank will behave. This emphasis suggests that the personalities involved may have a significant influence on the behaviour of the institution. The government's role in monetary policy is a second significant factor.¹² The government's role is judged based on three factors. First, does final responsibility for monetary policy reside with the central bank, the government or is it shared? Second, is there a government official (with or without voting power) on the board? Third, is there legislation in place to resolve conflicts in the event that there is a disagreement between the central bank and the government? While most central banks conduct policy in consultation with the political authorities, legislative measures of independence generally do not consider actual practice but look for a clear statement division of responsibilities in the legal statute.

A second observation concerns the change in focus of the most recent indices, which stress the importance of the lending to government and the central bank's mandate. First, limits on lending address the monetarist concern that a dominant fiscal authority can force the central bank to increase the money supply to accommodate budget deficits (Sargent et al. 1981). In theory, establishing legal limits protects the independence of the central bank under these circumstances, which otherwise may be forced by the government's fiscal decisions to expand the money supply, creating inflation (Leone 1991). Second, researchers have recognised that the central bank's mandate affects its ability to control inflation. An explicit mandate of price stability is preferred to a broad and potentially contradictory set of objectives. When the central bank has a single objective, it does not have to make political decisions, only technical ones, which reduces the pressure from interest groups and the government (Neumann 1991).

¹² Eijffinger and Schaling (1993) consider this issue to be the crux of independence, and assign 75% of the weight of their index to this category.

Weaknesses of Indices

The weaknesses concerning the construction of indices are well documented, notably by their creators. Perhaps the most obvious (and least stated) is that there is no agreed definition of independence among these authors. The authors measuring independence have defined the concept differently, with some focussing on goal independence while others stress instrument independence.¹³ This lack of clarity has led to disagreement on how to classify many central banks, affecting empirical results, as seen in the low correlation coefficients among indices in table 7.

Table 11: Rank-Correlation Coefficients of Indices of Central Bank Independence

	BP	GMT	ES	CWN
BP (Alesina)	1	0.58 (0.69)	0.71 (0.78)	0.38 (0.44)
GMT		1	0.36 (0.48)	0.52 (0.63)
ES			1	0.20 (0.35)
CWN				1

Note: Kendall rank-correlation coefficients are used, with Spearman rank-correlation coefficients in parentheses.

Source: Eijffinger and Haan (1996)

Second, legal indices have proven difficult to construct because the laws establishing central banks are incomplete and do not specify explicitly the limits of authority. This leaves room for different interpretations of legal statute. Coding legal independence, therefore, is a subjective process. Third, legal measures may not reflect a central bank's *de facto* level of independence. The actual practice of central banking deviates from the law, shown most dramatically by the actual term of central bank governors (Cukierman et al 1992; Woolley 1985, p.321). Likewise, legal limits on lending can be easily circumvented by using open market operations to provide deficit financing indirectly via the private sector. Fourth, legal independence does not guarantee that central banks will be free of informal or formal government pressure. A number of papers have

¹³ This distinction was introduced by Grilli et al (1991) and reinforced by Debelle and Fischer (1994).

demonstrated through comparative case study work that even the most independent central banks, such as the Bundesbank and the Federal Reserve, respond to signalling or threats from politicians.¹⁴ Finally, several authors have questioned the statistical robustness of these indices by highlighting multicollinearity between the variables, omitted variable bias or selection bias in the choice of cases (Banaian et al. 1998; Forder et al. 1998; Mas 1995; Posen 1993; Temple 1998). Taken together, these weaknesses suggest that any empirical study of the relationship between central bank independence and economic variables should be treated with caution.

Central bank independence as a Free Lunch

Despite these shortcomings, the studies employing these indices claimed to have established a number of statistically significant relationships that cast central bank independence in a positive light. Table 8 presents an overview of the results of these tests.

¹⁴ For the Bundesbank, see Lohmann (1998). For the Federal Reserve, see Havrilesky (1993), Hetzel (1990), Willett and Keen (1990) and Woolley (1984).

Table 12: Central Bank Independence and Economic Performance, 1989 - 1995

Dependent Variable	Significant Relationship		No Relationship		Mixed Results / Dependent ¹		Total
	# of studies	% of total	# of studies	% of total	# of studies	% of total	
Inflation	12	57	3	14	6	29	21
Inflation Variability	5	45	3	27	3	27	11
GDP Growth			8	80	2	20	10
GDP Variability			9	100			9
Sacrifice Ratio	5	83	1	17			6
Unemployment			4	100			4
Interest Rates	2	40	3	60			5
Interest Rate Variability	2	40	2	40	1	20	5
Budget Deficits, Debt, Credit to Government	3	30	7	70			10

1. Results were dependent on the choice of index used to measure central bank independence.

The majority of studies (12 out of 21 studies) claim to have found a negative statistical relationship between legal measures of central bank independence and the level of inflation in industrial economies.¹⁵ No study has found a statistical relationship between central bank independence and economic growth, or its variability, despite almost a dozen attempts. Nor did any studies find a significant relationship between central bank independence and unemployment. The lack of relationship between central bank independence and these key economic variables led Grilli et al (1991) to comment that central bank independence was a like having a ‘free lunch’, as “there are benefits but no apparent costs in terms of macroeconomic performance” (Grilli, Masciandaro, and Tabellini 1991, p.375).

If any single article can be credited with establishing central bank independence as the new paradigm, it must be Alesina and Summers (1993). The authors produced a series of easy-to-understand scatter plots – especially one displaying a clear negative

¹⁵ In developing countries, there is no relation between inflation and legal measures of independence, but turnover of the governor of the central bank is positively related to inflation (Cukierman et al. 1992).

relationship between inflation and central bank independence – which forcefully delivered the message supporting central bank independence. This article is referenced or the scatter plot is reproduced, wherever an argument has been made in a political context in support of central bank independence; often with little or no supporting discussion.¹⁶ While the original studies of central bank independence may have carefully qualified the negative relationship with inflation, this result was presented more starkly to policy makers. The picture was intended to speak for itself. The message it delivered was "Countries with independent central banks have low inflation", without experiencing higher unemployment or slower GDP growth. The fact that this paradigm was being questioned by the mid-1990s received little attention among supporters of central bank independence, consistent with Kuhn's (1962) description of paradigms.

The claim that central bank independence was a free lunch was a powerful message for politicians. It provided them with a rationale for supporting this institutional change by signalling the positive benefits that would accrue from delegating control of monetary policy to an independent central bank. This message was 'good news' to policymakers who had only received bad news about their role in economic management over the previous decade. Politicians had been told that the apparent Phillips curve trade-off between inflation and unemployment was illusory. Activist monetary policy could not affect real variables and would only lead to inflation in the long run. Nor could monetary policy be used to boost an incumbent's popularity prior to an election, the so-called political business cycle. Rational voters would learn to expect higher inflation and interest rates following an election, and would discount such an overtly political

¹⁶ The chart was reproduced in the reports of Select Committees in Canada and the UK (Canada 1992; Committee 1993a), and in a private report advocating BoE independence (Roll 1993). Early results of this

move in their decision making. Control of monetary policy was therefore not useful. Instead, politicians could hope to improve economic performance by delegating monetary policy to the central bank. This conclusion rapidly became the dominant paradigm, and was widely quoted by the financial press. This finding was presented as orthodoxy to receptive politicians and influenced the policy debates surrounding the Maastricht Treaty.¹⁷

paper were carried in *Fortune* magazine, 19 June 1989, and included in the NZ Business Roundtable submission on the RBNZ bill (Wilkinson 1989).

¹⁷ Forder argues that this association was misrepresented as causation in reports prepared for the European Commission that supported the case for an independent ECB (Forder 1998a, 1998b).

Table 13: Empirical Studies of Central Bank Independence, 1989 – 1995

DEPENDENT VARIABLE	CORRELATED TO CBI	DEPENDENT ON INDEX	NO CORRELATION
INFLATION	Alesina (1989); De Haan and Sturm (1992); Alesina and Summers (1993); Cukierman (1993); Havrilesky and Granato (1993); <i>De Haan and Eijffinger (1994)</i> ; <i>De Haan and Siermann (1994)</i> ; <i>Fratianni and Huang (1994)</i> ; Al Marhubi and Willett (1995); Cukierman and Webb (1995); De Gregorio (1995); De Haan (1995)	<i>Bade and Parkin (1978)</i> ; Grilli et al (1991); Cukierman et al (1992); Eijffinger and Schaling (1993); Debelle and Fischer (1994); <i>Eijffinger et al (1994)</i> ; Temple (1998); Banaian et al (1999)	Posen (1993); Cargill (1995); Mas (1995); Eijffinger and Van Keulen (1995); Campillo (1997); Chang (1998); Forder (1998); Hayo (1998)
INFLATION VARIABILITY	De Haan and Sturm (1992); Alesina and Summers (1993); <i>Fratianni and Haung (1994)</i> ; Cukierman and Webb (1995); De Haan (1995)	Eijffinger and Schaling (1993); <i>De Haan and Eijffinger (1994)</i> ; <i>Eijffinger et al (1994)</i>	<i>Bade and Parkin (1978)</i> ; Cukierman et al (1992); Eijffinger and Van Keulen (1995)
GDP GROWTH		De Long and Summers (1992); Cukierman and Webb (1995)	Grilli et al (1991); De Haan and Sturm (1992); Alesina and Summers (1993); Cukierman et al (1993); Eijffinger and Schaling (1993); <i>De Haan and Eijffinger (1994)</i> ; <i>Eijffinger et al (1994)</i> ; <i>Fratianni and Haung (1994)</i>
GDP VARIABILITY			Grilli et al (1991); De Haan and Sturm (1992); Alesina and Summers (1993); Cukierman et al (1993); Eijffinger and Schaling (1993); Posen (1993); <i>De Haan and Eijffinger (1994)</i> ; <i>Eijffinger et al (1994)</i> ; <i>Fratianni and Haung (1994)</i>

DEPENDENT VARIABLE	CORRELATED TO CBI	DEPENDENT ON INDEX	NO CORRELATION
SACRIFICE RATIO	Posen (1993); Debelle and Fischer (1994); <i>Gaertner (1995)</i> ; Fischer (1994); <i>Walsh (1995)</i>		<i>De Haan et al (1993)</i>
UNEMPLOYMENT			Alesina (1989); Grilli et al (1991); De Haan and Van't Hag (1995); Alesina and Summers (1993)
INTEREST RATES	Cukierman et al. (1993); <i>Eijffinger et al (1994)</i>		Alesina and Summers (1993); Cukierman (1993); Cukierman and Webb (1995)
INTEREST RATE VARIABILITY	Alesina and Summers (1993); Cukierman et al. (1993)	Cukierman and Webb (1995)	Cukierman et al. (1992); <i>Eijffinger et al (1994)</i>
BUDGET DEFICITS, SIZE OF PUBLIC DEBT, LENDING TO GOVT.	<i>Parkin (1987)</i> ; Masciandaro and Tabellini (1988); Leone (1991)		Alesina (1989); Grilli et al (1991); Cukierman et al (1992); De Haan and Sturm (1992); Posen (1993); De Haan and Van't Hag (1995); Pollard (1993)

Note: Studies in italics were not checked by the author.

Source: Author's calculations, De Gregorio (1995), Eijffinger and De Haan (1996).

Questioning the Paradigm

As with any paradigm, it is only a matter of time before the anomalies build up and the orthodoxy is questioned. This process occurred with central bank independence from the mid-1990s. Works by Posen (1993), Cargill (1995), Temple (1998) and Forder (1998) highlighted the inability of researchers to nail down any significant economic relationship related to central bank independence. Output, output variability, unemployment, interest rates, interest rate variability, budget deficits, and the size of government debt had all shown mixed or no relationship with central bank independence, despite considerable theoretical work predicting a relationship. One statistical relationship that did find empirical support was the positive relationship between central bank independence and output losses during disinflation (Ball 1993; Baltensperger et al. 2000; Debelle 1996; Debelle et al. 1994; Posen 1993). Independent central banks had higher sacrifice ratios, which measures the cost of reducing inflation one point through an aggregate demand contraction (Ball 1993, p.7).¹ The implication was that countries with independent central banks did pay a higher cost for low inflation, in terms of lost output and higher unemployment.

Early criticisms questioning the link with inflation were, however, discounted by the academic community and ignored by the financial press.² It was only towards the late 1990s that these claims began to be heard. At some point, the theoretical underpinnings of time inconsistency and the need to make a credible commitment was bound to be questioned. Central bank practitioners and informed policymakers had always been sceptical of the rationale behind time inconsistency and these empirical findings. For

¹ Debelle and Fischer concluded that "no credibility bonus exists in the labour markets for more independent central banks: they have to prove their toughness repeatedly, by being tough." (Debelle et al. 1994, p.205).

² For example, Eijffinger and De Haan (1996) dismiss Cargill's finding as unconvincing on the basis that his methodology is faulty.

example, Goodhart observes that the empirical relationship between central bank independence and inflation is quite weak and is “pretty feeble stuff on which to base a policy campaign” (Goodhart 1994b, p.112). Former French Prime Minister Raymond Barre states: “I was not inspired by the view that there was a causal link between [central bank] independence and low inflation; by itself, the [central bank] cannot assure stability because inflation results from many factors” (Posen 1993, p.55). Former RBA Governor Fraser commented argued that the suggestion that low inflation is the result of central bank independence was over simplistic, citing the anti-inflationary sentiment of the German people and the performance of the politically-controlled Bank of Japan (Fraser 1989).³

With the economic rationale for central bank independence being questioned by the mid-1990s, the monetary economics literature turned to research on inflation targets, which are the new fashion in monetary policy. There has also been a greater focus on normative issues such as accountability and transparency.

2.4 Central Bank Models and Policy Emulation

Politicians faced with a problem they cannot solve will look to the experience of other countries for successful policies they can emulate (McNamara 1998). In the case of central bank independence, politicians with poor inflation records looked to the example of the Bundesbank, and to a lesser extent the Federal Reserve. These two central banks weathered the storms from the 1970s better than their counterparts. The Bundesbank was able to keep inflation during the late 1970s at less than half the rate of the OECD countries, but without any cost in terms of increased unemployment. The Federal

³ These views concerning Germany and Japan were widespread among critics of central bank independence.

Reserve fared almost as well, although unemployment was higher than the OECD average.

Both the Bundesbank and the Fed had an increased public profile during the 1980s. Following the oil shocks and the arrival of stagflation, central bankers like Volcker and Tietmayer took the centre stage. The adoption of monetarism by the two leading central banks was mirrored by other central banks around the globe during the early 1980s, with monetary targeting spreading to other countries through a transnational epistemic network of central banks and monetarist economists. Despite the collapse of monetary targets in the mid-1980s, the Bundesbank and the Fed still managed to maintain low rates of inflation. At this point, academics speculated that the success of these two central banks owed much to their degree of independence from politicians. Studies concluded that the "more independent central banks have indeed been associated with less inflationary policies", pointing to the Bundesbank, the Federal Reserve and the Swiss National Bank as the main examples of this phenomena (Banaian et al. 1983, p.1).⁴ This message, supported by the empirical work on central bank independence, reinforced the view that the Bundesbank and the Fed were model central banks that politicians in other countries could emulate if they wished to improve their anti-inflationary performance.

⁴ Studies have questioned the independence of both the Bundesbank (Lohmann 1998) and the Federal Reserve (Hetzel 1990; Havrilesky 1993; Willett and Keen 1990; Woolley 1984).

Table 14: Inflation and Unemployment in Selected Countries

Country	Inflation			Unemployment		
	1950-72	1973-79	1980-89	1950-72	1973-89	1980-89
Germany	2.1	4.9	2.9	2.6	2.7	5.8
USA	2.4	8.2	5.5	4.7	6.5	7.3
Canada	2.6	9.0	6.5	4.5	6.9	9.3
Japan	4.4	10.1	2.5	1.7	1.8	2.5
France	5.0	10.2	7.3	1.9	4.3	8.9
Australia	4.5	11.7	8.4	1.6	4.6	7.5
OECD Average	4.2	11.9	8.8	2.4	3.7	6.8
New Zealand	4.6	13.0	11.8	0.1	0.7	4.6
United Kingdom	4.0	14.7	7.4	2.5	4.8	9.8
Italy	3.5	15.4	11.1	7.5	6.7	8.4

Source: IMF International Financial Statistics

2.5 Status of the Paradigm

By the early 1990s, central bank independence was widely seen as one institutional solution for the time consistency problem of monetary policy. By delegating to a central bank with a narrow mandate of price stability, politicians could hope to improve their inflationary record without any negative effects on output and employment. This view was supported by studies of economic performance in the post-Bretton Woods era, and embodied in the institutional frameworks governing the Bundesbank and the Federal Reserve. For politicians, this reform provided a relatively straightforward solution for controlling inflation that could be easily emulated, following the collapse of monetary targeting in the late 1980s. The fact that this paradigm was beginning to be questioned from the mid-1990s was not widely communicated in policy circles.

One problem with this view of events is that it has difficulty with explaining the actual trend in central bank independence during the 1990s. While it is true that the trend in central bank independence took off following the decline of monetary targeting, it does not explain why politicians chose to delegate when they did. For example, the change in legislation of the Reserve Bank of New Zealand took place in 1989, before much of the

empirical work on central bank independence had been published. Likewise the reform of the Bank of England in 1997 came nearly a decade later, when the paradigm was being widely criticised in academic journals. It is also puzzling that policymakers in Australia and Canada, who had access to the same body of literature, chose not to change the legislation governing their central banks despite the promised benefits of such a reform. Explaining this pattern of decisions and non-decisions, and the impact of ideas in these reforms, is the subject of the next chapter.

Ch. 3 Domestic and International Sources of Central Bank Independence

Despite the growing trend towards central bank independence throughout the 1990s, there has been little work from economists explaining the timing of these legislative changes. As Eijffinger states: “It is quite remarkable that the literature dealing with this question is, so far, hardly developed” (Eijffinger 1997, p.xxi). However a large and growing body of research in political economy has focussed on the status of the central bank.¹ Most of these studies treat an independent central bank as an independent variable and look at how it affects the formulation or implementation of foreign economic policy. A few works specifically focus on when a central bank is likely to be given independence. This literature suggests four independent variables for explaining why politicians delegate, of which two are international and two are domestic. These explanations are the subject of the next four sections.

The first and second explanations focus on the international sources of domestic policy change, consistent with Gourevitch’s ‘second-image reversed’ and the literature on two-level games (Gourevitch 1978; Milner 1997; Putnam 1988). The first section looks at the impact of financial globalisation on this trend, arguing that politicians use central bank independence to signal their anti-inflationary credibility to international financial markets. The second section points to international convergence around a new paradigm that was promoted by a transnational epistemic community. The third and fourth

¹ Recent works have used the status of the central bank to explain financial liberalisation (Helleiner 1994) and foreign exchange policy (Bernhard et al. 1999; Franzese 1999a, 1999b; Henning 1994; Simmons 1994). A second category has looked at the constraints imposed by independence on politicians (Alesina et al. 1995; Clark 1998; Elgie et al. 1998), unions (Al-Marhubi et al. 1995; Bleaney 1996; Garrett 1998a; Hall et al. 1998; Iversen 1998) or corporatist arrangements (Havrilesky et al. 1993). A third category explores the historical origins of specific central banks (Broz 1998; North et al. 1994; Woolley 1984). A

explanations are taken from the comparative political economy literature and focus on the demand and the supply of independence from different domestic actors. The third section argues that central bank independence results from the lobbying of domestic interest groups opposed to inflation. The fourth section considers why politicians may decide to 'tie their hands' out of electoral self-interest. The fifth section reviews the institutional variables that have been hypothesised to constrain the outcome. The final section summarises the four hypotheses that will be tested in the case studies.

3.1 Pressure from International Financial Markets

A feature of the late 20th century has been the rise of international capital mobility and trans-border capital flows, which is often described as financial globalisation. Some theories portray the international financial system as a deterministic structure that systematically constrains state behaviour by rewarding some actions and punishing

fourth category analyses the impact of central bank independence on political instability or party fractionalisation (Bernhard 1996; Cukierman 1994; Keefer and Stasavage 1998; Simmons 1994).

others (Andrews 1994, p.197).² This constraint operates through the foreign exchange markets and the investment decisions of institutional investors and multinational enterprises who direct large flows of capital in response to changing economic conditions.³ The implication of financial globalisation is to create a new audience – international financial markets – that political leaders must satisfy (Keohane et al. 1996, p.257).

Signalling Creditworthiness

Maxfield (1997) provides an explanation for the trend in central bank independence based on this power of international capital markets. She argues that politicians with a need for balance of payments financing give independence to the central bank as a mechanism for signalling their anti-inflationary creditworthiness to international capital markets.⁴ This institutional reform increases the confidence of international investors that politicians will not renege on their promise to pursue price stability. Signalling becomes more important when politicians have a long time horizon and the need for balance of payment financing is chronic. Insecure politicians with short time horizons are more likely to stimulate the economy prior to elections, and will not wish to be constrained by an independent central bank. With longer time horizons, politicians recognise the benefit of attracting investment from abroad and the need for policy credibility in order to reduce the premium charged on their international borrowings.⁵

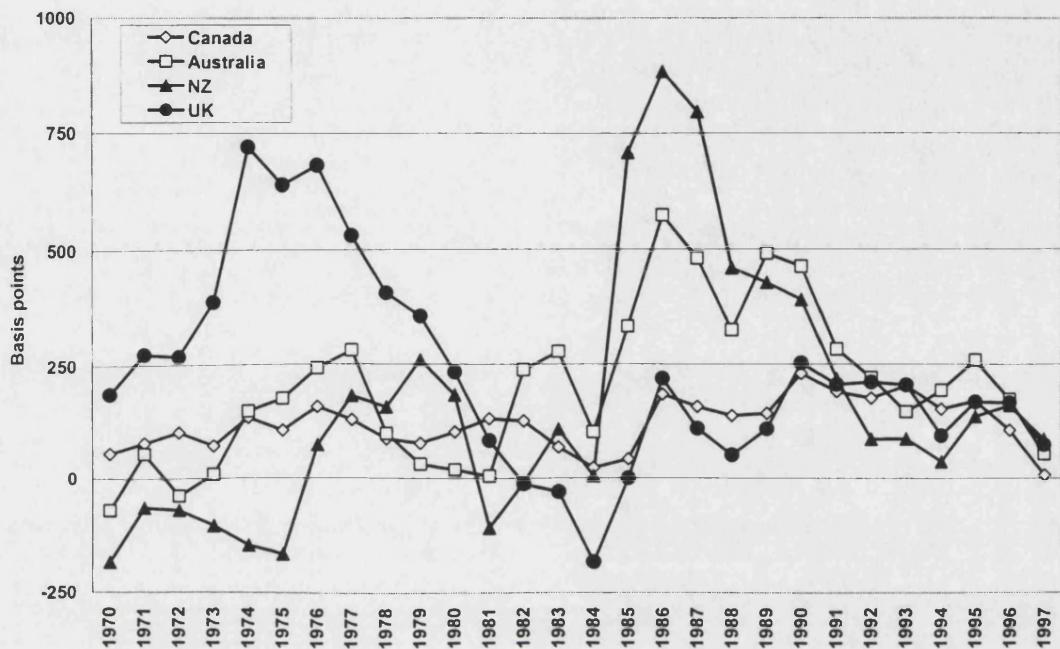
² There is a large and growing body of international political economy literature that addresses the constraints imposed on states by capital mobility. For the view that states have lost autonomy, see Andrews 1994; Crotty 1989; Kurzer 1991, 1993; Notermans 1993; Scharpf 1991; Strange 1996. For the contrasting view see Garrett 2000; Hay 2000; Helleiner 1994; Mosley 2000; Oatley 1999. For general discussions of the implications of capital mobility see Andrews and Willett 1997; Cohen 1996; Dombrowski 1998; Simmons 1998.

³ The Mundell-Fleming framework captures these trade-offs, where policymakers face a choice between monetary or fiscal policy autonomy based on their exchange rate regime and their use of capital controls.

⁴ Posen (1993) reaches a similar conclusion, but argues that the signalling is directed at domestic financial markets when the government relies on home markets to fund its budget deficits.

⁵ A higher rate penalises governments with large borrowing needs, although this cost has not prevented OECD countries from accumulating large external debt burdens (Garrett 1998c).

Figure 4: Cost of Long Term Debt Relative to US



Maxfield's signalling-hypothesis is premised on a long-run structural need for balance of payments financing. In other words, the need for capital inflows is chronic. It is also possible to envisage a case where there is an acute need for capital inflows, such as occurs during a speculative attack on a fixed exchange rate peg. Simmons (1994) studied the interwar period in order to understand why some countries devalued while others played by the rules of the game and defended their exchange rate pegs. She found that countries with an independent central bank during the period 1923 to 1931 had greater success in attracting capital inflows, as an independent central bank increased investor confidence that the peg with gold would be maintained and not be sacrificed to domestic political concerns (Simmons 1994, p.75). The architects of the 1992 Maastricht Treaty reached a similar conclusion, and made central bank independence a condition for joining the single currency. Even though the individual member states lose their monetary autonomy under a currency union, an independent central bank reassures investors that politicians in the member states will not renege on their commitments in response to domestic pressure. Likewise the IMF made central bank independence a

condition of its bailouts of Mexico in 1994, and Korea and Indonesia in 1997-98. In these cases, these countries had an acute need for capital inflows in order to pay-down foreign liabilities. These cases appear to show that central bank independence has some signalling value even in the presence of an external anchor.

Hypothesis I: Politicians will give independence to the central bank as a mechanism for signalling their creditworthiness to international financial markets, when they have a structural need for balance of payments finance or to support the credibility of an external anchor.

3.2 Ideas of a Transnational Epistemic Community

A number of authors note the association between the status of monetary institutions and the reigning economic paradigm (Capie et al 1994; Elgie and Thompson 1998; Fair 1979; Goodhart 1995; Henderson 1986). The status of the central bank has similarly been profoundly influenced by the development of academic theories about monetary policy, as described in chapter 2. The difficulty comes from explaining under what conditions academic ideas succeed in convincing politicians of the need to change the central bank's legislation. Based on her own study, Maxfield (1997) concluded that ideas alone provide an unsatisfactory answer for explaining the trend in central bank independence.

Pathways of Influence

Ideas are theorised to influence policy through a number of pathways, although theorists disagree on the motives of actors and the direction of causation. Three pathways suggested by political economy for explaining how ideas influence policy are: through the policy advocacy of an epistemic community; through the sponsorship of key political actors; or through the emergence of a new paradigm governing policy. These contrasting pathways share the view that ideas are important, although they disagree on

the pathway of influence or the impact of other variables such as interest groups or institutions. Each pathway will be addressed in turn.

Epistemic Community

The first view has been put forward by the literature on epistemic communities.⁶ An epistemic community is defined as “a knowledge-based group of experts and specialists who share common beliefs about the cause-and-effect relationships in the world and some political values concerning the ends to which policies should be addressed” (Haas 1990, p.xviii). This definition consists of three components - a high degree of expertise, a consensus on causation, and a shared political goal. The first part recognises that control over knowledge and information is an important dimension of power (Lukes 1974). Information asymmetries have been shown to provide different actors with greater levels of influence (Milner 1997). Under conditions of uncertainty, epistemic communities play a key role “in articulating the cause-and-effect relationships of complex problems, helping states identify their interests, framing the issues for collective debate, proposing specific policies, and identifying salient points for negotiation” (Haas 1997, p.2). This potential power is increased when policymakers are faced with a complex problem that must be addressed quickly, such as in response to a crisis (Haas 1990, 1997).

The second and third parts of this definition reflect the barriers to collective action. Olson (1971) argued that members of a group sharing a common interest must still overcome problems of free riding and enforcement. The dynamics of group behaviour inhibit cooperation. Likewise, an epistemic community can only translate its 'knowledge-based' power into effective influence when experts hold a shared set of

⁶ A number of scholars have used theories of epistemic communities to explain the direction of economic policy (Goldfinch 2000; Helleiner 1994; McNamara 1998; Verdun 1999; Woolley 1989). The literature on think tanks and their role in influencing policy fits within this view (Stone 2000).

causative beliefs and are able to agree on a policy prescription (Goldstein 1993; Goldstein et al. 1993). The group must also hold shared policy preferences. Without an agreement on the solution to a problem or the goals of a policy reform, experts are likely to work at cross-purposes. Their inability to agree will convince politicians to stick with the status quo, or will leave open the door for other policy entrepreneurs to choose select ideas that support their preferred policy position.

Political Champion

A second view argues that ideas require political sponsors in order to survive through the policy process. Ideas must have political salience or political viability in order to be championed through the political process (Hall 1989; McNamara 1998). Put differently, ideas must satisfy the interests or worldview of key politicians who adopt them for their own purposes (Gourevitch 1989; Jacobsen 1995). The extreme version of this view sees ideas merely as hooks upon which politicians hang their policies. A more nuanced sees ideas as tools that aid politicians in the building of new coalitions by redefining how different groups perceive their interests, making new alliances possible (Goldstein et al. 1993). For example, ideas reduce the complexity of a situation and provide a focal point, making action possible despite uncertainty. Institutions are important in this regard, as they facilitate or hinder coalition building (Goldstein et al. 1993; Hall 1989; Martin et al. 1998).

Paradigm Shift

A third view of ideas adopts a more psychological approach, rejecting the rationalist assumptions of the mainstream international political economy theories of ideas. Woods (1995) argues that new ideas emerge to meet the circumstances, with the best ideas being adopted as the reigning paradigm. This 'discovery view' is based on the work of Kuhn (1962). It sees ideas and interests as inseparable, being mutually constitutive. Ideas serve as maps that fit political priorities or rationalise action already taken. This

view adopts a path dependence approach to the influence of ideas, with the emergence of new ideas conditioned by the existing cultural or historical endowments (Johnson 1998). Many histories of central banking and monetary policy echo this view. “The switch to Keynesian principles of ‘managed money’ after World War II, the adoption of floating exchange rates and then monetary targets in the 1970s, and now the enthusiasm for central bank independence, all have owed much of their force to the power of academic ideas whose time has arrived.” (Capie, Goodhart, and Schnadt 1994, p.80).

How Ideas Influence Policy

While these pathways are suggestive, it has proven hard for many researchers to operationalise ideas in the study of policy. McNamara (1998) has developed a framework for explaining how new ideas become incorporated into policy that takes into account the role of epistemic communities, political sponsors and the existing paradigm. Ideas influence policy based on a three-stage process of policy failure, paradigm innovation and policy emulation.⁷ First, a period of policy failure leads to the collapse of the old paradigm and the search for new solutions. This policy failure may be accompanied by a crisis, although the main feature is a period of greater uncertainty. Second, a new paradigm emerges offering a clear policy solution that is advocated by the epistemic community and implemented in a few states. Other states monitor the results of these test cases to judge whether the policy is effective or not. Third, other states proceed to emulate this policy, embedding the new paradigm in their institutional framework. McNamara qualifies this framework by highlighting that ideas will survive into policy only if they are politically salient, as discussed above. In other words, a politician or influential civil servant must champion ideas in order to ensure that they

⁷ A similar framework for explaining the development of monetary policy frameworks has been suggested by Cottarelli and Giannini (1997).

are implemented. This framework will be developed below to explain the trend in central bank independence during the 1990s.

Monetary Experts as an Epistemic Community

Monetary policy appears to fit the criteria that would empower an epistemic community, a fact recognised by recent work in international political economy.⁸ The study of monetary policy is dominated by the monetarist paradigm. Members share the belief that the source of inflation is excess growth in the money supply; they also broadly share a policy prescription for addressing it by controlling monetary growth (Friedman 1969b). Monetary policy is a complex issue area, featuring a high level of uncertainty. Both the transmission mechanism and the length of lags are uncertain. Monetary policy is further complicated by international factors, such as the policy stances of neighbouring states and the impact of the exchange rate on the domestic rate of inflation. For this reason, the monetary instruments act on the economy with a lack of precision and are described as 'blunt'.

The field of central banking is dominated by a knowledge-based group of experts and specialists. This epistemic community is made up of a transnational network of central bankers, academic economists, economic advisers to politicians, 'conservative' think tanks, and the financial press. Many of the leading contributors to the field are central bankers, or scholars who were formerly central bankers or Treasury officials.⁹ Central banks have played a central role in formulating a consensus by sponsoring research on monetary policy and by educating policymakers and the public on how inflation affects

⁸ Recent studies have looked at monetarism and its impact in influencing policy (McNamara 1998, Johnson 1998) similar to an earlier body of work that focussed on the power of Keynesian ideas (Hall 1989, Ikenberry 1992).

⁹ Some examples are Guy Debelle of the Reserve Bank of Australia; Stanley Fischer of the IMF; Jacob Frankel of the Central Bank of Israel; Charles Goodhart, formerly of the Bank of England; Tommaso Padoa-Schioppa of the ECB; Adam Posen, formerly at the Federal Reserve of New York; and Lawrence Summers, formerly of the US Treasury.

them. This education has been conducted through the speeches and testimony of senior central bankers, the organisation of specialist conferences, and the dissemination of research through in-house journals and publications. Many of the leading findings on this debate have emerged from conferences of academics sponsored by central banks, university institutes or think tanks.¹⁰ The research on this epistemic community has been directed at educating the public on where its interests lie.

A New Paradigm for Inflation Control

McNamara's framework can be used to explain the trend in central bank independence. The first stage is a period of policy failure that leads to the collapse of the old paradigm and the search for new solutions. The 1970s were characterised by stagflation, and a fall in the growth of output. Widespread financial deregulation during the 1970s and 1980s led to structural changes in the international financial system and increased international capital mobility. These changes undermined traditional economic relationships leading to a breakdown in monetary targets during the 1980s. Exogenous shocks have also been transmitted among interdependent economies, such as the 1979 Volcker shock or the 1989 German reunification. Faced with this greater uncertainty and declining economic performance, politicians turned to the monetary epistemic community to provide them with a road map for how to go forward. Monetary experts were asked to find a monetary framework capable of delivering the same price stability witnessed under the classical gold standard and the Bretton Woods system. Monetarist ideas provided a focal point for such a solution, recommending that price stability be made the sole objective of monetary policy. However, initially there was no consensus on the institutional framework in which to pursue this goal as different camps debated the virtues of 'rules versus discretion'.

¹⁰ See: Capie et al. 1994; Cukierman 1994; Debelle and Fischer 1994; Eijffinger et al. 1994; Forder and Slater 1998; Laidler 1997; Masciandaro and Tabellini 1988; Persson and Tabellini 1993; RBA 1997;

Second, a new paradigm emerges offering a clear policy solution that is advocated by the epistemic community and implemented in a few states. The crisis in monetary targeting during the 1980s, together with a renewed attack on the monetarist paradigm by the rational expectations school, allowed a new paradigm based on the legal status of the central bank to emerge. The new paradigm focussed on delegation to an independent central bank as a credible mechanism for solving the time inconsistency problem. This epistemic community shared a causal belief that monetary policy could not be used to influence real variables in the long run, nor could it be used for short-term electoral gain. Instead, delegation to an independent central bank with a mandate of price stability was a simple policy solution that could deliver low inflation without causing lower output or higher unemployment. The paradigm portrayed central bank independence as a 'free lunch' that brought economic gains without costs. This claim was supported by selective empirical studies described in chapter 2. A vocal group of monetary experts and advisers convinced key politicians that this institutional change was in their best interests.

Third, other states proceed to emulate this policy and embed the new paradigm in their institutional framework. Central bank independence was modelled on the success of the Bundesbank, widely seen as the most successful central bank in history, as well as the US Federal Reserve and Swiss National Bank. This relatively straightforward solution was tested in New Zealand in 1989, which radically overhauled its institutional framework for monetary policy. Other states monitored the results of the 'New Zealand experiment' to see if inflation could be brought under control. The early success of the independent RBNZ contributed to faith in this new paradigm, and led to its emulation in

other countries. It was extensively studied and described by the epistemic community. Many countries sent delegations of politicians and civil servants to study these models. By the early 1990s, central bank independence was accepted as the new paradigm for controlling inflation, as given testament by the statutes of the ECB. This institutional reform was also used as a template by the newly founded central banks in Eastern Europe. Finally it was accepted as part of the 'Washington consensus' and became part of the conditionality for IMF bailout packages in Mexico in 1994 and Asia in 1997.

Hypothesis II: Politicians give independence to their central banks in response to academic ideas concerning monetary policy promoted by an epistemic community of monetary experts.

- Corollary A: Uncertainty or an economic crisis increases the effective influence of an epistemic community over policy.
- Corollary B: The epistemic community is only effective when its experts hold a shared set of causative beliefs and policy preferences.
- Corollary C: Ideas must satisfy the interests key politicians who champion them through the political process.

3.3 Lobbying by Groups Opposed to Inflation

Inflation is a political issue, with well-documented distributional consequences that benefit some groups at the expense of others (Briault 1995; Fischer 1994b). Theory suggests that interest groups that are disadvantaged by an institutional framework can be expected to lobby for change to a more preferential arrangement (Frieden 1991b; Gourevitch 1986). An independent central bank is seen as favouring actors that prefer

price stability above competing policy objectives, such as full employment or output maximisation. Posen (1993, 1995) and Goodman (1991) have therefore developed explanations of central bank independence arguing that this institutional change results from the lobbying of domestic interest groups opposed to inflation.

In general, theories of interest groups have proved unsatisfactory for explaining policy reform. An oft-heard criticism is that studies of interest groups do not lead to a set of observable, testable hypotheses due to a lack of precision in the specification of interest groups and their policy preferences, and an overemphasis on the impact of historical or cultural variables (Baumgartner et al. 1998; Frieden 1999; Milner 1997).¹¹ In order to avoid this problem, this section begins by discussing the factors that determine when interest group lobbying is likely to be effective. Next it outlines those domestic interest groups that should be concerned with the status of the central bank. Finally it outlines the *a priori* preferences of these interest groups towards the independence of the central bank, and predicts which coalitions of domestic actors are likely to be effective at influencing policy on this issue.

Demand from Domestic Interest Groups

An interest group is an organisation that seeks to influence the formulation and implementation of policy (Grant 2000b, p.14).¹² Political science and public choice view politicians exchanging policy promises for the votes or campaign contributions from key interest groups (Becker 1983). Political economy studies of interest groups focus on how lobbying allows some interest groups to capture distributional benefits from policy while pushing the costs of adjustment on other less-influential groups. As

¹¹ Interests refer to a basic need that a rational actor is seeking to fulfil when choosing how to act. Preferences refer to the specific policy choice that actors believe will maximise their interest in a particular issue area (Milner 1997).

¹² The term 'interest groups' is used instead of the term interest group in this discussion.

with social sciences, determining the effectiveness of lobbying is difficult and plagued by methodological difficulties (Grant 2000, p.192). This study adopts the approach taken by Coleman (1996) in his study of interest group lobbying of financial services regulation, and evaluates the conditions that allow political potential to be converted into effective influence over policy.

Potential versus Effective Influence

In the modern capitalist economy, there is nothing automatic in economic power being transformed into political influence due to the shift from the *esoteric* politics of private networks, informal arrangements and specialist knowledge to a more open, formalised and partisan process, termed *exoteric* politics (Moran 1984b, p.5). Coleman (1996) breaks down the study of interest group lobbying into two parts: political potential and effective influence. The first step is to examine the characteristics of interest groups that allow them to convert their considerable economic power into political potential. Political potential can be measured using a range of variables which include the size and density of membership, the size and source of a group's budget, the professional expertise of the staff, and the control of specialised information (Coleman 1988, p.58). These variables allow an interest group to gain access and develop legitimacy with policymakers by providing briefings, technical expertise and analysis to politicians who lack the resources or the time (Grant 2000b, p.78). These resources become even more important in a complex issue area such as monetary policy.

The next step is to look for those characteristics that allow an economic interest group to transform its political potential into effective influence over politicians. Three main areas determine the effectiveness of an interest group: its acceptance as a 'policy insider', its control of information, and the configuration of political institutions. Grant (2000) distinguishes between insider and outsider groups, where insider groups have

preferential access to policymakers. An interest group's legitimacy in claiming to speak for a segment of the population is based on the group's density and coverage of membership. The control of information becomes an important variable for achieving insider status and vital for determining the success of an interest group in influencing politicians in their favour (Milner 1997).

An effective interest group must therefore be able to manage the complex information in its issue area and provide technical expertise and analysis to politicians who lack the resources or the time (Grant 2000b, p.78). Sinclair terms this 'epistemic authority' (Sinclair 2000). An association with full-time policy experts on its staff may be effective at influencing policy. In the area of monetary policy, the interest group must have the ability to understand this specialised and highly complex issue area, and must have an incentive to make the investment of time and resources required for lobbying (Posen 1993; Broz 1998).

Table 15: Factors influencing interest group effectiveness

Political Potential	Effective Influence
Concentrated geographically or by sector	Perceived as 'insider' group with access to policymakers
Shared set of preferences	Technical experts on staff
Represented by peak association	Control of specialised information
Autonomous from members	Rents from lobbying exceed the costs
Ability to sanction members	Design of political institutions
Ability to understand issue area	

Source: Based on Coleman (1988, 1996), Grant (1993, 2000) and Milner (1997).

Policy Preferences towards Central Bank Independence

Having identified the criteria that make interest group lobbying effective, the next step is to determine which groups have an incentive to lobby for or against central bank independence. Such an analysis begins from the view that inflation has distributional consequences, creating identifiable winners and losers within society. Those interest groups most harmed by inflation will seek protection by pressing for the independence

of the central bank. The political economy literature on central bank independence suggests three interest groups that should be active on this issue: the financial sector, businesses, and organised labour. The preferences of each of these groups towards the central bank will be outlined, in order to predict the formation of coalitions in favour or opposed to central bank independence.

Financial Sector

Existing interest group explanations of central bank independence have focussed on the financial services sector as the most effective interest group lobbying for central bank independence (Goodman 1991; Posen 1993). This group has strong incentives to support central bank independence. First, this reform is argued to promote the interests of the financial community by controlling inflation, which reduces the real value of financial sector assets. Second, an independent central bank may be better able to respond when a bank is in trouble, by acting as the lender of last resort and providing liquidity. This type of intervention may be delayed or constrained if politicians get involved.¹³ Third, the central bank and the banking sector exist in a relationship of mutual dependency – central banks and private banks have incentives to protect each other's interests and independence. Thus the financial sector has an incentive to lobby for this institutional reform.

A number of factors put the financial sector in the best position to effectively influence politicians on this issue. First, the financial sector has the necessary expertise to understand this complex issue area. Their control of information relevant to monetary policy puts them in a powerful position relative to politicians. Second, the financial sector has the resources required to lobby politicians and to monitor policy actions in

¹³ A dependent central bank may be able to get around or minimise interference from politicians by delaying reporting the crisis to the Minister of Finance. Such was the case with the Johnson Matthey rescue by the Bank of England (Lawson 1992).

order to ensure politicians deliver on their promises. Third, the financial sector is a key sector of the economy, controlling the flow of credit to industry and employing a significant segment of the work force. This control of credit has a direct impact on economic performance and the ability of politicians to deliver on their electoral promises. Fourth, the financial sector is able to overcome collective action problems because it is made up of a few, large firms, with a narrowly defined objective and a greater incentive to act than the median voter (Posen 1995b, p.256). For these reasons, the financial sector is well placed both to lobby for greater central bank independence and to protect this independence should it be threatened following a change in government.

Moran (1991) challenges the view that the financial sector may be able to lobby effectively. In his study of the financial services revolution in the USA, the UK and Japan, he found that financial firms had difficulty in reaching a common policy position, due to the inherent rivalries and competing concerns of individual firms. "The striking feature of the three cases examined...is that private interests could not independently organise effective reforming coalitions. The interests of the firms were so divided that change either ground to a halt, or happened with agonising slowness" (Moran 1991, p.124). Both Moran (1991) and Porter (1993) found that this deadlock in the area of financial regulation was only overcome by the intervention of state agencies. This view questions the ability of the financial sector to form an effective coalition to lobby for central bank independence.

The structure of banking supervision affects the financial sector's incentive to lobby for central bank independence. Posen (1995) argues that a potential conflict of interest exists when the central bank is responsible for regulating the banking sector. Banking

regulation generally imposes a cost on banks, reducing their profitability. A more independent banking regulator is in a stronger position to resist indirect pressure by the banks it is supervising, as politicians are not in a position to intercede on behalf of the banks. When the central bank is the regulator, financial sector firms are expected to be less unified as they individually lobby the central bank on different regulatory issues. Under these circumstances, the banking sector may have a preference to limit the central bank's supervisory powers. Financial sectors not regulated by the central bank should offer stronger opposition to inflation and have a clearer interest in central bank independence, as their interests are more closely aligned with the central bank.

Business

Business remains a core political constituency, due to the influence of investment and employment decisions on the economy (Coleman 1988; Gourevitch 1986; Kurzer 1993; Lindblom 1977; Moran 1984a; Milner 1988; Mitchell 1997). Businesses are affected by monetary policy, although their policy preferences will vary based on the degree of leverage in their capital structure, the cyclical nature of their industry, and their exposure to the traded-sector of the economy (Frieden 1991b). Economic stability with low inflation creates a climate that is positive for long-term investment. By contrast, boom-bust cycles with high inflationary periods leading to higher interest rates discourage firms from investing. High inflation and inflationary expectations lead to a premium for uncertainty being built into nominal interest rates, raising the cost of capital and increasing the required rate of return on investments. Seen from this point of view, business should be in favour of an independent central bank, which can provide price stability, reduce the variability of interest rates and lower the risk premium resulting from political interference in markets.

While business may have an incentive to lobby, their ability to convert political potential into effective influence is questionable. Coleman (1988) and Moran (1984a) argue that the fragmentation of business associations representing different sectors or industries means businesses associations often have a difficult time seeing what problems they have in common. Many cyclical industries are sensitive to the level of interest rates, such as construction, real estate and engineering. These industries benefit from lower interest rates, and should prefer a dependent central bank where politicians are in a position to suppress interest rate increases. When lobbying for lower interest rates, these firms should stand a better chance of success convincing politicians than central bankers. Exporters will favour a competitive exchange rate relative to their international competitors. High interest rates lead to an over-valued exchange rate in the short run, hurting their competitiveness. An independent bank bent on pursuing price stability is likely to hold interest rates higher for longer than their politically controlled counterparts. Exporters should therefore support a dependent central bank.

Organised Labour

Trade unions and central banks have developed an uneasy, if not antagonistic, relationship due to the role played by wage pressure in creating inflation and the perceived short-term Phillips curve trade-off between unemployment and inflation. Given the choice between higher inflation and higher unemployment, trade unions will generally prefer more jobs. From this perspective, it would appear that trade unions would prefer a dependent central bank where politicians have control of the monetary instruments, as trade unions can lobby politicians more effectively than they can unelected central bankers.

However research on the relationship between collective bargaining and central bank independence casts some doubts on the preferences of organised labour on this issue

(Bleaney 1996; Hall et al. 1998; Iversen 1998). The anti-inflationary benefits of central bank independence may not be realised in the absence of coordinated wage bargaining. When wage bargaining is coordinated, trade unions may prefer an independent central bank because inflation is kept in check – mitigating the need for either wage increases or wage restraint - and the economy is more stable. This research, however, has only emerged during the late 1990s. For this reason, it is unlikely to have affected the policy preferences of unions on this issue.

An additional consideration concerns the preferences of unions in the traded-sector. Recent research has suggested that these unions are likely to hold the same preferences as their employers towards the exchange rate (and by default the interest rate), as opposed to the preferences of unions that are not exposed to international competition (Garrett 1995; Garrett 2000; Frieden 1996). The rationale is that economic conditions that damage the profitability or viability of exporters hurts management as well as workers. For this reason, unions in the export sector can be expected to have an additional incentive to oppose central bank independence.

Hypothesis III: A central bank will be given independence in response to lobbying by interest groups opposed to inflation.

- Corollary A: The financial sector will be most effective when the central bank is not responsible for banking regulation.
- Corollary B: The greatest support for central bank independence is expected be found in a coalition of the financial sector and businesses in the non-traded sector.
- Corollary C: The coalition opposing central bank independence will come from businesses in the export sector, manufacturers and unions.

3.4 Politicians Tying the Hands

Comparative political economy has provided a number of explanations of central bank independence focussing on the incentives facing politicians to supply this reform. The political business cycle literature views politicians exploiting their control of macroeconomic policy to increase their popularity around elections, despite the negative consequences for price stability (Hibbs 1977; Nordhaus 1975; Tufte 1978). The corollary of this view is that politicians may delegate control of monetary policy to an independent central bank, when this strategy is perceived to provide electoral gains. A number of variations of this 'tying the hands' argument can be found in the literature, which differ in the importance they assign to partisanship. Partisan theories argue that central bank reform is associated with a change of government from a right wing to a left-wing party. Non-partisan theories focus on the desire of the executive to increase its chances of re-election. These hypotheses will be discussed in greater detail below.

Partisan Views of Political Behaviour

This class of 'tying the hands' arguments is premised on the view that political parties on the right and the left of the political spectrum pursue distinctive policies (Hibbs 1977). Partisan economic cycles emerge because the constituents supporting left and right wing political parties have different preferences towards growth, employment and inflation. Rational voters support the parties that best represent their preferences. Left-wing parties have the support of trade unions and workers, and are expected to give priority to policies designed to increase employment and redistribution. Right-wing parties representing business and wealthy individuals are expected to be more concerned with low inflation. Nordhaus (1975) found evidence of political business cycles prior to elections across a variety of industrial countries, while Alesina (1989) found systematic partisan differences in output and employment following elections. Empirical work has

confirmed that central bank independence acts as a domestic constraint preventing political business cycles (Clark 1998).

Coalition for Reform

Goodman (1991) has extended theories of partisan politics to predict which coalitions of domestic actors will support or oppose central bank independence. Goodman's view begins from the assumption that politicians concerned with re-election will deliver policies appealing to the largest group of voters. Non-financial actors such as labour, manufacturing and agriculture hold the majority of votes and prefer employment and output growth to inflation control. These groups are opposed to any attempts to institutionalise monetary restriction through central bank independence (Goodman 1991, p.329). By nature central bankers are conservative and support price stability, gaining them the support of the financial sector and other groups opposed to inflation. Because the anti-inflation coalition usually holds only a minority of votes, it cannot change the status of a politically dependent central bank alone so the status quo is preserved. This situation changes during 'hard times' when exogenous shocks originating in the international economy create an upswing in inflation, leading non-financial actors to change their preferences. Such a situation presents an opportunity for a new coalition to form among financial and non-financial groups that support giving independence to the central bank.

Impact of Political Time Horizons

The willingness of politicians to delegate to the central bank is conditioned on their expected time horizon in office. "Political leaders who expect their party to be in office for a long time and to maintain a solid majority will seek to protect, if not increase, their room for manoeuvre. Regardless of their economic objectives, they will be unlikely to favour an increase in central bank independence" (Goodman 1991, p.334). Right-wing politicians with an expected short time frame grant independence to the central bank in

order to tie the hands of their left-wing successors (Alesina and Rosenthal 1994).¹⁴

Delegation reduces the policy options available to the incoming government and preserves the existing line of policy.

A second partisan version of the 'tying the hands' argument focuses on the relative gains available to left-wing governments. Left-wing governments are known to prefer employment to price stability, and are expected to be more interventionist, using budget deficits to fund counter-cyclical policies and wealth redistribution. This reputation leads financial markets to charge left-wing governments an interest-rate premium on their borrowing relative to right-wing governments (Garrett 1998). Goodhart (1997) argues that it may be rational for a left-wing government to give independence to the central bank in order to reduce this interest-rate premium. This view suggests that left-wing governments with a longer time horizon will tie their own hands upon taking office, rather than inheriting this change from a right-wing government.

Taken together, these two views argue that both a right wing and a left-wing government have an incentive to 'tie their hands'. However the impact of the time horizon and the timing is different, as the change will take place when a right-wing government is about to leave office or when a left-wing government has just taken office.

Non-Partisan Explanations

Bernhard (1996) provides a non-partisan explanation for why politicians may 'tie their hands'. Politicians view central bank independence as a mechanism for increasing cabinet stability and durability, by removing conflicts between the executive, backbench

¹⁴ Garrett and Lange (1996) argue that politicians will only be willing to change an institution if they have long time horizons as institutional reform provides few short-term benefits and may instead be damaging

legislators and coalition partners over monetary policy (Bernhard 1996). With a coalition or minority government, there is always the risk that conflicts over monetary policy will threaten the stability of a government. Raising interest rates is unpopular with politicians, making monetary policy a contentious political issue. Not only has monetary policy wide-ranging consequences for the electorate, it is also technically complex, poorly understood with information asymmetries and lack of transparency. These characteristics make it hard for partners in a government to verify that the executive is sticking to its promises – a political version of time inconsistency.¹⁵

If backbench legislators or partners in the ruling coalition can credibly threaten to bring down the government, the executive has an incentive to delegate as a means of removing this potential source of instability. Central bank independence reduces intra-party conflict, Bernhard argues, by providing credible verification that government ministers have attempted to achieve certain policy outcome.¹⁶ Bernhard's intra-party conflict hypothesis presents a twist to the economics literature on delegation, as it views central bank independence as a technology for resolving *internal* conflicts within the government, as opposed to providing credibility *externally* to domestic actors.

Central bank independence may be used by politicians who wish to minimise economic risks and maximise the chances of re-election. Elgie and Thompson (1998) analyse the relationship between politicians and central banks in France and the United Kingdom over 300 years, using both quantitative and qualitative measures. They argue that the rise of financial interdependence and the increased complexity of monetary policy have

to a politician's position with different sectors of the economy.

¹⁵ Broader changes in the international economy brought about by deregulation and financial liberalisation further complicate these efforts at verification.

¹⁶ Using Milner's terminology, an independent central bank is an 'informed signaller' who can endorse or veto a policy (Milner 1997).

made control of monetary policy a liability for politicians. The ‘core executive’ – consisting of the executive branch of government, heads of state, ministers and civil servants – will use central bank independence to deliver anti-inflationary benefits while minimising the risks of poor economic performance for which they are blamed. “Politicians hoped that if central banks were made responsible for judging monetary policy with a statutory framework defined by the pursuit of price stability, then they themselves could preside over the delivery of a set of particularly anti-inflationary benefits without risking the economic and political pitfalls inherent in more ambitious projects of political control over economic life” (Elgie et al. 1998, p.144). Delegation to an independent central bank is seen as a risk-reducing exercise that fits within the wider neo-liberal paradigm that the government should not intervene in the economy. The timing of the change is explained by the broader changes in the international economy during the 1990s, which have changed the incentives facing the core executive.

Hypothesis IV: Politicians will ‘tie their hands’ by granting the central bank independence, when they judge that the electoral gains from this institutional reform exceed the electoral costs.

- Corollary A: Right-wing politicians with a short time horizon will delegate to the central bank in order to reduce the room to manoeuvre of an incoming left-wing government.
- Corollary B: Left-wing politicians with a longer time horizon will delegate to the central bank in order to reduce the cost of financing government debt.
- Corollary C: Politicians in a minority or coalition government will ‘tie their hands’ by granting independence to the central bank in order to increase cabinet stability and durability, but only if backbench legislators or partners in the ruling coalition can credibly threaten to bring down the government.

- Corollary D: Politicians will delegate to maximise the chances of re-election.

3.5 Impact of Political Institutions

All the authors cited in this discussion have been careful to qualify their claims by referring to the institutional setting in which policy is made. Institutions can be defined as “the formal and informal procedures, routines, norms and conventions embedded in the organisational structure of the polity or political economy” (Hall et al. 1996, p.938).¹⁷ Institutions both constrain and enable the influence of interest groups, by ‘loading the dice’ in favour of some groups at the expense of others (Underhill 1994). Institutions also affect the incentives and costs facing different groups, and regulate the rules of the policymaking game (Keohane 1989; Krasner 1982). The effectiveness of interest groups at influencing policy is therefore dependent on the nature of existing institutions in a given issue area.

A political economy taxonomy of institutions classifies them in two categories - political institutions and economic institutions. Political institutions are the political regime type, the election formulae, the degree of fractionalisation of political parties and the number of veto-players in the political system. Political institutions affect policy directly through a system of checks and balances on the power of the executive, and indirectly through elections that render policymakers accountable to the electorate on a regular basis. Examples of economic institutions are the structure of the financial system, the regulation of the banking sector and the system of collective wage bargaining. Economic institutions alter behaviour by affecting the distribution of wealth among economic interest groups. This study considers the role of political institutions

¹⁷ Institutions can be usefully broken down into three classes: conventions which are informal with implicit rules, regimes which are formal with explicit rules and organisations which are ‘purposive entities’ (Keohane 1989).

only, as the economic institutions in the four case studies outlined in chapter 4 were found to be very similar while the political institutions had some significant differences.

The political regime type is hypothesised to influence the status of the central bank, with a number of authors associating independence with federal political systems (Banaian et al. 1983; Pollard 1993; Posen 1993; Swinburne et al. 1991). Posen (1993) argues that federal systems are the most decentralised, increasing the effectiveness of lobbying by increasing the avenues of influence available to interest groups and by making it more difficult for the government to monitor policy implementation. Despite its appeal, federalism is a poor predictor of central bank independence, with the trend displaying no clear pattern based solely on political regime type. Federal states such as Austria, Australia, and Canada have had relatively dependent central banks while unitary states such as Denmark, Italy (post-1981) and New Zealand (post-1989) had relatively independent central banks (Goodman 1991, p.331). These discrepancies have led authors such as Posen to suggest that while a federal system of government may be an enabling condition for central bank independence, it is not sufficient.

A number of authors have made the opposing argument, namely that federalism acts as a constraint on the government's ability to pursue economic policy reform (Bolland 1993; Castles et al. 1996; Gold 1989; Nagel 1998). Rather than facilitating the delegation of power, federalism creates more obstacles when passing legislation, as it requires more logrolling and consensus building in order for the policy to survive. Such is the case with federal politics in Canada and in Australia. Similarly, a bicameral legislature is more obstructive than a unicameral legislature. For example, New Zealand's unicameral parliament was seen as a permissive because it concentrated

executive power in the hands of few individuals, with no checks and balances built into the system.

Moser's (1999) work on checks and balances has provided a theoretical basis for the apparent association between federalism and central bank independence. The explanation has two parts. First, the existence of checks and balances in a political system renders central bank independence credible as a commitment technology. Central banks are generally awarded independence by statute, rather than a change of the constitution, which should in theory make it easy to reverse at politically convenient moments. Thus the credibility of the central bank as a commitment technology is not guaranteed beyond the term of the existing government. But almost no independent central bank has lost its legal independence since the initial wave of nationalisations following W.W.II, with the exception of the Bank of Canada.¹⁸ Moser argues that central bank statutes are not over-ruled following a change of government when the number of veto players whose approval is required to pass legislation is large. Winning over these veto players introduces a cost and acts as a disincentive for politicians to change existing legislation. Such is the case with a bicameral legislature or a federal parliament. Moser argues that delegation to an independent central bank becomes credible when there are at least two veto players in the legislative process and if they disagree to some extent about monetary policy (Moser 1999,p.1589). ¹⁹ Moser tested this hypothesis for OECD countries and found that the negative association between legal central bank independence and inflation is stronger in countries with strong checks and balances than in countries with no checks and balances.

¹⁸ The Bank of Canada formally lost its independence following the Coyne Affair and the Rasminsky directive in 1967 (Rymes 1994).

¹⁹ Lohmann has used this argument to explain the conditions under which the Bundesbank will respond to pressure from federal politicians, while Keefer and Stasavage have used checks and balances to explain when a commitment not to inflate is credible. (Keefer et al. 1998; Lohmann 1998)

Posen (1993) provides a similar view, arguing that political fractionalisation should be negatively associated with central bank independence. Fractionalisation, which measures the number of political parties forming the government, reduces the effectiveness of lobbying, as greater fractionalisation increases the amount of policy compromises and logrolling needed to pass legislation. Efforts of lobbyists may get lost in this process. Less fractionalisation therefore increases the voice of interest groups seeking to influence government. Higher fractionalisation increases the number of veto-players who need to be ‘bought out’ in order to change the legislation. Therefore fractionalisation may be viewed as a second proxy for the number of checks and balances or ‘veto-gates’ in the political system.

Institutional Constraint I: Political systems with fewer number of checks and balances will find it easier to reform the legislation governing their central banks, while countries with federal systems, bicameral legislatures or higher fractionalisation will be more likely to stick with the status quo.

3.6 Summary of Hypotheses

The four hypotheses put forward to explain the trend in central bank independence during the 1990s are summarised below. These hypotheses will be tested in the four case studies outlined in the next chapter.

Hypothesis I: Politicians will give independence to the central bank as a mechanism for signalling their creditworthiness to international financial markets, when they have a structural need for balance of payments finance or to support the credibility of an external anchor.

Hypothesis II: Politicians give independence to their central banks in response to academic ideas concerning monetary policy promoted by an epistemic community of monetary experts.

- Corollary A: Uncertainty or an economic crisis increases the effective influence of an epistemic community over policy.
- Corollary B: The epistemic community is only effective when its experts hold a shared set of causative beliefs and policy preferences.
- Corollary C: Ideas must satisfy the interests key politicians who champion them through the political process.

Hypothesis III: A central bank will be given independence in response to lobbying by interest groups opposed to inflation.

- Corollary A: The financial sector will be most effective when the central bank is not responsible for banking regulation.
- Corollary B: The greatest support for central bank independence is expected be found in a coalition of the financial sector and businesses in the non-traded sector.
- Corollary C: The coalition opposing central bank independence will come from businesses in the export sector, manufacturers and unions.

Hypothesis IV: Politicians will 'tie their hands' by granting the central bank independence, when they judge that the electoral gains from this institutional reform exceed the electoral costs.

- Corollary A: Right-wing politicians with a short time horizon will delegate to the central bank in order to reduce the room to manoeuvre of an incoming left-wing government.
- Corollary B: Left-wing politicians with a longer time horizon will delegate to the central bank in order to reduce the cost of financing government debt.
- Corollary C: Politicians in a minority or coalition government will 'tie their hands' by granting independence to the central bank in order to increase cabinet stability and durability, but only if backbench legislators or partners in the ruling coalition can credibly threaten to bring down the government.
- Corollary D: Politicians will delegate to maximise the chances of re-election.

Institutional Constraint: Political systems with fewer number of checks and balances will find it easier to reform the legislation governing their central banks, while countries with federal systems, bicameral legislatures or higher fractionalisation will be more likely to stick with the status quo.

These four hypotheses are arranged in table 2 to show the different emphasis given to domestic or international factors, and the role played by different actors.

Table 16: Theories of Central Bank Independence

Focus	Theory	View of CBI	Main Actors
International	Signal creditworthiness	Political response to need for balance of payments financing, or need to bolster credibility of external anchor.	International Investors
International	Power of economic Ideas	Politicians implement paradigm to gain anti-inflationary credibility and achieve price stability.	Transnational Epistemic Community
Domestic	Lobbying by Interest Groups opposed inflation	Result of lobbying by domestic interest groups, led by financial sector.	Financial sector, business and unions.
Domestic	'Tying the hands'	Partisan - politicians reduce room-to-maneuvre of incoming government, or reduce interest-rate premium on debt. Non-partisan - solution to internal conflict within ruling coalition or desire to increase chances of re-election.	Politicians

These hypotheses provide a range of plausible explanations for explaining why politicians choose to delegate. A cursory review, however, demonstrates that these explanations are not incompatible, nor are they mutually exclusive. More generally, it will be difficult to judge whether the central bank's legislation is changed in response to purely domestic factors, or purely international factors, as both may be present. For example, politicians who are convinced that independence will provide anti-inflationary benefits may also implement this reform in order to improve their chances of re-election. Or a newly elected, left-wing government with a need for balance of payments financing may wish to signal their creditworthiness to international markets in addition to improving their chances of re-election. Given the increase in international interdependence during the 1980s and 1990s, it is likely to be the case that both domestic and international factors are present.

This situation suggests two strategies. The first strategy, based on Popper's method of falsification is to use a case study to reject a hypothesis rather than to support it. In this

approach, the hypotheses are rejected one by one until the most likely explanation remains. A related strategy is to use what Eckstein referred to as the 'crucial case study' (George 1979, p.53). A case study may be chosen which fits as closely as possible to the existing theory but does not fit any of the competing hypotheses. If this case study fails to satisfy the prediction of the hypothesis, the hypothesis may be rejected. As the discussion of the cases will show, Canada and Australia both provide crucial case studies of Posen's lobbying hypothesis. A second strategy is to look for combinations of explanations between hypotheses that reoccur in the positive cases. For example, if two countries with newly elected left-wing governments reform their central banks following a currency crisis, then the hypotheses concerning left-wing governments and signalling may be compatible. The discussion of the case studies will attempt to make these connections, but any conclusions must be carefully qualified by the size of the sample and the potential for omitted variable bias.

Ch. 4 Monetary Reform in Four Industrial Countries: An Introduction

This thesis will test the hypotheses outlined in chapter 3 by comparing the history of four central banks during the 1980s and 1990s – the Reserve Bank of the New Zealand ("RBNZ"), the Bank of Canada ("BoC"), the Reserve Bank of Australia ("RBA") and the Bank of England ("BoE"). These central banks were all classified as among the most politically dependent during the 1980s, based on the different legal indices of central bank independence discussed in chapter 2. New Zealand and the United Kingdom subsequently legislated increased independence for their central banks, in 1989 and 1997 respectively. Politicians in Canada and Australia rejected such reform proposals. These cases therefore provide variation across the dependent variable, namely the legal independence of the central bank, as recommended by King et al (1994).

The period being studied is 1980 to 2000, a timeframe chosen to include the rapid rise in the number of independent central banks during the 1990s in contrast to the relative absence of such a trend during the 1980s. This period was characterised by high capital mobility and rising levels of international interdependence, both of which represented significant structural changes in the international monetary system. Focussing the examination on the last two decades does not, of course, discount the historical events that may have shaped the path taken by politicians in each state. The research on the path dependency of institutions suggests that decisions taken in the past are one of the strongest forces for shaping future outcomes (Garrett et al. 1996; Goldstein et al. 1993; North 1990; Zysman 1983). In particular, the institutional endowment in each country must be carefully considered in order to draw the correct lessons from these case studies.

King et al (1996) argue that a productive research design “should include a section or chapter carefully explicating the assignment and selection processes” (King et al. 1994, p.199). This chapter satisfies this requirement. The first section outlines background detail on the individual cases, focussing on their level of central bank independence at the start of the 1980s and their inflationary performance in the post-war period. The second section outlines the key institutional variables for each case, focussing on the political and economic institutions that were highlighted in chapter 3 as influencing the trend in central bank independence. The third section briefly outlines the interest groups representing the financial sector, business and unions in the four countries. The final section draws together the various strands from the discussion of institutions and interest groups to predict what should have been observed in each case. This prediction is based on the hypotheses outlined in the previous chapter. Highlighting these observable implications of the theories being tested allows us to construct a qualitative, empirical test of each hypothesis by comparing the predicted versus the actual outcome (King et al. 1994, p.100).

4.1 Overview of Cases

Central bank independence is perceived to be an institutional mechanism designed to solve the problem of inflation. The table below shows the economic performance of a range of industrial countries over the 1970s and 1980s, along with the degree of legal independence of their central banks over this period. The countries are ranked based on their success in controlling inflation during the 1970s. What stands out from this table is the association between central bank independence and low inflation, as predicted by theory. Germany, Switzerland and the USA had the best inflation records over this period, although their records on GDP growth were below the OECD average. In particular, unemployment rose sharply in Germany. Both Canada and Australia had

better than average success in controlling inflation, although GDP growth slowed noticeably and unemployment rose in both countries. New Zealand and the UK were amongst the worst performers in terms of inflation, with below average growth and rising unemployment.

Table 17: OECD Economic Performance

Year	Independence of central bank ¹	Inflation		GDP Growth ²		Unemployment	
		1970-79	1980-89	1970-79	1980-89	1970-79	1980-89
Germany	100	4.9	2.9	2.7	2.1	2.3	6.0
Switzerland	96	4.9	3.3	1.2	2.1	0.6	1.8
USA	74	7.1	5.5	2.7	2.9	6.1	7.2
Canada	55	7.3	6.5	4.6	2.9	6.6	9.3
Sweden	44	8.6	7.9	2.0	1.9	1.7	2.1
France	45	8.9	7.3	3.2	2.2	3.8	9.0
Japan	52	9.0	2.5	4.5	4.2	1.7	2.5
Australia	42	9.8	8.4	3.2	2.9	3.8	7.5
<i>OECD Average</i>	<i>n.a.</i>	<i>10.1</i>	<i>8.8</i>	<i>3.4</i>	<i>2.5</i>	<i>3.5</i>	<i>7.3</i>
New Zealand	29	11.4	11.8	2.1	1.9	0.6	4.4
Italy	41	12.2	11.1	3.8	2.2	4.4	7.0
United Kingdom	44	12.5	7.4	1.9	2.6	4.4	9.9
Ireland	59	12.7	9.2	4.7	3.5	6.9	14.2

1. Average of Bade and Parkin (1987), Grilli et al (1991), Cukierman et al (1992), Eijffinger and Schaling (1993), re-scaled as a percentage of score awarded to Germany.

2. GDP growth at 1985 prices.

Source: IMF, OECD

Inflation Record

The inflation record of countries over these two decades, shown in table 1, appears to present a simple explanation for which countries legislated more independent central banks. Countries like New Zealand and the UK that had politically controlled central banks and experienced a poor inflationary record post-Bretton Woods had an incentive to reform their monetary institutions in order to emulate the inflationary record in Germany, Switzerland and the USA. In 1989, New Zealand adopted an independent central bank, leading the trend during the 1990s. The UK was amongst the last to introduce this reform in 1997, a difference of almost a decade. These countries' relative

success at managing inflation would appear to provide a simple explanation for this divergence. New Zealand's economic performance was poor over both decades, with inflation remaining stubbornly high during the 1980s providing a clear incentive to adopt an independent central bank early. The UK had a poor inflationary record during the 1970s, with below average GDP growth with rising unemployment. However, the UK's inflationary performance improved substantially during the 1980s, removing any immediate incentive to delegate monetary policy to the central bank. Likewise Canada and Australia had below average inflation among OECD countries during the 1980s, which suggests that their monetary regimes were successful. Thus a country's inflation record during the 1980s relative to the OECD average would appear to provide a simple explanation for the need to legislate greater independence for the central bank.

There are several problems with this statement. First, empirical studies that attempted to predict changes in the central bank's legislation did not find any statistically significant relationships (Eijffinger and Haan 1996). Second, this simple predictor does not explain why the UK reformed its central bank legislation in 1997, even though inflation had been brought down to below 3 per cent during the early 1990s. Third, this argument does not explain why both France and Japan - that had better than average inflation records during the 1980s - both legislated greater independence to their central banks, in 1993 and 1998, respectively. If a country's inflation record does not explain the need for this reform, what accounts for the difference in timing among these countries? The answer lies in politics.

Central Bank Statutes

Table 2 shows details of the statutory framework governing the central bank in each of these countries, as it existed at the start of the 1980s, with the Bundesbank and the Federal Reserve included for comparison. It focuses on some of the main areas that

have been highlighted by the literature as resulting in political control over the central bank. At first glance, there does not appear to be much difference between them. In all cases, the appointment of the senior officials was controlled by the executive with the government controlling the majority of appointments to the main monetary policy decision making body in the central bank, and the governor's term matched or exceeded the length of the electoral cycle. In the case of Australia and New Zealand, a government official sat as a voting member of the board, while in Canada and Germany there was a government observer. Turning to the objectives of monetary policy, only Germany had a narrowly defined goal of price stability, while Australia, Canada, New Zealand and the USA had broad mandates that combined potentially conflicting objectives for currency stability and full employment.

Table 18: Central Bank Independence: Early 1980s

Country	Australia	Canada	New Zealand	UK	Germany	USA
Electoral cycle (years)	3	5	3	5	4	4
Governor Term (years)	7	7	5	5	8	4
Appointed by	Executive	Board	Executive	Executive	Executive	Executive
Decision making body	Board	Board	Board	Governor	Board	FOMC
Voting members	9	14	5	18	17	12
Appointed by	Executive	Executive	Executive	Executive	Executive	Executive 7, member banks 5
% Appointed by govt.	100	12 out of 14	100	100	100	7 out of 12
Govt. officials on body	1 (voting)	1 (ex officio)	1 (voting)	0	1 (ex officio)	0
Statutory objective (s)	Currency stability, full employment , public welfare	Money supply, currency stability, output and employment , public welfare	Stable prices, maximum output and employment , public welfare	None stated	Currency stability	Employment, stable prices
Who takes the final decision on monetary policy?	Board in consultation with Executive	Board in consultation with Executive	Joint between Board and Executive	Executive with advice of central bank	Board in consultation with Executive	Board
Does the government have the right to instruct the central bank?	Yes	Yes	Yes	Yes	Executive can defer decision for up to 2 weeks	No
Are there legal provisions in case of conflicts between the Board and the government?	Yes	Yes	No	No	No	No
Can the government borrow from the central bank?	Yes	Yes	Yes	Yes	Yes	Yes
Does the central bank participate in the primary market for government debt?	Yes	Yes	Yes	Yes	No	No
Is the central bank responsible for banking supervision?	Yes	No	Yes	Yes	Shared with other agencies	Shared with other agencies

Source: Grilli et al (1991), Capie et al (1994), and national legislation.

Differences begin to appear when focussing on the ultimate responsibility for monetary policy decisions. At one extreme in the UK, the Chancellor of the Exchequer made interest rate decisions whereas in the USA full responsibility rested with the central bank. In Australia, Canada and Germany the Board took interest rate decisions in consultation with the executive, with the government holding the right to direct the Board in case of disagreement in Australia and Canada, or to defer interest rate decisions for two weeks in Germany. In New Zealand, the executive and the board reached a joint decision on monetary policy. Finally, all countries had some facility for the government to borrow from the central bank, with four out of six central banks participating in the primary market for government debt. Based on Sargent and Wallace (1981), this arrangement could result in the government forcing the central bank to monetize its debts.

Government Finances

Turning to government finances, most of these countries had low levels of debt and manageable deficits by the end of the 1980s (compared with the criteria specified for European countries under the Maastricht Treaty). The exception was New Zealand where the budget deficit exceeded 6 per cent of GNP and government debt was 75 per cent of GDP. The trend in government debt in Canada was also upwards, with the budget deficit increasing sharply over the 1980s. None of these countries appears to have turned to the inflation tax to finance government spending, as seigniorage levels were low, being the highest in Australia during the 1980s.

Table 19: Government Finances

Country	Australia	Canada	N.Zealand	UK	Germany	USA
Govt. net debt (% of GDP)						
1970	40.1	11.6	n.a	79.2	-8.1	27.8
1980	24.9	13.0	n.a	47.3	14.3	18.8
1989	16.5	38.0	74.7	30.3	21.9	29.2
Govt. budget (% of GNP)¹						
1960-69	-1.8	-1.0	-3.0	-0.9	-0.5	-0.6
1970-79	-1.9	-2.7	-4.9	-3.7	-0.9	-2.1
1980-89	-2.0	-4.4	-6.1	-3.7	-1.6	-3.9
Seignorage (% of GNP)						
1960-69	0.4	0.4	-0.1	0.4	0.6	0.3
1970-79	0.7	0.7	0.7	0.8	1.0	0.5
1980-87	0.6	0.2	0.2	0.1	0.3	0.4
Current account (% of GNP)						
1960-69	-3.1	-2.3	n.a.	0.2	n.a.	0.5
1970-79	-1.8	-2.6	n.a.	-0.2	n.a.	0.0
1980-89	-4.7	-2.2	-3.3	-0.3 ²	n.a.	-1.7

1. Total budget surplus.

2. Only for years 1987-89.

Source: Grilli et al (1991), OECD Main Economic Indicators

4.2 Political and Economic Institutions

Political Institutions

Table 20: Political Institutions during 1980s

Country	Australia	Canada	New Zealand ¹	UK
Federal or unitary	Federal	Federal	Unitary	Unitary
Unicameral or Bicameral	Bicameral	Bicameral	Unicameral	Bicameral
Main elected chamber	House of Representatives	House of Commons	House of Representatives	House of Commons
Electoral rules	Preferential from single member districts	Plurality from single member districts	Plurality from single member districts	Plurality from single member districts
Fractionalisation	Low	Low	Low	Low
Checks and balances	Intermediate	Intermediate	Very Low	Low
Political stability	High	High	High	High
Electoral Cycle (yrs)	3	5	3	5
Average duration of parliament (yrs)	2.5	3	3	3.7
Average mandate (yrs)	12	8	6.7	8
Majority governments	100 % ²	67 %	90 %	94 %
% of control by two parties ³	100 %	100 %	100 %	100 %
% of control by left-wing ³	40 %	0 %	30 %	38 %

1. From 1996, New Zealand has introduced a new electoral system based on mixed member proportional representation.
2. The Liberal-National coalition in Australia is treated as a majority government, due to its stability and consistency.
3. Based on election results post-1945, with control designated based on the party of Prime Minister.

All these countries are parliamentary democracies based on the Westminster model that recognise the British monarch as the head of state.¹ Effective executive power resides with the Prime Minister, the leader of the majority party or coalition in the principal elected chamber, and his cabinet of ministers. Australia, Canada and the UK have bicameral legislatures, while New Zealand has a unicameral legislature after abolishing its upper house in 1950. The elected or lower chamber is the main legislative body with sole authority to approve government spending and taxation.

All of these countries have been dominated by two principal political parties, a result of their system of electoral rules. Canada, New Zealand and the UK use plurality voting in single-member constituencies to allocate seats in the lower chamber, commonly known as 'first-past-the-post'. Plurality electoral rules strongly favour a two-party system and generally deliver parliamentary majorities (Hague et al 1998). By contrast, the lower house in Australia is elected using preferential, majority voting, which tends to generate a multi-party system that over-represents the largest parties, usually leading to single-party majority governments or a stable coalition (Jackson et al. 1994, p.474). Among these cases, Australia is unique in having an elected upper house with seats allocated based on proportional representation, providing a larger number of veto players.

The Westminster model concentrates power in the hands of the Prime Minister and the Cabinet with few checks and balances. The government may fall if the ruling party

¹ Executive power is nominally vested in the sovereign, who invites the leading party to form a government and dissolves the Lower House on the recommendation of Prime Minister, leading to an election.

loses a vote of non-confidence in the lower chamber by simple majority. Neither the upper house nor the judiciary has a veto, except in Australia where the Senate can force an election. Individual Backbenchers have little power under the Westminster system, other than the ability to threaten the executive by passing a vote of non-confidence in the lower chamber, or by working on parliamentary committees (Grant 1993, p.113).²

Under the Westminster model, the policy making process is centred on departments and the civil service. The main route for interest groups to influence policy is through the Cabinet and the committee system at the formulation stage, or the civil service at the implementation stage (Grant 2000b, p.62). Secondary forms of lobbying involve working through political parties, the Parliament (such as proposing a Private Member Bill) or the courts (Grant 2000b, p.149).

Australia

Australia combines a federal structure with the Westminster model of Parliament. Australia has a bicameral legislature consisting of the House of Representatives and the Senate. The House of Representatives is elected by preferential voting from single-member districts with an election held at least once every three years.³ The Senate is elected by preferential voting with seats allocated based on proportional representation, with one-half of the members elected every three years to six-year terms. Voting in Australia is compulsory. Australia has both a Treasury and a Department of Finance and Administration, with the former responsible for the conduct of fiscal and monetary policy while the latter has responsibility for the preparation of the budget and the auditing of government spending.

² Grant (1993) argues that ministers and civil servants get off relatively easily in these forums as disagreement among committee members generally reduces their influence.

³ Under preferential voting, voters must rank all candidates in order of preference. Votes are transferred based on voter's preferences until one candidate is supported by the majority of voters.

Table 21: Results of Australian Federal Elections to the House of Representatives

Election	Result	Ruling Party	Prime Minister	Duration
28 September 1946	Majority	ALP	Chifley	3 yrs, 2 mth
19 December 1949 28 April 1951 29 May 1954 10 December 1955 22 November 1958 9 December 1961 30 November 1963 26 November 1966 25 October 1969	Coalition	Liberal – National Party	Menzies Menzies / Holt / Gorton Gorton / McMahon	22 yrs 10 mths
5 December 1972 18 May 1974	Majority	ALP	Whitlam	3 yrs
11 November 1975 10 December 1977 18 October 1980	Coalition	Liberal – National Party	Fraser	7 yrs, 4 mths
11 March 1983 1 December 1984 11 July 1987 24 March 1990 13 March 1993	Majority	ALP	Hawke Hawke / Keating	13 years
11 March 1996 3 October 1998 – present	Coalition	Liberal – National Party	Howard	5 years +

Source: Australian Electoral Commission

In the post-war era, Australia has effectively had a two party system, with the Prime Minister's office rotating between a coalition of the Liberal Party and National (Country) Party, and the opposition Australian Labor Party ("ALP").⁴ The Liberal-National coalition has dominated, holding the Prime Minister's office 60 per cent of the time. The ALP, whose roots are with the trade unions, has had greater success at the state level holding office for significant periods in five out of the six states.⁵ Commonwealth governments have been stable, with the ruling party holding office for an average of three terms or almost 12 years. Both major parties have exhibited rigid

⁴ Other smaller parties that are represented in the House of Representatives following the 1998 election are the Australian Democratic Party, the Green Party, and the One Nation Party.

⁵ The ALP has held office in New South Wales, Queensland, Western Australia, Tasmania and South Australia (Delury 1983).

discipline over backbenchers in both the House and the Senate. Fractionalisation is limited and the two major parties are clearly differentiated between a conservative-rural coalition and a social-democratic alternative.

Australia's federal structure does not provide a check on the power of the executive, as the constitutional division of power favours the national government over the state governments. The Commonwealth has such obviously 'national' powers such as monetary policy, defence, foreign affairs, and immigration. In addition, the Commonwealth monopolises the collection of income taxes and reimburses the states based on a revenue sharing agreement, allowing the Commonwealth to set terms and conditions for the use of these funds.

However, Australia's bicameral structure presents a credible check on the power of the executive, as the elected Senate has the ability to force an election through a double dissolution. A double dissolution occurs when the Senate has twice failed to pass a bill introduced and passed by the House of Representatives. In these circumstances the government may advise the Governor-General to dissolve both Houses, so that the disagreement between the Houses may be determined by the people at an election. Double dissolutions have occurred six times during the history of the federal Parliament—in 1914, 1951, 1974, 1975, 1983 and 1987. The Whitlam Labor government was forced out of office after two consecutive double dissolutions in 1974 and 1975. Likewise, the incoming Hawke Labor government overcame two double dissolutions in 1983 and 1987. During the period being studied, the Australian Democrats controlled the key seats needed by both major political parties to control the Senate, forcing both the ALP and the Liberal-National coalition to court the support of the Democrats, as seen in table 6.

Table 22: Distribution of Seats in the Australian Senate

Year	Australian Labor Party	Liberal – National	Australian Democrats	Other Parties ¹
1977	27	34	2	1
1980	26	32	5	1
1983	30	28	5	1
1984	34	32	7	2
1987	32	34	7	3
1990	32	36	8	2
1993	30	36	7	3
1996	29	37	7	3
1998	29	35	9	3

1. Other parties include: Democratic Labor Party, Australian Greens, Independent Party and One Nation Party.

Canada

Like Australia, Canada combines a federal structure with the Westminster model of parliament, with elections held at least once every five years. Legislation is the responsibility of a bicameral parliament consisting of the elected House of Commons and the appointed Senate. Canada has low fractionalisation and moderately high political stability, with plurality electoral rules generally delivering parliamentary majorities. Two non-ideological, centrist parties – the Liberal party and Progressive Conservative Party – have dominated the Prime Minister's office (Jackson et al. 1994). The Liberals have won 12 out of 18 elections in the post-war period, holding office 72 per cent of the time. Canada's political system has shown only moderate stability with 6 out of 18 elections generating minority governments. The average parliament has lasted only 3 years (instead of the maximum 5 years). In addition, since 1980 two acting Prime Ministers have been forced to resign as head of their parties while in office.⁶ The left-wing New Democratic Party ("NDP") has suffered most under the plurality system, as

⁶ Prime Ministers Pierre Trudeau and Brian Mulroney resigned as party leaders while in office, leading to the short lived mandates of John Turner (66 days) and Kim Campbell (122 days), respectively

its evenly spread support implies that the NDP receives fewer seats in parliament than is justified by its 15-20 per cent share of the federal vote. By contrast small, regional parties with concentrated membership have benefited disproportionately, such as the separatist Bloc Quebecois that formed the opposition following the 1997 election.

Canada's federal structure acts as a check on the power of the executive, which shares legislative power with the Senate and Provincial legislatures. While the constitution gives the Senate considerable *de jure* power, in practice it plays only a nominal and constraining role on the executive.⁷ The power of the Provinces is greater, and parties that are in opposition at the federal level frequently have control of the provincial legislatures. The ten Provinces share fiscal power with the federal government in many areas including taxation and spending. However, the federal government has exclusive jurisdiction over currency and banking, trade and commerce and national security, among other areas.

⁷ The House of Commons generally introduces legislation, but both Houses must approve all bills before they become laws.

Table 23: Results of Canadian Federal Elections to the House of Commons

Election	Result	Party	Prime Minister	Duration
11 June 1945	Majority	Liberal	Mackenzie King	8 yrs 2 mth
27 June 1949	Majority			
10 August 1953	Majority		St. Laurent	
10 June 1957	Minority	PC	Diefenbaker	9 yrs 8 mth
31 March 1958	Majority			
18 June 1962	Minority			
8 April 1963	Minority	Liberal	Pearson	16 yrs 1 mth
8 November 1965	Minority			
25 June 1968	Majority		Trudeau	
30 October 1972	Minority			
8 July 1974	Majority			
22 May 1979	Minority	PC	Clark	
18 February 1980	Majority	Liberal	Trudeau / Turner	4 yrs 6 mth
4 September 1984	Majority	PC	Mulroney	9 yrs 1 mth
21 November 1988	Majority		Mulroney / Campbell	
25 October 1993	Majority	Liberal	Chrétien	7 yrs 7 mth
2 June 1997	Majority			
27 November 2000	Majority			

PC = Progressive Conservatives

Source: Canadian House of Commons

New Zealand

New Zealand is a Westminster-style parliament with a single legislature, the House of Representatives, elected from single-member constituencies using plurality 'first-past-the-post' electoral rules. Elections are held every three years. This system delivered majority governments in every year.⁸ This combination concentrates power in the hands of the Prime Minister and Cabinet to a greater extent than in any of the other cases, earning the nickname of a 'parliamentary dictatorship' (Nagel 1998). Until the 1996 electoral reforms, New Zealand had a two-party system with the conservative National party competing with the left-wing Labour Party. The National Party dominated, winning 13 out of 19 elections and holding office for 70 per cent of the time in the post-war period. The Labour Party has formed the government on four occasions. New Zealand has experienced stable governments with low fractionalisation, with the

average mandate lasting for two parliaments. The only check and balance on this electoral system is a short electoral cycle.

Table 24: Results of New Zealand Elections to the House of Representatives

Election	Result	Ruling Party	Prime Minister	Duration
27 November 1946	Majority	Labour Party	Fraser	3 yrs
30 November 1949	Majority	National Party	Holland	9 yrs
1 September 1951	Majority			
13 November 1954	Majority			
30 November 1957	Majority	Labour Party	Nash	3 yrs
26 November 1960	Majority	National Party	Holyoake	12 yrs
30 November 1963	Majority			
26 November 1966	Majority			
29 November 1969	Majority			
25 November 1972	Majority	Labour Party	Kirk	3 yrs
29 November 1975	Majority	National Party	Muldoon	8 yrs 6 mths
25 November 1978	Majority			
28 November 1981	Majority			
14 July 1984	Majority	Labour Party	Lange	6 yrs
15 August 1987	Majority			
27 October 1990	Majority	National Party	Bolger	6 yrs
6 November 1993	Majority			
12 October 1996 ¹	Coalition	National Party / New Zealand First Party	Bolger (National)	3 yrs
27 November 1999	Coalition	Labour Party / The Alliance	Clark (Labour)	n.a.

1. The 1996 election was the first held under mixed-member proportional representation.

Source: New Zealand Electoral Commission

United Kingdom

The United Kingdom has a bicameral legislature, consisting of the elected House of Commons and the hereditary or appointed House of Lords. The House of Commons is elected at least once every five years. The House of Lords has the power to review, to amend or to delay legislation. Britain has a partisan, dual-party, political system with

⁸ Since 1996, New Zealand has used a mixed member electoral system based on proportional representation. An appointed upper house, the Legislative Council, was abolished in 1950 (Delury 1983, p.721).

low fractionalisation.⁹ The right-of-centre Conservatives and the left-of-centre Labour Party have dominated Parliament, with the Conservatives winning eight out of 15 elections since 1945, holding office two-thirds of the time. Majority governments have been the norm with a minority government formed only once in 1974 and lasting less than a year. Political stability is high, with only two governments failing to serve their full term in the post-war period (in 1950 and 1974, both under Labour). The most recent significant threat to the ruling party occurred in 1993 when the Major government faced a backbench revolt over the government's paving bill for the Maastricht Treaty.

Table 25: Results of British Elections to the House of Commons

Election	Result	Ruling Party	Prime Minister	Duration
5 July 1945 23 Feb 1950	Majority Majority	Labour	Attlee	6 yrs 3 mth
25 Oct 1951 26 May 1955 8 Oct 1959	Majority Majority Majority	Conservatives	Churchill Eden /Macmillan Macmillan / Douglas-Home	13 yrs
15 Oct 1964 31 Mar 1966	Majority Majority	Labour	Wilson	5 yrs 8 mth
18 June 1970	Majority	Conservatives	Heath	3 yrs 8 mth
28 Feb 1974 10 Oct 1974	Minority Majority	Labour	Wilson Wilson / Callaghan	5 yrs 2 mth
3 May 1979 9 June 1983 11 June 1987 9 April 1992	Majority Majority Majority Majority	Conservative	Thatcher Thatcher / Major Major	18 yrs
1 May 1997 6 July 2001	Majority Majority	Labour	Blair	5 yrs+

Source: (Banks et al. 1995; Mackie et al. 1990)

Domestic Financial Structure

This section reviews the changes taking place in the financial system of these four cases over the 1980s and 1990s. All of the cases introduced significant financial deregulation, which altered the structure and the actors in their financial systems significantly. However, this review shows that all four countries went through similar reforms, and

⁹ There are a number of smaller parties, of which the Liberal Democrats are the most significant.

ended up this period with largely similar economic institutions. For this reason, these economic institutions were not seen as explaining the outcome of the study, due to the lack of variation across the cases.

Australia

The Australian financial system was radically reformed in the early 1980s as a result of the Committee of Inquiry into the Australian Financial System (the “Campbell Committee”) (RBA 1989b). The Campbell Committee’s final report in November 1981 called for a sweeping deregulation of the financial system, arguing that a less-regulated, more open and more competitive financial system was needed. Despite a change of government to the ALP in 1983, most of the committee’s recommendations were implemented following the endorsement of a second commission, the Review Group on the Australian Financial System (“Martin Review Group”).

The recommendations of the Campbell Committee affected all aspects of the financial system (RBA 1991). In external economic policy, it led to the adoption of a market-determined exchange rate with reduced official intervention and an end to exchange controls (RBA 1989c). In domestic monetary policy, it led to the overhaul of the government securities markets, allowing a secondary market for government securities to develop (RBA 1989d)¹⁰. Direct controls on banks – such as interest rate ceilings, quantitative controls on lending and reserve asset requirements – were removed between 1984 and 1987, allowing open market operations to become the main instrument of monetary policy (RBA 1989e). A limited number of foreign banks were finally allowed to establish operations in Australia from 1985.

¹⁰ The Treasury moved from a ‘tap’ system to a competitive ‘tender’ system, where Treasury yields reflected market demand. This change led to an increase in the range of securities on offer, including index-linked Treasuries from 1985.

There are three broad categories of banks in Australia: privately owned Australian banks, where shareholders own the bank; government-owned banks such as the State Bank of South Australia, and overseas-owned banks. For historical reasons, private, domestic banks have dominated the financial industry, controlling almost half the total assets in the financial system in 1990 (RBA 1991). Deregulation under the Campbell Committee led to a consolidation in the financial sector, with the private banks absorbing their finance companies and merchant banks that had been set up to get around regulatory controls, and a number of building societies converting into banks.

Canada

Canada's financial services industry has undergone enormous change in the 1990s, evolving from four distinct pillars separated by legislation to a universal banking model controlled by the top chartered banks.¹¹ Financial reforms from the late 1980s onward led to breakdown of these pillars. In 1987 commercial banks were allowed to acquire securities dealers then in 1992 all financial institutions were allowed to acquire the cross-ownership in the other pillars, but only through stand-alone subsidiaries (Chant 1997, p.22). The 1992 legislation effectively led to a universal banking model, with institutions participating in banking, trust services, securities underwriting and insurance. Consolidation reached its peak in 1998 when the four largest charted banks announced merger plans that were subsequently disallowed by the Finance Minister due to concerns over competition. However, the trend towards consolidation in the financial services industry continues.

¹¹ Prior to 1980, financial services were grouped under 'Four Pillars' that were kept distinct by legislation. For a discussion see Chant (1997).

Table 26: Canadian Financial Sector Overview

Sector	No. of Companies		Assets (C\$ billions)		1997 per cent of Total Assets
	1991	1997	1991	1997	
Canadian Banks	8	11	553.7	1,132.4	57.0
Foreign Banks	56	44	58.2	91.9	4.6
Trusts	78	34	155.1	55.1	2.8
Credit Unions	2,700	2,289	79.9	107.0	5.4
Life Insurance	155	132	200.5	251.4	12.6
Property Insurance	350	216	33.7	53.6	2.7
Securities Dealers	118	187	26.9	13.3	0.7
Mutual Funds	<u>119</u>	<u>78</u>	<u>49.9</u>	<u>283.2</u>	<u>14.2</u>
Total	3,584	2,991	1,157.9	1,987.9	100.0

Source: Standing Committee on Finance (1998)

New Zealand

Prior to 1984, the New Zealand financial services industry was divided into protected but strictly controlled segments (Margaritis 1992, p.6). Banking was strictly licensed providing a monopoly to four registered banks – one government-owned institution and three foreign-owned banks (Margaritis 1992; Spencer et al. 1988). Domestic financial markets were underdeveloped, with the government funding its debt by placing securities at below market interest rates with various institutions. Low domestic interest rates and an inability to invest overseas discouraged private savings while subsidising domestic investment.

Among the first reforms introduced by Labour government elected in 1984 was financial sector deregulation (Deane 1985, p.6; Margaritis 1992, p.28; Spencer et al. 1988). Banking and foreign exchange was opened up to full competition. All controls on prices, wages, credit, dividends, foreign exchange and out-bound overseas investment were lifted and the New Zealand dollar was floated. Banks were freed from any quantitative limits on their lending growth. Bank deposit- requirements and

investment restrictions were abolished. These reforms led to a boom in the financial services industry, with a major reorganisation of ownership and management.

From a segregated system of financial services in the early 1980s, the financial sector in New Zealand has evolved towards a system of universal banking that is dominated by foreign institutions. By 1988, ten new banks had been registered while the restrictions on trustee savings banks and building societies had been eased, allowing them to compete for commercial banking business (Spencer et al. 1988, p.11). By 1996, the banking sector had 19 registered banks but only one New Zealand-controlled bank, and that a comparatively small one (Brady 1997). The majority of life insurance companies are owned and controlled overseas. Securities underwriting services are mostly offered by the registered banks, which also own two large finance companies and offer mutual fund products through bank branches.

United Kingdom

The UK financial services sector has developed from a segregated structure towards a universal banking structure during the 1990s, driven by domestic and international mergers. Banking is concentrated in the hands of less than a dozen clearing banks, with extensive branch networks, which sit atop a hierarchy of smaller banks, building societies and other specialised financial entities. As an international financial centre, foreign banks dominate London and outnumber their domestic counterparts five to one. Britain's traditional merchant banks have been swallowed over the 1990s by American and European investment banks. Britain's deep capital markets reflect a well developed sector of institutional investors, featuring large pension funds, an extensive asset management industry and the largest insurance market in the world.

Monetary Policy Frameworks

Table 27: Overview of Monetary Policy Frameworks

	Exchange Rate Peg	Monetary Target	Floating Exchange Rate	Inflation Target
Australia ¹	1970-1983	1976-1984	1984-1992	1993-present
Canada		1977-1982	1970-1976 1983-1990	1991-present
New Zealand	1970-1978 1982-1984		1985-1989	1990-present
UK	1970-1971 1990-1992	1980-1983	1972-1979 1984-1989	1993-present

1. Australia had both an exchange rate peg and monetary targets from 1976-84.

Source: Cottarelli and Giannini (1997), Edey (1997), Macfarlane (1998).

Australia

Following the collapse of the Bretton Woods system of pegged exchange rates, the Australian dollar ("A\$") was pegged to the US dollar in December 1971 (RBA 1987; Macfarlane 1998). This link was discontinued in 1974 in favour of a fixed peg against a trade-weighted basket of currencies. In 1976 the fixed peg was replaced by a crawling peg following a devaluation of the A\$. Monetary policy was then without an anchor from 1976 to 1983. In December 1983 the A\$ was floated and exchange controls were abolished as part of a wider deregulation of the financial system. Australian monetary policy then evolved through three distinct frameworks (Lowe 1997; Macfarlane 1998).

First, a loose form of monetary targeting under an exchange rate peg was adopted from February 1976 until January 1985, based on 'monetary projections' contained in the Treasurer's annual budget. These monetary projections were discontinued in January 1985, as financial deregulation had undermined the usefulness of monetary aggregates. Monetary policy was again without an operating framework until 1993, when the central bank began informally pursuing price stability under an inflation targeting regime (Grenville 1997, Stevens 1999). This regime was formally adopted from 1996, following a joint announcement by the government and the central bank.

The RBA has sole responsibility for foreign exchange operations and owns Australia's foreign exchange reserves that form part of its balance sheet (Committee 1993b, p.154).¹² Under the floating exchange rate regime, the RBA views its objective not as targeting a level for the exchange rate, but of maintaining a degree of order in the market by dampening large fluctuations.

Canada

The Canadian dollar has floated continuously since 1970. The removal of the Bretton Woods peg, however, left monetary policy without an anchor until 1975.¹³ In that year, the Bank of Canada adopted monetary targets under a program of 'monetary gradualism', which were supplemented by wage and price controls introduced from 1975-78. Monetary targets were formally abandoned in November 1982, leaving the Bank of Canada without an intermediate guide to policy.¹⁴ Since the late-1980s, the Bank of Canada has focussed on price stability as the appropriate objective of monetary policy. This objective was formalised in February 1991 with the introduction of inflation targets, jointly announced by the central bank and the government (BoC 1991b).¹⁵

The exchange rate has always played an important role in Canadian politics due to the economic importance of the traded sector and the high level of integration of Canada in international financial markets. The Bank of Canada views the exchange rate as an operational target for policy and a complementary transmission mechanism to the interest rate for signalling a shift in monetary conditions (Crow 1993c). This

¹² The RBA engages in foreign exchange intervention with – as a practical matter – no prior consultation with the Treasury, although the RBA keeps the government informed of major developments.

¹³ The Canadian dollar was floated from 1950 until the exchange rate was fixed in 1962, then floating again from 1970 to the present (Crow 1993c).

¹⁴ For a comprehensive review of Canadian monetary policy in the post-war period, see (Courchene 1976, 1981; Howitt 1986; Laidler 1997; Laidler et al. 1993). A summary is available in Howitt (1993).

¹⁵ The initial target aimed at reducing CPI inflation to a range of 1 to 3 percent by the end of 1995.

relationship was formally recognised by the introduction of the monetary conditions index (“MCI”) as the operational intermediate target for monetary policy in 1995. The use of the MCI has been downplayed since 2000 due to market misperceptions of its importance for monetary policy.

New Zealand

New Zealand adopted a short-lived US dollar peg in 1973 that was replaced with a trade-weighted peg later that year. From 1979 to 1982, a crawling band was introduced with the rate of crawl adjusted to reflect inflation differentials against New Zealand’s trading partners. The peg was fixed in June 1982 and remained until the currency was floated in March 1985, following the removal of exchange controls in December 1984. Floating the currency was part of a broader package of reforms that liberalised the financial system and freed the monetary instruments.

Prior to 1984 monetary policy was based mainly on a framework of regulatory controls. Following financial deregulation, the Reserve Bank of New Zealand implemented a strategy of monetary base control aimed at achieving a rate of inflation comparable to its trading partners, by controlling the quantity of cash reserves in the banking system (Caesar 2000; Deane 1985; Margaritis 1992). This approach was supplemented by a check-list of indicators – the exchange rate, the level and structure of interest rates, inflation expectations, monetary aggregates and trends in the real economy (Deane 1985, p.20; Margaritis 1992, p.15). The pursuit of price stability was made more explicit in 1988 with the public endorsement of this goal by Minister of Finance Douglas, which was then confirmed with the adoption of an inflation target in 1989.¹⁶ Starting in September 1988, the RBNZ also began monitoring a monetary conditions

¹⁶ The initial inflation target of 0 to 2 per cent was agreed between the Labour government and the Governor, with a path for disinflation extending until year-end 1992.

index (“MCI”). From June 1997, the relationship between interest rates and exchange rates in the formulation of monetary policy was clarified when the RBNZ began publishing its operating target level for the MCI (Brash 1997).¹⁷ In March 1999, the RBNZ adopted an official cash rate as its main policy instrument. However, the MCI still plays an important role in the determination of monetary policy.

United Kingdom

The British pound has floated from 1972 to 1990, then again from 1992 onwards. Following exit from the Bretton Woods system, Britain adopted a broad monetary target as a domestic anchor in 1975. The following year, faced with a balance of payments crisis, the Labour government went to the IMF for a stand-by loan of \$3.9 billion, with monetary targets formally included as part of that package. The Conservative government suspended the use of the broad monetary target in 1985, then scrapped all monetary targets altogether in 1987 (Atkinson, Baker, and Milward 1996, p.274). Monetary policy was without an anchor until October 1990, when Britain joined the Exchange Rate Mechanism of the European Monetary System (“the ERM”) at a fixed parity of DEM 2.95 to the pound. The UK was forced to exit the ERM in September 1992. The Conservative Chancellor sought to restore some monetary policy credibility by adopting an inflation target in November 1992. This inflation target has been continuously renewed, and was embedded in the Bank of England Act 1998.

¹⁷ The MCI is constructed as a 2:1 weighted average of the trade-weighted exchange rate and the 90-day interest rate.

Supervisory Arrangements

Table 28: Overview of Supervisory Arrangements

Country	Australia	Canada	UK	New Zealand
Bank regulator	Central bank (until 1998)	Office of the Supervisor of Financial Institutions	Central bank (until 1997)	Central bank (post-1984)

Source: Goodhart and Shoenmaker (1993), national authorities.

Australia

The *RBA Act 1959* gave the central bank only general responsibility for banking supervision, in so far as financial stability affected 'the economic prosperity and welfare of the people of Australia' (RBA 1991). Following deregulation, the RBA gradually built up a specialised banking supervision function that was formalised in 1984 with the establishment of a separate Supervision Unit. The following year foreign banks were invited to open operations in Australia for the first time. The RBA's regulatory responsibility was only formalised in 1989 when the *Banking Act 1959* was amended to give the RBA explicit supervisory powers (RBA 1989a). Finally, in July 1998, banking supervision was taken from the RBA and transferred to a new organisation, the Australian Prudential Regulation Authority.¹⁸ At the same time, the RBA was given extensive regulatory powers over the payments system to be exercised by a new Payments System Board within the RBA.

Canada

In 1987 the Inspector General of Banks merged with the regulators responsible for trust companies and insurance to create the Office of the Supervisor of Financial Institutions ("OSFI") (Chant 1997, p.16). OSFI was given the powers to supervise and regulate all federally regulated financial institutions, namely all banks, federally incorporated trust and loan companies, insurance companies, co-operative credit associations and pension

¹⁸ This separation of monetary policy and supervision functions was considered by the Martin Review, but then dismissed. The RBA was naturally opposed (Fraser 1991, p.2).

plans. Prior to these reforms, chartered banks were subject to federal regulation, while trusts and insurance companies were regulated either provincially or federally depending on how they were incorporated.

New Zealand

Prior to 1984, New Zealand had only four registered banks that were supervised informally by the central bank. Extensive controls on all aspects of the financial sector had led to the emergence of a large number of non-financial institutions outside the RBNZ's supervision that dis-intermediated financial flows while escaping the regulatory net. The *RBNZ Amendment Act 1986* tried to address this situation by making the RBNZ responsible for both bank and non-bank financial institutions, although the central bank remained without statutory powers to ensure financial disclosure, to lay down standards or to punish offenders. With the *RBNZ Act 1989*, RBNZ is responsible for supervising only registered banks, while the use of the term 'bank' has been restricted (Dawe 1990, p.32). The RBNZ remains the lender-of-last-resort for the banking system, with only registered banks qualifying for assistance. New Zealand has no system of deposit insurance, to discourage moral hazard by ensuring that depositors invest their funds prudently.

United Kingdom

Prior to the 1980s, bank supervision had been conducted by the Bank of England on an informal and non-statutory basis, which proved inadequate as seen in the secondary banking crisis of the early 1970s (Lawson 1992, p.407). The arrival of Big Bang in October 1986 made the need to improve the regulatory framework more pressing, and resulted in the 1986 Financial Services Act ("FSA") and the various agencies set up under that Act (Lawson 1992, p.400). Following the collapse of Johnson Matthey Bankers, the Conservative government introduced regulatory reforms in 1987 that strengthened the supervisory regime. This framework remained in place for the next

decade, despite the collapse of BCCI, the failure of Barings Bank and the Maxwell pensions scandal. In 1997 a new Financial Services Authority ("FSA") was created with responsibility for the financial industry as a whole. As a result of this change, 450 Bank of England employees were seconded to the new FSA, but the Bank of England retained responsibility for financial stability and continued to act as lender-of-last-resort – a position it formalised in a Memorandum of Understanding with the FSA and the Treasury agreed in Autumn 1997.

Labour Market Institutions

Table 29: Overview of Labour Market Institutions

Country	Australia	Canada	UK	New Zealand
Trade union density (%)				
1980	48	36	50	56
1990	41	36	39	45
1994	35	38	34	30
% workers covered by collective agreement				
1980	88	37	70	n.a.
1990	80	17	47	67
1994	80	16	47	31
Collective wage bargaining agreement	Yes	No	No	No
Public Sector Unions as per cent work force				
1980	17	11	15	n.a.
1990	14	11	12	n.a.
Days lost to strikes				
1980	1,173	441	128	834
1990	730	270	50	298

Source: OECD, Garrett and Way (1999)

Union membership in industrial countries has been significantly affected by changes in the structure of developed economies, such as the shift in jobs from the public to the private sectors and from manufacturing to service industries. Industrialised countries have experienced a decline in unionisation, with membership declining between 1985 to 1995 by 13 per cent in Australia, by 22 per cent in New Zealand and by 12 per cent in the UK.

Australia

Labour market institutions and negotiated wage restraint with trade unions have played a significant role in Australia's political economy over the past two decades. In 1990, Australia had some of the most encompassing unions among industrial countries, with collective wage bargaining covering 80 per cent of union agreements (Garrett et al. 1999, p.423). Australia also had powerful public sector unions. However these figures conceal a decline in the strength of organised labour, with union membership dropping from a peak of 42 per cent in the mid-1980s to 28 per cent of the workforce by 1998.¹⁹ Public sector union membership also fell to 53 per cent. Voluntary wage restraint was an important element of Australia's economic policy for more than a decade under the Prices and Incomes Accord ("the Accord"), which was in place from 1983 to 1995. The Liberal-National coalition elected in 1996 rejected any Accord with the trade union movement, ending this period of voluntary wage restraint.

Canada

In 1990, about a third of workers were unionised of which 35 per cent were public sector employees, a decline from the levels of unionisation of previous years. Canada has the least coordination of wage bargaining among 18 OECD countries and among the least encompassing unions (Garrett et al. 1999; Hall et al. 1998).²⁰ In 1975, the government announced mandatory wage and price controls under the Anti-Inflation Board, which restricted or rolled back union wage increases. Following the 1981-82 recession, public sector unions were targeted by legislation that reversed union's collective bargaining rights and right to strike, and imposed wage controls under the government's "6 & 5" program in 1982-84. This pressure on organised labour has led to a significant decline in union membership and power in Canada (Phillips 1997).

New Zealand

Prior to the 1980s, New Zealand had a tradition of tripartism between the government, unions and businesses (Scott 1996). In 1982 the National government legislated wage and price freezes and passed legislation to reduce the power of unions. The wage freeze was ended in 1984 following the election of the Labour government, which reinstated compulsory unionism while preserving centralised wage bargaining.²¹ While unions were entitled to negotiate directly with individual employers, individual firms could not bargain directly with individual unions and were required to take part in national wage negotiations held annually. The *Labour Relations Act 1987* contested union coverage of certain industries and introduced legislative changes designed to strengthen the democracy and accountability of unions, while removing unnecessary restrictions in the wage-setting process (Margaritis 1992; Scott 1996). The National government elected in 1990 passed the *Employment Contracts Act 1991*, which ended compulsory unionism, reducing unions to the status of incorporated societies and extending the practice of enterprise bargaining (Castles et al. 1996, p.17). The proportion of the workforce on individual or collective enterprise-specific contracts increased dramatically and by December 1995 only 17 per cent of the workforce was covered by union-negotiated collective contracts (Brash 1996b). As a result of these reforms, union membership fell by 22 per cent over the decade from 1985, faster than in any other industrial economy.

United Kingdom

Britain does not have a centralised system of wage bargaining. About one in three workers belong to a union, with union membership declining due to structural changes

¹⁹ As of February 1999 there are approximately 8.7 million workers in the Australian workforce, of which 28 per cent belong to unions. Source: ACTU.

²⁰ Similar results are reported by a number of other authors (Garrett 1998b; Garrett et al. 1999; Iversen 1998).

²¹ Specifically, membership of a union having in excess of 1,000 members was compulsory for all individuals working in an organisation where a compulsory union membership ballot had been successful (Spencer et al. 1988, p.33).

in the economy and the anti-labour policies introduced by Thatcher. Britain's decentralised wage bargaining led to a legacy of strikes and industrial conflict that finally declined in the 1990s. There are few all-encompassing unions, although mergers over the past decade have created some large unions. The peak association for organised labour, the Trades Union Congress, has declined in importance and cannot control its members who are increasingly diverse.

4.3 Interest Groups by Country

This section outlines a number of the associations representing the interest groups identified in the last chapter as being most likely to hold a preference for or against central bank independence. The list is not comprehensive, and the discussion is necessarily cursory, due to the large number of associations in operation in each of these countries. This list is intended to give a quick assessment of which associations are most likely to prove effective in transforming their economic power into political influence. This judgement is based on four criteria: their 'insider' status, the existence of a full-time staff with technical expertise in monetary policy, their control of specialised information, and identifiable rents from their activities that can be used to finance their costs of lobbying.

Australia

Table 30: Summary of Interest Group Effectiveness in Australia

	Insider status	Full-time staff with technical expertise	Control of specialised information	Identifiable rents > costs	Score
Australian Bankers Association	✓	✓	✓		3
Business Council of Australia	✓	✓	✓		3
Australian Chamber of Commerce and Industry	✓	✓			2
Australian Council of Trade Unions	✓ ¹	✓	✓	✓	4

1. The ACTU has insider status with the Australian Labour Party but not the Liberal-National coalition.

The Australian Bankers Association ("ABA") is the national organisation representing licensed banks in Australia. It is funded by its 27 member banks that include retail banks, investment banks, and foreign banks. Financial deregulation and increased competition post-1985 has reduced the profitability of the domestic banks, leading to industry consolidation that has benefited the four largest players – ANZ, Westpac, National Australia Bank and the Commonwealth Bank. The ABA has a full-time staff that includes expertise in monetary policy. The ABA, together with its members, produces industry research that is then made disseminated through the ABA.

Australian business was represented by a range of associations during the period being studied, ranging from the all-encompassing associations such as the Business Council on Australia to sectoral associations such as the Metal Trades Industry Association. These business associations have been fragmented and divided during the 1980s and 1990s, with their organisational disunity and conflicting preferences mitigating their political influence on the left-wing ALP government in power for much of this period (Bray et al. 1996, p.81; Singleton 1997). By the 1990s, several of these associations had declined in importance, merged or disappeared. The Business Council of Australia

("BCA"), established in 1983, is an association of chief executive officers of over 100 leading Australian corporations. The Australian Chamber of Commerce and Industry, formed in 1992, claims to be the peak business association, with a nation-wide network exceeding 350,000 businesses. The Metal Trades Industry Association merged with the Australian Chamber of Manufactures to form the Australian Industry Group, Australia's largest industry association.

The Australian Council of Trade Unions ("ACTU"), formed in 1927, is the peak association for Australian unions, representing over 70% of union members or around one in three Australian employees. The ACTU speaks on behalf of all workers including those in manufacturing, finance, government and the service sector generally. The ACTU employs a professional staff of 35 that include economists, researchers, and journalists. The ACTU increased its authority during the 1980s thorough its role in negotiating the Accord, which can be viewed as a source of rents for its membership. It also increased its scope and membership through mergers with two white-collar peak organisations, the Australian Council of Salaried and Professional Associations in 1978 and the Council of Australian Government Employees Organisations in 1981 (Bray et al. 1996, p.71).

Canada

Table 31: Summary of Interest Group Effectiveness in Canada

	Insider status	Full-time staff with expertise	Control of specialised information	Identifiable rents > costs	Score
Canadian Bankers Association	✓	✓	✓	✓	4
Business Council on National Issues	✓	✓	✓		3
Canadian Federation of Independent Businesses	✓	✓	✓		3
Canadian Labour Congress	✓	✓			2
Canadian Auto Workers	✓	✓	✓		3

1. Formed from the merger of the Canadian Exporters Association and the Canadian Manufacturers Association.

The Canadian banking industry is represented by a single trade association with limited membership, the Canadian Bankers Association (“CBA”). Established in 1891, membership in the CBA is compulsory but is limited to chartered banks, generating a membership of 40 domestic and foreign institutions. It has a full-time, salaried staff and has employed a permanent lobbyist in Ottawa since 1894 (Coleman 1988, p.184). The CBA has been successful in creating and controlling private rents for its members, initially through monopoly control of the payments system and now through ownership of a proprietary, national network of automated teller machines (Chant 1997, p.18). The CBA has a full-time staff with technical expertise in monetary policy, but relies on its members to comment on macroeconomic policy.

Business does not speak with a single voice in Canada, due to sectoral and geographic divisions among business associations (Coleman 1988). A number of associations with overlapping memberships compete on the policy stage for the attention of politicians and the public. The Business Council on National Issues (“BCNI”) views itself as ‘the

senior voice of Canadian business on public policy issues'. Founded in 1976, the BCNI is composed of the chief executive officers of 150 leading Canadian corporations representing every major sector of the Canadian economy including banking. The BCNI has a full time staff of 10, including technical expertise in monetary policy. The Canadian Federation of Independent Business ("CFIB"), founded in 1971, is the voice for small business and speaks for 98,000 members. The CFIB's ability to survey its membership and report the expectations of small business supports its claim to 'insider' status in Ottawa, but this activity only began in the mid-1990s.

The Canadian Labour Congress ("CLC") is the peak organisation for trade unions, representing provincial labour federations and 125 district labour councils, covering 2.3 million unionised workers. However with coverage of only 60% of unionised workers, the CLC has one of the lowest densities among its peers reducing the legitimacy of its claim to 'insider' status. The CLC's claim to speak for organised labour is challenged by the major unions themselves, such as the Canadian Union of Public Employees ("CUPE") and the Canadian Auto Workers ("CAW"), both of which are active members of the CLC. CUPE is Canada's largest union representing 485,000 workers in the public sector with headquarters in Ottawa and over 70 regional offices, employing a staff of more than 700. The CAW is the largest private sector union in Canada, representing 245,000 workers organised into 282 local unions from a wide range of industries.²² Both union associations have a full-time staff with technical expertise on monetary policy.

²² The CAW has been transformed through mergers with other unions into a broad-based, general workers' union, doubling its membership since 1985.

New Zealand

Table 32: Summary of Interest Group Effectiveness in New Zealand

	Insider status	Full-time staff with technical expertise	Control of specialised information	Identifiable rents > costs	Score
New Zealand Business Roundtable	✓	✓	✓		3
Federated Farmers	✓	✓	✓		3
Manufacturers' Federation	✓	✓	✓		3
Employers' Federation	✓	✓	✓		3
New Zealand Council of Trade Unions ¹		✓	✓		2

1. Formed from merger of the Federation of Labour and the Combined State Unions.

The financial sector in New Zealand was not coordinated in the 1980s, with associations representing the different financial sectors, namely the New Zealand Bankers' Association, the Finance Houses' Association²³, the Mortgage Lenders Association and the Insurance Council of New Zealand (Gold 1989; Lawn 1994; Roper 1992). These associations did make submissions to government committees, but pursued lobbying activities to the New Zealand Business Roundtable, to which many of their members belonged.

The New Zealand Business Roundtable ("NZBR"), formed in 1980, is an organisation of Chief Executives of major business firms, which represented around 40 of largest business and financial interests in New Zealand by 1989. Around one-third of its members were from the financial sector. The NZBR did not have a formal structure or an office until 1986, when Roger Kerr left the Treasury to become NZBR Director (Goldfinch 2000). It has a full-time professional staff of 3. The NZBR's members meet

²³ Subsequently renamed the Financial Services Association.

informally every two months to discuss public policy issues and form common positions. The NZBR's focus on the general economy, rather than particular sectors or industries, has allowed it to develop a broad consensus around issues based on a longer-term perspective. The NZBR is well-funded, and its staff have produced or commissioned numerous research reports and briefings that have proven effective in influencing policy in many areas, particularly microeconomic reform and labour market reform (Goldfinch 2000). The NZBR does not seek publicity, preferring to act as a 'quiet lobby'.

The main associations representing business over this period were the Federated Farmers, the Manufacturers' Association and the Employers' Federation (Gold 1989, p.275). The Federated Farmers, founded in 1946, had coverage during the late 1980s of 80 per cent of agriculture representing 60 per cent of export revenues. Its 30,000 members were organised in three commodity sections. The Manufacturers' Association, founded in 1927, had 2,400 members organised into 70 trade groups. Its membership represented 85 per cent of manufacturing output, 50 per cent of manufacturing employment and 25 per cent of exports. Both of these organisations held annual conferences to determine policy. The Employers' Federation, founded in 1902, consisted of four provincial employers' associations with a combined membership of 10,000, representing two-thirds of employers and 80 per cent of private sector employment. Its biennial conference was not a policy-making forum. All three associations played an active role in policy lobbying, meeting as a 'Top Tier' association (with three other associations) since the 1970s in order to coordinate their lobbying and sitting on the steering council of the 1894 Economic Summit. However these groups had overlapping

memberships and were unable to speak with one voice due to its members' sectoral interests.²⁴

Organised labour was fragmented during the 1980s, without a clear peak organisation representing workers (Bray et al. 1996, p.85). Unions were represented by three main associations, the Federation of Labour, the Combined State Unions, and the Public Service Association. In 1987, the Federation of Labour merged with the Combined State Unions to form the New Zealand Council of Trade Unions ("NZCTU"), which acted as the peak association for labour with an Executive elected by its membership. It had a membership of over 500,000 representing 78 per cent of union members. Despite its size, the NZCTU had difficulty speaking for labour as not all unions were members, and it had little control over its 69 affiliated unions (Gold 1989). It also had weak links with the Labour government, making it an ineffective voice for organised labour (Bray et al. 1996, p.68; Easton et al. 1996, p.35). For example, the NZCTU's policy stance led a number of blue-collar unions not to join, leading to the formation of a competing peak organisation - the Trade Union Federation - undermining the unity and voice of organised labour (Bray et al. 1996, p.79).

²⁴ In June 2001, the Manufacturer's Association and the Employers' Federation merged to form Business New Zealand, in order to strengthen the voice of business and act as a coordinating body for lobbying activities.

Table 33: Summary of Interest Group Effectiveness in UK

	Insider status	Full-time staff with technical expertise	Control of specialised information	Identifiable rents > costs	Score
British Bankers Association	✓	✓	✓		3
Confederation of British Industry	✓	✓	✓		3
Institute of Directors		✓	✓		2
Trades Union Congress		✓	✓		2

With the decline of 'esoteric politics' and the restructuring of the financial sector during the 1970s, the City of London has been forced to adopt the same tactics as other pressure groups in the 1980s, lobbying politicians through trade associations (Grant 2000; Moran 1984b). The City has a large number of trade associations, most with small staffs and overlapping memberships. The largest is the British Bankers Association, with income of almost £5 million, representing 95% of the domestic banking sector in London and acting as an umbrella organisation for a number of other banking associations. The BBA is funded by subscriptions from its 300 members. It has a full time staff of over 60, with a Director whose responsibilities include monetary policy. The BBA is active in monitoring and commenting on banking legislation, giving submissions and expert testimony to policymakers. However, the BBA has a policy of not commenting on macroeconomic policy, leaving this role to the Confederation of British Industry, of which it is a member. It does produce a limited number of specialised surveys, but no regular publications.

The promotion of the City's interests has suffered due to the confusing and overlapping group of bodies with no shared policy agenda (Clarke 1995, p.39). While there has been

some consolidation of banking associations in the early 1990s, there are still too many associations representing different areas of the industry, such as payment clearing bodies, investment banks, building societies, mortgage lenders and securities dealers. There are an equally large number of bodies representing insurance and pensions. This overlap of bodies does not allow any one to speak for the industry, and creates problems of collective action and free riding.

The Confederation of British Industry ("CBI") is the peak association for business, and the largest trade association in the UK. The CBI's members come from every sector and include half of the FTSE Top 500 companies, as well as over 1,500 small and medium-sized businesses. CBI member corporations employ over four million workers. The mission of the CBI is to influence government and party policy-making. It has a full-time staff of over 80 professionals that includes a Chief Economist and an Economic Policy Unit. CBI staff meet with ministers, backbench MPs and civil servants. Its staff produce briefings on the public policy issues, economic forecasts and surveys of business trends, and organise conferences and other networking opportunities for members.²⁵ The CBI also maintains a high media profile. Despite this view of its own importance, Grant (1993) argues that the CBI is an ineffective voice for business, as it is too monolithic and encompassing.

The Institute of Directors ("IoD"), established in 1903, is a private-member organisation for business directors. Membership is not restricted, and spans the spectrum from large, public companies to small, private firms. The main purpose for joining is to have the use of the IoD's meeting and entertaining facilities in London, as well as similar facilities in the regions. Members receive a variety of benefits including information,

advice, training, conferences and publications to help them in their businesses. The day-to-day running of the Institute is managed by a small team, headed by the Director General. There is no attempt made to survey the membership on policy positions, which are determined unilaterally by a Policy Unit, headed by a trained economist. The IoD prepares specialised surveys of its members on a variety of issues, such as pensions, business opinion, and taxation issues. It also prepares commentary on economic trends and submissions for government committees.

The Trades Union Congress ("TUC"), founded in 1868, is the peak organisation representing trade unions. It is made up of 74 unions with a combined membership of nearly 7 million workers. The TUC is funded by annual subscriptions paid by the affiliated unions, and had an income of £12.5 million in 1996. The TUC employs more than 200 staff in seven departments, which include a Campaigns and Communications department and an Economic and Social Affairs department. The TUC is committed to lobbying the government, political parties and employers based on common policy positions negotiated with its affiliated unions. The TUC's staff carry out research on employment-related issues, and run an extensive training and education programme for union representatives. The TUC maintains close ties with international bodies, such as the European Union and the International Labour Organisation. Despite these activities, the TUC is seen by Grant (2000) to be an association in decline. Organised labour lost political influence under Thatcher and has shrunk in size, being spurned first by the Conservatives and then by New Labour.

²⁵ Recent economic commentary has focussed on the budget issues, EMU, interest rate policy and public spending and borrowing.

4.4 Observable Implications of Hypotheses

Table 19 summarises the variables identified in chapter 4 as being important for explaining why politicians delegate. Rows 1 through 3 are proxies for the need to signal financial creditworthiness to financial markets. Row 4 and 5 measures the degree of uncertainty in the monetary framework, as evidenced by a lack of anchor for policy or a currency crisis. Row 6 reproduces the index of lobbying effectiveness derived in section III (with a scale of 0-4 where 4 is the most effective influence). The remaining rows of the table reflect the institutional constraints, with political institutions highlighted in rows 7 through 9 and economic institutions in rows 10 through 13.

Table 34: Summary of Explanatory and Institutional Variables, End of 1980s

	Proxy	Australia	Canada	New Zealand	UK
1	Government debt level, 1989 (% of GDP)	Low (16.5%)	Intermediate, but rising (38%)	High (75%)	Intermediate, but falling (30%)
2	Budget deficit, 1980-89 (% of GDP)	Low (-2.0 %)	Intermediate to High (-4.4 %)	High (-6.1 %)	Intermediate (-3.7%)
3	Current account, 1980-89 (% of GDP)	-4.7%	-2.2%	-3.3% ¹	-1.7%
4	Currency crisis	1983	n.a.	1984	1992
5	Monetary framework	No anchor (float 84-93)	No anchor (float 82-91)	No anchor (float 85-89)	No anchor ² (float 85-90)
6	Lobbying index: (i) financial sector (ii) business (iii) unions	3 2-3 4	4 3 2-3	3 3 2	3 2-3 2
7	Party in power	Labor (1983-96)	Conservatives (1984-93)	Labour (1983-90)	Conservatives (1979-97)
8	Stability of government	High	High	High	High
9	Political system with checks and balances	Yes	Yes	No	No
10	Banking regulator	Central bank	OSFI	Central bank	Central bank

1. Only for years 1987-89. 2. Monetary targets were suspended in 1985.

The following predictions can be made from this table concerning the willingness of politicians to give independence to the central bank. (The relevant hypothesis and corollary are referenced in brackets, marked H and C, respectively).

Australia

The indicators for Australia are mixed. The following factors suggest that politicians would delegate to the central bank. The Labor government should have an incentive to adopt this reform, as they were faced with a currency crisis upon being elected (H.I) and they had a strong electoral mandate suggesting a long-time horizon (H.IVB). The short electoral cycle suggested a strategy to minimise economic risks would be prudent (H.IVD). Delegation would also increase cabinet durability due to the ability of the Senate to credibly bring down the government (H.IVC). The Senate had used two double dissolutions to bring down the Labor government of Whitlam, making this threat credible. The presence of a currency crisis and the lack of monetary anchor should have made the ideas of an academic community more influential (H.IIA). The trade unions were the strongest position to influence policy, as witnessed by their role in negotiating the Accord, implying that opposition to this reform should have been strong. Business groups were likely to oppose this institutional reform but had low levels of lobbying effectiveness (H.IIC).

Several factors mitigated the need for central bank independence. Low debt levels, moderate budget deficits and a sophisticated domestic financial market indicated politicians faced no need to signal creditworthiness to international financial markets (H.I, H.IVB). The financial sector may have faced a conflict of interest against central bank independence as the RBA was responsible for banking supervision (H.IIIA). Finally, the Australian federal system of parliament made legislative change more difficult due to the checks and balances in the system (C.I).

Canada

The Canadian case offers a crucial test of Posen's hypothesis, as it satisfies most of Posen's criteria supporting financial sector lobbying in favour of central bank

independence (H.IIA). The financial sector had unified preferences due to the presence of universal banking and a central bank that was not responsible for banking regulation (H.IIIA). It was led by an association with the highest level of lobbying effectiveness, as seen in row 6 of table 19. Rising government deficits and intermediate government debt levels suggested that politicians were dependent on this sector for financing. Groups opposed to this reform - manufacturers, exporters and unions not covered by a collective wage agreement - showed weaker lobbying effectiveness (H.IIC). A political system featuring high stability and low levels of fractionalisation was a contributing factor (C.I). The lack of a monetary anchor suggests that the academic ideas would also have some influence (H.IIA).

However, a number of factors suggest that politicians would stick to the status quo. First, the federal political system and bicameral parliament lead to a high number of checks and balances in the passing of legislation (C.I). Canada's conservative politicians have no incentive to 'tie their hands' due to the lack of a credible, left-wing alternative in Canada, strong parliamentary majorities and high levels of political stability (H.IVA, H.IVC). Nor did these politicians see any strong incentive to signal their creditworthiness to international financial markets (H.I).

New Zealand

The case of New Zealand is unique, as it satisfied all four hypotheses for explaining why politicians should delegate to an independent central bank. The government had a strong need to signal its creditworthiness, due to high debt levels, high budget deficits and a need for balance of payments financing (H.I). The currency crisis faced by an incoming Labour government reinforced the need to signal creditworthiness (H.I), provided incentives for a left-wing government with a strong majority to 'tie its hands' (H.IVB) and created the uncertainty that would increase the influence of the epistemic

community (H.IIA). The new Finance Minister Douglas has signalled his willingness to undertake radical reform through his 1980 book, suggesting that he would champion ideas through the legislative process (H.IIC). New Zealand's unicameral legislature offered few checks and balances to such a reform (C.I). In addition, the incoming left-wing government faced a short electoral cycle of three years that supported a strategy designed to minimise economic risks and maximise the chances of re-election (H.IVD). The financial sector displayed only intermediate levels of lobbying effectiveness and faced a conflict of interest as the central bank was responsible for banking supervision (H.IIIA). The unions were in a weak position to influence politicians on this issue (H.IIC).

United Kingdom

The UK, like Australia, presents a mixed picture. UK politicians had no strong incentive to signal their creditworthiness to international capital markets, due to a falling debt levels and an external account that was relatively balanced over the 1980s (H.I). However, the lack of credibility of the exchange rate peg led to the ERM crisis in 1992, suggesting that international financial markets were not convinced of the government's commitment. This event, combined with the increased uncertainty of a floating exchange rate, should have increased the influence of supporters of this reform (H.II). The financial sector in the City was in a strong position than the trade unions to influence the Conservative government (H.IIIA, H.IIC). Only the supervisory framework presented an obstacle to these efforts (H.IIIA). However, Conservative governments under Thatcher and Major had a strong mandate, a history of stability, and a long time horizon with no credible threat from either backbenchers or the upper chamber, suggesting few incentives to delegate (H.IVA). The few checks and balances in the Westminster system support this view (C.I).

Summary of Predicted Outcomes

In summary, this review of explanatory variables suggests that only New Zealand politicians faced clear incentives to delegate to the central bank. On balance, Canada and the UK should have pursued this institutional reform if Posen's financial sector lobbying hypothesis is valid. The outcome of the Australian case cannot be easily predicted, although effective opposition of the unions is likely to have influenced a left-wing government not to introduce this reform.

Table 35: Predicted Outcome for the Case Studies

Country	Prediction
Australia	Mixed, favouring status quo
Canada	Mixed, favour central bank independence
New Zealand	Strongly in favour of central bank independence
United Kingdom	Mixed, favouring central bank independence

Ch. 5 Reserve Bank of New Zealand: Financial Crisis as a Catalyst for Reform

In 1989, a Labour government in New Zealand introduced legislation that overhauled the framework for monetary policy by giving the Reserve Bank of New Zealand ("RBNZ") operational independence in the setting of interest rates.¹ As a result of this legislation, New Zealand went from having one of the most politically controlled central banks to one of the most independent. The institutional design was revolutionary, incorporating both a contract between the government and the RBNZ Governor and a formal inflation target – both innovations that had not been seen elsewhere. The legislation was introduced following a successful disinflation, at a time

¹ The RBNZ was founded in 1933 then nationalised in 1936 by the Labour government (Capie, Goodhart, Fischer et al. 1994, p.203).

when New Zealand's public finances were on the road to recovery from a position of economic crisis during the early 1980s.

This situation suggests a number of puzzles for the study of central bank independence. First, why was a Labour government with a strong majority willing to tie its hands by delegating control of interest rates to the central bank? Second, how did New Zealand settle on this institutional framework, which was not based on any existing central bank models and was ahead of the state of the economic paradigm, particularly the research on central bank independence and inflation targeting? Finally, how do we explain the timing of this reform, which was introduced after a financial crisis had passed and inflation had been brought down, at the end of the Labour government's second term?

The chapter will proceed as follows. The first section reviews the features of the new legislation, comparing the degree of independence of the RBNZ before and after 1989. The second section places central bank reform in the context of the wider economic reforms introduced by the Labour government under Finance Minister Roger Douglas. The third section reviews the drafting of the act, and considers the influences on the institutional design. It then reviews the subsequent political debates after the plans to reform the RBNZ were made public in 1988. The fourth section analyses the 1989 reform from the point of view of the four hypotheses put forward by the literature. The fifth section concludes by demonstrating how RBNZ independence was heavily influenced by the literature on time inconsistency and was designed to 'tie the hands' of politicians to prevent partisan interference with monetary policy.

5.1 Overview of RBNZ Act 1989

The *Reserve Bank of New Zealand Act 1989* ("RBNZ Act 1989") was introduced into Parliament in May 1989 by the Labour government of Prime Minister Lange, which had

been re-elected for a second 3-year term in August 1987. The Act came into force in February 1990, shortly before the opposition National Party was elected in October 1990. The *RBNZ Act 1989* radically reformed the institutional framework for the conduct of monetary policy, introducing three main changes relating to objectives, accountability, and transparency.

Objectives

The Act had two main objectives. First, it gave the RBNZ operational independence in the setting of monetary policy with a single objective of price stability. Under the *RBNZ Act 1964*, monetary policy had been decided by the government, on the advice of the central bank, and was “directed towards the maintenance and promotion of economic and social welfare, having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level” (Lloyd 1992, p.208).² These incompatible objectives left the door open for the political manipulation of interest rates, and led to a stop-go policy resulting in high levels of inflation and poor economic performance typical of a political business cycle (Nordhaus 1975, Wood 1994). The *RBNZ Act 1989* gave the central bank a single objective “of achieving and maintaining stability in the general level of prices” (RBNZ 1990b, section 8). Explicit policy targets for price stability were set out in a separate Policy Targets Agreement (“PTA”) agreed between the Minister of Finance and the RBNZ Governor. The first PTA signed in March 1990 set a target of achieving inflation between 0 to 2 percent by December 1992, making New Zealand the first country to have a formal inflation target (Lloyd 1992, p.211; Bernanke et al. 1999).³ Each PTA must be published and tabled before Parliament, and specifies the assumptions

² The objectives in the RBNZ Act had been changed four times in 1936, 1950, 1960 and 1973 (Wood 1994).

³ While the current PTA specifies an inflation target, the *RBNZ Act 1989* leaves open the possibility of specifying other targets in future (Lloyd 1992, p.213).

underlying the policy targets as well as the shocks that may cause inflation to deviate in the short term (Dawe 1990, p.33).⁴ Notably, the new Act did not set specific legal limits on the central bank's ability to finance the government (Wood 1994, p.65).⁵

Second, the *RBNZ Act 1989* gave the central bank stronger but narrower powers of banking supervision. The RBNZ's responsibilities were reduced to only registered banks, and the use of the term 'bank' was restricted. The RBNZ remained the lender-of-last-resort for the banking system, but only registered banks could qualify for assistance. These changes led many non-bank financial institutions to register as banks, bringing them under the new supervisory regime.

Accountability

Section 11 of the *RBNZ Act 1989* holds the Governor responsible for achieving the inflation targets set out in the PTA. The Minister of Finance appoints the Governor to a 5-year, renewable term on the recommendation of the RBNZ Board. The Governor can be replaced for failure to deliver on the agreement, for unsatisfactory performance, or for a failure to sign a new PTA within one month of a formal override of the price stability objective (Lloyd 1992, p.215). This framework was designed to create personal accountability, as the *RBNZ Act 1964* had created a situation where no individual could be called to account for the RBNZ's performance (Dawe 1990, p.30). This arrangement, however, does not relieve the Governor of the responsibility to consult with the government over the conduct of policy as required under Section 10 of the Act (Lloyd 1992, p.210). Under Section 12, the government has the power to issue a directive to the RBNZ by passing an Order in Council that must be tabled in Parliament. Such a

⁴ The price index used for the inflation target is designed to measure underlying inflation, and thus excludes supply shocks, changes in energy and commodity prices, and indirect taxes (Bernanke et al. 1999, p.87).

⁵ While leaving open the possibility of debt monetization, such a restriction was believed unnecessary due to the government's commitment to fully fund its budget deficits.

directive may be valid for up to 12 months, and would override any PTA. The directive ensures that ultimate accountability for monetary policy remains with elected politicians. It also ensures any actions taken by politicians to interfere with the RBNZ are made public.

As part of the Act, the RBNZ Board lost its policy-making role and became the government's agent, responsible for monitoring the Governor and the conduct of monetary policy (Lloyd 1992, p.214).⁶ The Board therefore replaced the role of the Treasury Secretary, who formerly sat as an *ex-officio* member on the policy-making Board under the old legislation. Finally, the *RBNZ Act 1989* deprived the central bank of the automatic right to the seignorage. Instead the Governor is required to negotiate five-year funding agreements with the Minister of Finance, which are frozen over this period (Brash 1996b).

Transparency

Under the old legislation, the government could direct the RBNZ to aim monetary policy at different objectives, without the public's knowledge (Dawe 1990, p.30). This lack of transparency is seen as the main cause for the lack of credibility of the old framework and the resulting high level of inflationary expectations. A principal concern of the *RBNZ Act 1989* was to increase the transparency of monetary policy in order to make it more credible with the public and the financial markets. The focus is therefore on disclosure. The RBNZ is required to publish a semi-annual policy statement and an annual report, both of which are tabled in Parliament. The Governor is required to give regular testimony to a Parliamentary Committee, the Finance and Expenditure Committee. Other features designed to increase transparency are the stipulation of a

⁶ The new Board has between seven to ten directors: the Governor, either one or two Deputy Governors, and between four to seven non-executive directors appointed by the government (Lloyd 1992, p.214).

single objective, the use of an inflation target, the requirement to publish the PTA and the requirement to publish any government directive.

Table 36: Comparison of RBNZ Independence

	<i>RBNZ Act 1964</i>	<i>RBNZ Act 1989</i>
Governor Term (years)	5	5
Appointed by	Executive	Executive
Decision making body	Board	Governor
Voting members	5	1
Appointed by	Executive	Executive
% Appointed by govt.	100 %	100 %
Govt. officials on body	1 (voting)	None
Statutory objective (s)	Stable prices, maximum output and employment	Stability in the general level of prices
Who takes the final decision on monetary policy?	Joint between Board and Executive	Governor
Does the government have the right to instruct the central bank?	n.a. (Government sets policy)	Yes, by Order-in-council laid before Parliament.
Are there legal provisions in case of conflicts between the Board and the government?	n.a.	Yes
Can the government borrow from the central bank?	Yes	Yes
Does the central bank participate in the primary market for government debt?	Yes	Yes
Does the central bank have responsibility for the supervision of the financial system?	Yes, registered banks & 'specified entities'.	Yes, registered banks only.

5.2 Background to Central Bank Reform

Economic Underperformance

The *RBNZ Act 1989* represented the final step in a widespread program of economic reforms introduced by the Labour government between 1984 and 1990. Central bank reform cannot be properly understood in isolation from this wider programme, which has been labelled 'Rogernomics' after its chief protagonist, Finance Minister Roger Douglas. The *RBNZ Act 1989* and Rogernomics were a direct response to New Zealand's chronic economic underperformance over the post-war era, particularly during the two decades to the mid-1980s (Bernanke et al. 1999; Douglas et al. 1987; Lloyd 1992; Scott 1996). This economic underperformance was visible in the level of

inflation, GDP growth, the employment record, the government's finances, and debt levels. First, inflation averaged almost 12% per year over the 1970s and 1980s, as New Zealand developed a seemingly entrenched tendency towards high inflation (Lloyd 1992, p.205). Second, New Zealand had one of the slowest rates of GDP growth in the OECD, with growth between 1976 and 1984 totalling only 1.15 per cent annually (Lloyd 1992, p.205; Scott 1996, p.7). New Zealand's per capita GDP growth averaged 0.3 per cent per annum, compared with the OECD average of 2.0 per cent, so that New Zealand's relative ranking based on GDP per capita declined from fifth in the world in the 1950s to twentieth by the 1980s (Scott 1996, p.6; Spencer et al. 1988, p.7).

Table 37: New Zealand Economic Underperformance, 1975-1985

Year	New Zealand	Australia	USA	Germany	Japan
GDP per head ¹					
1975	97	99	137	96	93
1980	81	95	134	100	89
1985	82	95	134	98	96
Unemployment (%)					
1975	0.4	4.8	8.3	3.6	1.9
1980	3.3	6.0	7.0	2.9	2.0
1985	4.3	8.2	7.1	7.1	2.6
Inflation (%)					
1975	14.9	15.0	9.2	6.0	11.8
1980	17.3	10.2	13.5	5.5	8.0
1985	15.5	6.7	3.5	2.1	2.0

1. Expressed in 1991 purchasing power parity equivalents, with the average OECD countries =100.
Source: Lloyd (1992)

Third, unemployment began to rise rapidly from negligible levels in the 1960s to 5 per cent in the late 1970s, finally reaching 7 per cent by 1983 (Scott 1996, p.7). Fourth, the government faced persistent balance of payments deficits and rising fiscal deficits, arising from a stop-go policy that amplified the business cycle. The current account deficit averaged 4.8 per cent of GDP, compared with an OECD average of 0.3 per cent for the same period (Spencer et al. 1988, p.7). The budget deficit reached 9 per cent of GDP in 1982. Fifth, government deficits were funded by an increase in both external

and internal debt. Gross public and private sector debt rose from 11 per cent of GDP in 1974 to 95 per cent in 1984 (Evans et al 1996).⁷ New Zealand's credit rating was downgraded as international confidence in the economy eroded (Brash 1996b).

Figure 5: New Zealand Inflation and Unemployment Record

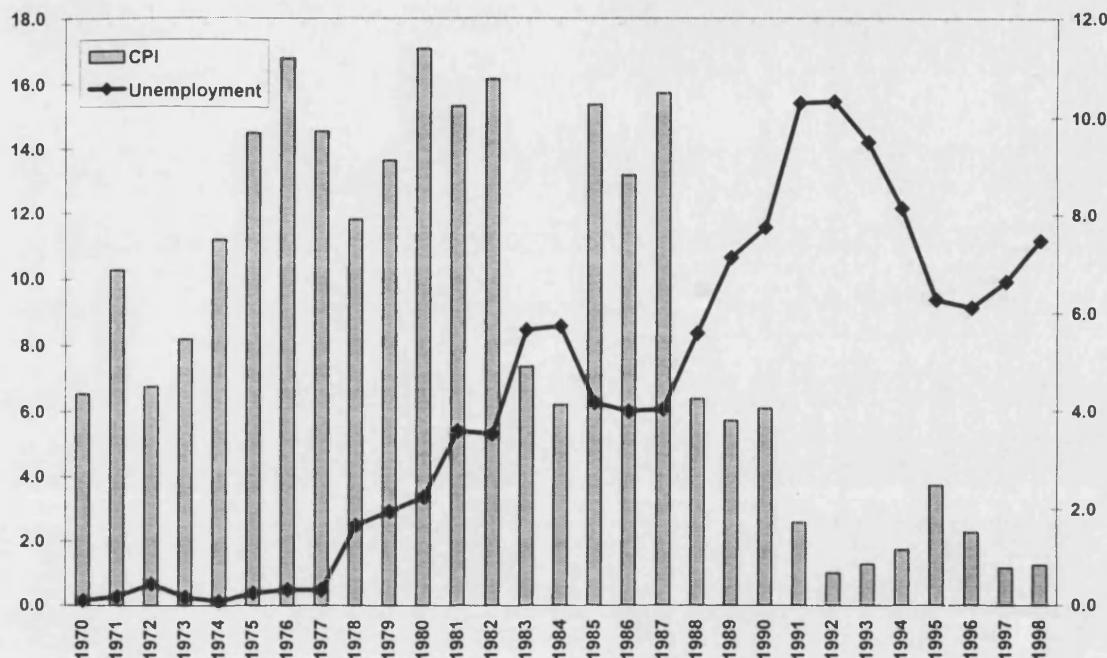


Table 38: New Zealand Gross and Net Public Debt

NZ\$mln	Foreign Gross Debt as % GDP	Total Gross Debt % GDP	Foreign Net Debt as % GDP	Total Net Debt as % GDP
1983	23%	56%	20%	27%
1984	21%	57%	19%	29%
1985	28%	63%	25%	36%
1986	28%	61%	26%	37%
1987	36%	71%	26%	43%
1988	26%	59%	19%	39%
1989	24%	57%	19%	43%
1990	28%	61%	22%	49%

Source: NZ Treasury, OECD

⁷ Failure of the Muldoon government's large energy-related industrial projects added NZ\$ 7 billion worth of debt alone, equal to 10 per cent of GDP (Scott 1996, p.6).

The National party elected under Prime Minister Muldoon in 1975, and re-elected in 1978, must bear the responsibility for most of these economic problems. After failing to negotiate an incomes policy with New Zealand's powerful trade unions, the National government legislated a total freeze on prices and incomes in 1982 in an attempt to stop inflation that reached 15 per cent that year (Scott 1996). Prime Minister Muldoon, who also served as Finance Minister, responded with a program of massive government intervention and control of the economy. Wages, prices, dividends, rents, interest rates and foreign exchange transactions were all regulated. Direct government-ownership industry increased, reaching 12 per cent of total economic activity, with the government providing goods and services below cost pushing up the deficit. Extensive licenses, tariffs and subsidies were used to protect domestic industries, and to protect key interest groups such as farmers and manufacturers.

This protectionism, combined with monetary, fiscal and income policies to control inflation, led to a misalignment of the exchange rate that undermined the tradable sector. Capital markets were distorted by controls on the financial sector intended to channel savings into the public sector. Financial institutions were forced to hold government bonds at below-market interest rates and pension funds were restricted to holding government bonds. As former Treasurer Scott recalls: "New Zealand's reform program...began in 1984 from a situation in which government interventions and controls in the economy were more pervasive and rigid than in any other developed economy. The regime of controls was parallel in significant respects to the control regions in Eastern Europe" (Scott 1996, p.5).

Rogernomics

The introduction of economic reforms following the 1984 election of the New Zealand Labour Party ("NZLP") would not have been accomplished without the leadership of

Finance Minister Douglas, who is widely seen as driving the reform process from his power-base within the Labour Cabinet (Easton 1989; Jesson 1989; Scott 1996). Douglas believed in the need for fast and comprehensive action, as opposed to gradual and piecemeal reform (Douglas 1993). He rejected the conventional view that reform could succeed only if political support for it has been established beforehand, which he felt merely compromised the quality of the reforms, thus adding to their eventual cost and sowing the seeds of opposition (Brash 1996b). Instead reform should advance in quantum leaps, which do not give interest groups time to mobilise and drag the process down. “Consensus among interest groups on quality decisions rarely, if ever, arises before they are made and implemented. It develops after they are taken, as the decisions deliver satisfactory results to the public” (Douglas 1993, p.218). Rapid reform retained the initiative in the hands of government and confounded the efforts of vested interests to coalesce against further reform. The nature of political institutions in New Zealand and dynamics of the NZLP caucus made this type of reform process possible as the unitary legislature and first-past-the-post electoral rules offered few checks and balances (Bolland 1994; Goldfinch 2000; Nagel 1997; Schwartz 1994, p.546).

Rogernomics took shape prior to 1983 while the NZLP was in opposition. Douglas put together an ‘Economic Policy Package’ with the assistance of Doug Andrew, the Treasury official seconded to the Opposition, and Geoff Swier, an economist in the Opposition Research Unit (Douglas et al. 1987, p.30).⁸ The package reflected many of the ideas that Douglas had elaborated in his 1980 Alternative Budget, which had been published as the pamphlet *There's Got to Be a Better Way* (Douglas et al. 1987, p.16). The reforms were free market-oriented and included a proposal to devalue the currency

⁸ Doug Andrew had worked in the Economics Department of Auckland University, before joining the Treasury and spending time at the World Bank (Jesson 1996, p.60). While seconded to the Opposition,

by 20%, followed by a tight monetary policy, tax reform and the dismantling of trade protectionism. The paper “prescribed a firm monetary stance and the need to signal that intention very clearly to the business and financial community, to minimise any uncertainty about the economic climate a Labour government would create” (Douglas et al. 1987, p.33). At this point in time, institutional reform of the RBNZ was not on the agenda.

This Economic Policy Package was submitted to the NZLP Policy Council in November 1983. The package faced resistance from the left-wing within the party, as well as the trade unions. Opposition leader David Lange assured these groups that a Labour government had no such plans for radical reform (Jesson 1989, p.65). A watered down version of the Economic Policy Package became the NZLP’s 1984 economic manifesto. Douglas later concluded: “[For] anyone who had read that first document, there were no surprises in the actions taken by the Labour government after its election. The total programme had been spelled out in detail in advance...[Everyone] now knew clearly what I intended to do if I became Minister of Finance” (Douglas et al. 1987, p.38).

Overview of Economic Reforms

In June 1984, Prime Minister Muldoon called a snap-election. During the month-long election campaign, speculation mounted against the currency with the RBNZ selling as much foreign exchange as it would normally have sold in one year (Deane 1985).⁹ New Zealand has a history of runs on the currency prior to elections, but the situation was made worse in 1984 by the knowledge that Douglas was in favour of devaluation

Andrew had no contact with his Treasury colleagues. Source: Interview with Doug Andrew, 24 August 2001.

⁹ Total spot sales of foreign exchange during the four-week election campaign reached NZ\$1.39 billion, leaving liquid reserves at NZ\$929 million - insufficient to cover the NZ\$1.48 billion of forward exchange rate commitments (Gustafson 2000, p.388)

(Douglas et al. 1987, p.42; Gustafson 2000; Margaritis 1992, p.8). The RBNZ and the Treasury had also been calling for devaluation since December 1982, which Muldoon steadfastly refused (Gustafson 2000). The end of a two-year wage and price freeze in February 1984, combined with loose fiscal and monetary policies, added to the speculative pressures. Speculators were offered a one-way bet against the currency, with the inevitable outcome. The massive defeat of the National government triggered the currency crisis, forcing the RBNZ to suspend trading in foreign exchange for several days.¹⁰

The currency crisis forced the incoming Labour government to abandon many of its election promises (Scott 1996, p.6). It also provided a window of opportunity for Douglas to push forward with his preferred neo-liberal reforms. “The extremity of the currency situation presented an opportunity which I doubt our political opponents recognised... The foreign exchange crisis brought with it the chance to introduce change more quickly” (Douglas et al. 1987, p.136). On the advice of the Treasury and RBNZ, Douglas devalued the exchange rate by 20 per cent, removed all interest rate controls and imposed a three-month wage and price freeze. These changes bought the new government some breathing space from financial market pressures, but created momentum for the reform program (Deane 1985, p.3).

Following the election and the currency crisis, the New Zealand Treasury briefed the incoming Labour government on the many pressing problems that faced them, not least chronic budget and balance of payment deficits and a large external debt. The Treasury – under the leadership of Graham Scott – had been preparing an economic reform package for some time, and was able to present the new government with a

comprehensive road-map, covering all areas of the economy. These proposals were in line with the recommendations reached by Douglas and his team in the Economic Policy Package. Douglas made the 352 pages of briefings public, which saw their publication under the title *Economic Management 1984*. The Treasury briefings were significant for influencing the direction taken, as they laid out a detailed strategy at a time when the new Labour government was coming to terms with the shock of the currency crisis (Douglas and Cullen 1987).

Following the election, the Labour government held a promised four-day Economic Summit, modelled on the Australian summit of the previous year (Douglas et al. 1987, p.128). The summit was attended by 230 delegates and was run by a steering committee that included key domestic interest groups - the Federation of Labour, the Combined State Unions, the Manufacturers' Association and the Federated Farmers. (Douglas et al. 1987, p.74). Finance Minister Douglas played little part in the summit, leaving the stage to Assistant Finance Minister Caygill, as the consensual approach of the Summit did not fit with Douglas's belief in the pursuit of unilateral policies imposed without consultation (Goldfinch 2000). Critics later argued that the Summit was an elaborate attempt at window-dressing (Castles et al. 1996; Douglas et al. 1987, p.82; Easton 1989).

Douglas revealed his own neo-liberal plans for reform in the November 1984 Budget. The reforms outlined a liberalisation of the economy designed to promote greater government efficiency with greater accountability. The cornerstone was the introduction of a comprehensive Goods and Services Tax ("GST") of 10 per cent. The budget was swiftly followed by reforms designed to lay the groundwork for floating the currency.

¹⁰ Prime Minister Muldoon's lack of cooperation with the devaluation has led to the view that New

Douglas abolished restrictions on overseas borrowing, deregulated the financial markets and removed controls on foreign exchange trading. Then in December 1984 he abolished all foreign exchange controls, which effectively made the float of the New Zealand dollar in March 1985 a foregone conclusion. The main economic reforms making up Rogernomics are summarised in table 3 below.¹¹

Table 39: Chronology of Economic Reforms, 1984 - 1989

Year	Action
1984	Exchange rate devalued 20 per cent Removal of controls on interest rates, overseas borrowing and investment End of export credit guarantees and other incentives Abolition of credit growth guidelines End of Wage and price freeze Deregulation of foreign exchange trading and removal of foreign exchange controls
1985	Currency floated Removal of lending restrictions, reserve ratio requirements, sector lending priorities Liberalisation of portfolio investment, foreign direct investment & profit repatriation Deregulation of financial services Removal of ownership restrictions on financial institutions Corporate tax reform
1986	Liberalisation of stock exchange Introduction of Goods and Services Tax Reform of core government departments under <i>State Sector Act</i> Introduction of user fees for government services <i>Reserve Bank Amendment Act</i> allows unlimited increase in number of banks
1987	Sale of state-owned enterprises to repay public debt begins Abolition of 50 quasi-governmental and non-governmental agencies Removal of tax concessions on savings
1988	Personal income tax reform Redesign of public sector accounts under <i>Public Finance Act</i>
1989	RBNZ independence with mandate of price stability under <i>RBNZ Act 1989</i> Adoption of inflation target of 0 to 2 per cent Public sector reform under <i>Public Finance Act</i>

Source: Scott (1996), Margaritis (1992), Evans et al (1996)

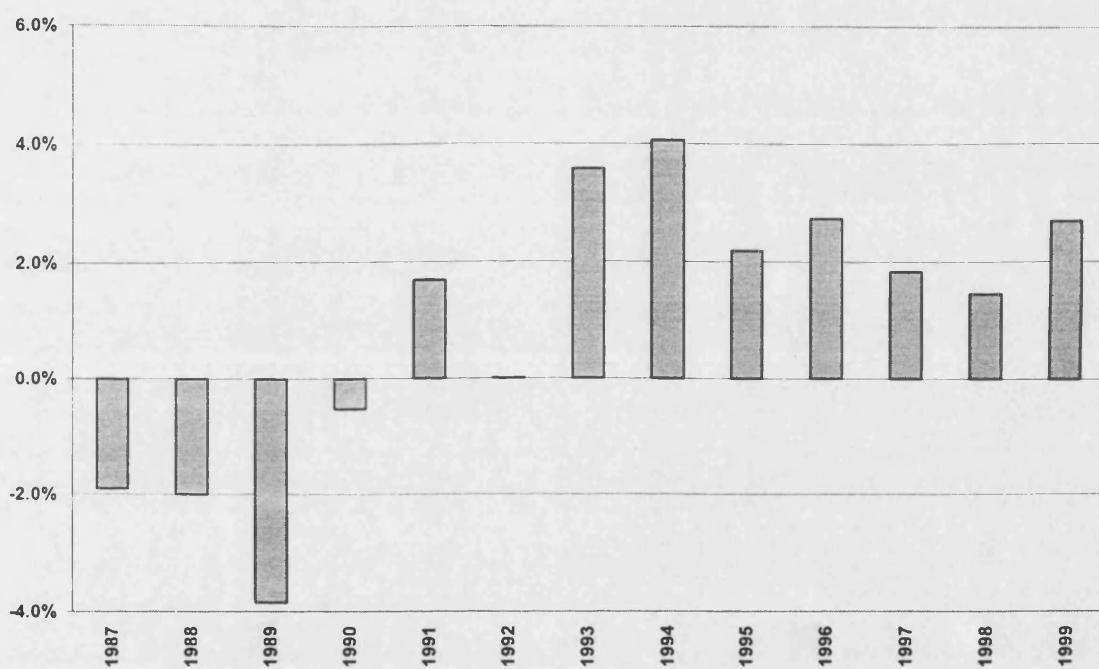
The financial reforms introduced over 1984-1985 paved the way for central bank reform by altering the domestic financial structure. Interest rate and lending controls were abolished, freeing up the monetary instruments. The government committed to fully

Zealand experienced a constitutional crisis during this period (Evans et al 1996).

¹¹ Comprehensive summaries of the reforms are available in Brash (1996), Evans et al (1996) and Scott (1996).

funding its budget through debt issues at market rates, ending the monetization of deficits and increasing the supply of government debt. Restrictions on domestic capital markets were removed allowing these markets to develop. These changes enhanced the RBNZ's ability to engage in open market operations and made an autonomous monetary policy possible.

Figure 6: New Zealand Budget Position



Financial reforms also had negative side-effects. Deregulation led to a speculative boom in the real estate and equity markets over 1985-1986, funded by international investment flows and bank credit. The exchange rate appreciated sharply. Inflation rose and unemployment doubled, even as a bubble developed in the asset markets. From late 1986, the RBNZ began to tighten monetary policy significantly with the express support of Finance Minister Douglas. This tightening brought down inflation, albeit with further increases in unemployment, and massive falls in real and financial asset values. The global stock market collapse of October 1987 hit the New Zealand economy hard, and led to a significant number of corporate failures (Margaritis 1992, p.12). This stock

market collapse came only weeks after the NZLP had been re-elected to a second 3-year term in August 1987.¹²

As with the 1984 currency crisis, Douglas used the stock market crash to push forward with the second phase of economic reforms. While these reforms were influenced by the Treasury's post-election briefings, *Government Management 1987*, the Labour government did not deregulate the labour market despite the urging of the Treasury. The NZLP's unwillingness to touch this area is explained by New Zealand's 3-year electoral cycle and the need for the NZLP to carry these voters with them in order to be re-elected to a second term (Evans et al 1996; Nagel 1998). "Labour's commitment to compulsory unionism and effort to cushion the blows that liberalisation inflicted on workers and the poor were major reasons for 'botched' sequencing" (Nagel 1994, p.260).

The growing intrusion of the Treasury in social policy, and the realisation by Prime Minister Lange of the social costs of Rogernomics, led to a confrontation between the Prime Minister and Finance Minister. In December 1987, Douglas's proposed 23 per cent flat rate of income tax, which Lange publicly declared dead the following month (Castles et al. 1996, p.16). Despite Lange's objection, tax reform went forward with the system being flattened from three to two steps. The ensuing conflict led Lange to dismiss both Douglas and his supporter Prebble from Cabinet at year-end 1988. Lange was forced to resign in August 1989, after the Labour caucus re-elected Douglas to Cabinet (Easton 1989, p.183). The NZLP went into the 1990 election a divided party that was adrift between its former left-wing support and its new-found centre-left support. Not surprisingly, it was routed by the opposition National Party led by Prime

¹² The Lange government played a two-level game to win electoral support for its unpopular economic reforms, using its anti-nuclear policies combined with wage increases in health and education sector to keep its traditional supporters loyal (Schwartz 1994, p.547).

Minister Bolger. Incoming Finance Minister Richardson not only continued the reforms undertaken by Douglas, but introduced fiscal policy and labour market reforms designed to give monetary policy 'some friends' in the fight against inflation.

Intellectual Influences on Rogernomics

Rogernomics is widely seen as incorporating the ideas of monetarism, neo-classical theory, institutional economics and public choice theory (Bolland 1988; Boston and Uhr 1996; Caesar 2000; Goldfinch 2000; Lattimore, Silverstone, and Bolland 1996; Lloyd 1992; Scott 1996).¹³ Many of these views originated in the US, although the contributors to Bolland (1988) point to influences from the UK, Australia and Canada.¹⁴ The Treasury under Graham Scott is seen as a particularly important source of influence, and one that was highly ideological and pro-market in its views (Jesson 1989, p.42). Publications by Treasury economists such as Cameron, Kerr and Wilkinson channelled foreign academic theories to politicians, providing the incoming government with a road-map of reform - best seen in the Treasury briefing papers prepared for the incoming governments in 1984 and 1987 (Easton 1988; Jesson 1989; Schwartz 1994, p.546). The Treasury's influence on economic debate was further increased by a requirement in the *Cabinet Office Manual* that all departmental submissions to the Cabinet of an economic nature must have the Treasury's signed endorsement or be accompanied by a Treasury report (Easton 1989, p.72). This requirement provided the Treasury with an effective veto on economic advice from other areas of government.

¹³ Jesson (1989) provides a left-wing account of this capture by the Chicago school and the 'libertarian right' within the Treasury. Brash (1996) argues that the influence of Chicago School is somewhat overstated.

¹⁴ The University of Canterbury was the home of a group of influential monetarist and Chicago-school theorists, while a number of key Treasury officials either graduated from US universities or had spent time at the World Bank (Jesson 1989, p.41).

5.3 Design and Political Debate over RBNZ Act 1989

In mid-1986, Finance Minister Douglas initiated the process leading to the RBNZ Act when he invited RBNZ and Treasury officials "to explore options for reforming the institutional structure of monetary policy, with a view to reducing the scope for active political involvement in monetary policy decision making (Reddell 1999, p.65). As Governor Brash explains: "[There] was a perception that the previous National Party Government led by Sir Robert Muldoon had manipulated monetary policy in a very cynical way for the political benefit of that Government. So one of the requests made to the Reserve Bank and the Treasury by the Finance Minister of the incoming Labour Government was to find ways of 'Muldoon-proofing monetary policy', so that never again could government manipulate monetary policy for political gain."¹⁵ Douglas had in mind the type of independence that existed at the Bundesbank or the Fed, which were the policy models that New Zealand wished to emulate. By mid-1988, all the significant institutional issues had been resolved and Douglas announced his intention to introduce the legislation, which was announced in the 1988 budget.

A key concern of Douglas's economic team was to lift confidence in New Zealand's economy and its currency by convincing the public that low inflation was going to be the norm. As former Associate Finance Minister Prebble recalls: "New Zealand had suffered double digit inflation under Sir Robert Muldoon's National government. MPs like myself studied inflation. I became convinced that inflation was bad for the workers - wages were always to catch up with inflation and never did. Inflation transferred wealth, particularly to property holders. Inflation undermined investment in

¹⁵ Governor Don Brash, RBNZ Governor, correspondence dated 30 July 2001.

employment industries.¹⁶ One reason for the *RBNZ Act 1989* was to change this mind set and to reduce inflationary expectations.

Finance Minister Douglas delegated this process to then Associate Finance Minister Peter Neilson, who supervised RBNZ and Treasury officials in this process.¹⁷ Interestingly, the 'autonomy project' was run on parallel, but distinct, tracks from the development of the inflation target.¹⁸ Neilson's main role was adjudicating between the Treasury and the RBNZ, as each organisation came up with competing frameworks that were fundamentally incompatible. The RBNZ was very focused on a "independent central banking" model while the Treasury focussed on an "accountable public sector agency" model.¹⁹ The different academic influences and policy experiences of the two organisations explain these contrasting approaches taken, as seen below. The framework finally agreed represented a compromise between the two positions, combining the Treasury's principal-agent model with the RBNZ's independence with an inflation target.

Design of Central Bank Reform

The actual drafting of the RBNZ bill was completed by the RBNZ itself, under a team led by Assistant Governor Peter Nicholl along with two RBNZ officials, Steven Dawe and Arthur Grimes. This team prepared all the policy documents, drafted the legislation, and wrote the accompanying Cabinet papers and ministerial speeches. In the words of Dawe, they were responsible for "putting the economic theory/jargon into legal jargon". This work took place at the same time as wider public sector reforms, which led to the

¹⁶ The Hon. Richard Prebble, former Associate Minister of Finance, correspondence dated 2 August 2001.

¹⁷ Neilson had been a professional economist in the Department of Labour before going into Parliament in 1981.

¹⁸ Reddell (1999) provides a comprehensive discussion of the development of the inflation target.

¹⁹ Material in this section is drawn from discussions with present and former RBNZ and Treasury officials as well as their external advisers.

State Sector Act and Public Finance Act. Grimes admits that the RBNZ officials were largely ignorant of the specifics of these other reforms but were aware of the general thrust. The RBNZ team therefore recognised the need to establish a framework with clear objectives, clear monitoring and clear accountability structures. But the RBNZ team did not set out to consciously 'mimic' the other public finance reforms. Instead the primary focus was on making the RBNZ independent, a view was shared by Douglas.

A Treasury team, led by Howard Fancy of the macroeconomic policy area, held intense debates with the RBNZ team throughout 1986 and 1987. A second key participant was Paul Atkinson, an OECD official who was seconded as manager of the Treasury's macroeconomic policy over this period. Due to the Treasury's position as chief architect of on-going state sector reforms, Treasury officials were much more cognisant of the need to fit RBNZ reform into this wider context. Treasury officials were preoccupied with the idea of trying to find an output-based measure by which they could assess RBNZ performance to ensure accountability. The Treasury considered it inappropriate that the RBNZ target inflation directly, as this target was an "outcome" not an "output" for which the RBNZ could be directly accountable. The Treasury's focus on output measures led to a flirtation with monetary base control, as well as a suggestion to divide the RBNZ into two departments - an Issue department and a Banking department - so that note issue could be used as an output target.

Intellectual Influences on the Design

Even today, RBNZ officials disagree on the primary influences on the institutional design of the *RBNZ Act 1989*. One view points to the influence of the economics literature on time inconsistency while another view looks to the principal-agent literature. The impact of the former can be seen in the wish to have an independent

central bank, as protection against inflation-prone politicians, whereas principal-agent theory points to the contracting model wherein the Governor is held personally responsible for results. The time inconsistency view was introduced by Grimes, who had returned to the RBNZ in 1987 having completed a PhD in monetary theory at the London School of Economics.²⁰ Grimes was deputy head of the Economics Department, and worked on the details of the *RBNZ Act 1989* over the next three years. In early 1987, Grimes drafted a seven-page memorandum summarising the key findings from the time inconsistency literature that was debated within the RBNZ. The memo outlined the work of Kydland and Prescott (1979), Calvo (1979), Barro and Gordon (1983), Backus and Driffill (1985) and Barro (1986) and provided some worked examples of time inconsistent policies. The memo featured a long discussion of the importance developing a reputation for credibility in a repeated game. Empirical support for time inconsistency was evident in the failure of inflation expectations in New Zealand to come down. In New Zealand, year-ahead inflation expectations were 14.1 per cent and 10 per cent, respectively, in March 1987 and March 1988, while actual inflation in these periods turned out to be 7.4 per cent and 4.1 per cent, respectively (Grimes 1996, p.256).

Missing from Grimes's memo is any discussion of central bank independence as an alternative to reputation. While the empirical work supporting central bank independence was not widely developed in the economics literature at this point, practitioners were very familiar with the concepts and studied the existing institutional models. Governor Brash notes: "Prior to the drafting of the RBNZ legislation in 1989, there was considerable work done by Reserve Bank staff on the various options for

²⁰ At the LSE, Grimes was most influenced by Charles Goodhart, Mervyn King (now Deputy Governor of the Bank of England), and David Webb. Source: Prof. Arthur Grimes, Victoria University of Wellington, correspondence dated 31 July 2001.

independence, and these staff had contact with a number of people both inside New Zealand and abroad. As you will be aware, the model of central bank independence which was typical at that time was the Bundesbank model, also exemplified by the Swiss National Bank and the Federal Reserve, where the central bank has both instrument independence and a substantial measure of goal independence". These central banks provided a number of features that were emulated in the design of the *RBNZ Act 1989*.

Grimes recalls that the idea to have a legally independent RBNZ with a single objective of price stability came up in discussion with the RBNZ economics group, following an internal seminar on time inconsistency. The officials present had been debating how it was not credible for one institution to be responsible for two policy objectives, such as inflation and employment. Instead the suggestion was made to have a single institution with one policy instrument pursue a single objective. This solution led to the institutional design based on an inflation target, similar to the statutory single targets at the independent Bundesbank and Swiss National Bank. What was novel about this solution was to link accountability formally to a specific numerical inflation target. When presented with this idea, Treasury officials objected to the inflation target as it was not strictly an output. Discussions between the two organisations delayed the drafting of the RBNZ bill by a year while the two groups fought out their differences.

Visiting academics and central bankers also influenced the RBNZ's thinking. However, external economic advisers did not play a role in determining the fundamental institutional design. The RBNZ brought in one economic adviser to act as a 'sounding board', Professor Charles Goodhart of the LSE. Goodhart was invited to New Zealand in 1987 and asked to comment on the RBNZ's blueprint of the policy framework, although

he was not involved in the specific drafting.²¹ Goodhart was asked to critique the RBNZ's proposals internally before they were debated externally with the Treasury.²² The RBNZ arranged for Professor Goodhart to return in 1989 while the bill was before parliament to act as an "expert witness" in the Committee hearings on the legislation. At the Treasury, Atkinson arranged to bring in an external adviser, Professor Geoffrey Wood of City University Business School, who provided advice on monetarist issues.

Domestically, the RBNZ team ran their proposals past Roderick Deane, a former RBNZ Deputy Governor who left this position to become Head of the Public Service in 1986 (among other positions), and Professor Frank Holmes of Victoria University, who had worked as the Head of the New Zealand Planning Council. Otherwise domestic academics had no constructive influence on the RBNZ design. In fact, the RBNZ bill was opposed by "nearly all New Zealand university academics, economists and political scientists alike" (Caesar 2000). Keynesian-oriented economists and political scientists such as Dalziel, Easton, Kelsey and Whitwell were vocal critics of the RBNZ's monetary policies over this period, and were opposed to the bill when it was debated before parliament (Dalziel 1989; Easton 1989; Kelsey 1996; Whitwell 1990). Professor Dalziel comments: "It was academic economists (including myself) who were loudest in pointing out the dangers of independence... In official submissions to the hearings on the Reserve Bank Bill, the Reserve Bank was very critical of academic economists for this reason".²³

²¹ Charles Goodhart had a longstanding relationship with the Bank, having been the guest public lecturer at the RBNZ's 50th anniversary celebrations in 1984.

²² One idea that Goodhart originated, that was subsequently rejected as politically infeasible, was the proposal of tying the Governor's salary to the inflation performance. Walsh (1995) later picked up this idea.

²³ Professor Paul Dalziel, University of Canterbury, correspondence dated 17 August 2001.

Political Influences on the *RBNZ Act 1989*

Far from leaving all the detail to civil servants, politicians played a key role in three aspects of the institutional design. Finance Minister Douglas provided the initial impetus for RBNZ independence. While Douglas may not have read the time inconsistency or principal-agent literature, these ideas were at the heart of his own thinking. For his part, Associate Finance Minister Neilson played a very active role in shaping the final institutional design. Neilson was responsible for deciding that the Policy Targets Agreement would be expressed in terms of an inflation objective, as opposed to the Treasury's recommendation to use an 'output' measure and the RBNZ's preference for no structure at all. And Neilson - together with Douglas - decided on the single decision maker structure to ensure greater accountability, siding with the Treasury perspective that it was possible to 'sack' one person, but hard to sack a whole Board. Finally the Treasury played a major role in determining the accountability framework that was adopted. The Treasury was able to impose restrictive funding provisions, whereby the Governor must negotiate the central bank's operating budget, albeit on a five-yearly basis, with the Minister of Finance.

Political Debate over the Bill

The NZLP's intention to give the RBNZ independence was first announced by Finance Minister Douglas in the 1988 Budget Statement, with the legislation to enact this reform being introduced into Parliament in May 1989 and becoming effective in February 1990. By December 1988 Douglas had left the Cabinet, leaving newly-appointed Finance Minister Caygill to steer the legislation through the House. The Act was controversial, particularly the adoption of an inflation target of 0 to 2 per cent when unemployment was approaching double digits. In his introduction of the RBNZ bill (later the *RBNZ Act 1989*), Finance Minister Caygill set out the objectives for these reforms:

The Bill is significant. It implements a reform that was announced in the 1988 Budget. It will place the Reserve Bank on a more independent basis to improve the credibility, consistency, and effectiveness of monetary policy. The Bill is an important ingredient in the Government's battle to get inflation down and to keep it down... The Bill places the bank on a more independent, but also more accountable, legislative basis than at present, while recognising that it is the Government's right to determine economic policy. Within that constitutional framework the Bill sets the primary objective for the Reserve Bank's implementation of monetary policy as the achievement and maintenance of price stability. It also provides for the Government by Order in Council to substitute alternative economic objectives.²⁴

After the first reading, the bill was sent to the House of Representatives Finance and Expenditure Committee ("the Committee") for review. The Committee considered 25 submissions and 9 supplementary submissions, and heard 12 hours of evidence from 19 witnesses.²⁵ Officials from the Reserve Bank provided the Committee with 23 reports on the Bill which the Committee spent a week considering.

Submissions to the Committee revealed disagreement on two main issues: the narrowing the RBNZ's statutory objective to the pursuit of price stability, and the reduction of the RBNZ's supervisory role to cover only registered banks.²⁶ The Reserve Bank, the New Zealand Treasury, the Federated Farmers and the New Zealand Business Roundtable firmly supported the concepts in the bill. A number of groups opposed legislating a single objective of price stability: the New Zealand Council of Trade Unions ("NZCTU"), the Manufacturers' Federation, the Public Service Association, the National Council of Women and a large group of New Zealand academics. The NZCTU

²⁴ Hansards, 4 May 1989, "RBNZ Bill – Introduction", Speaker: Hon. David Caygill.

²⁵ Hansards, 12 December 1989, "Report of Committee", Speaker: Mr. J.R. Sutton.

²⁶ Hansards, 12 December 1989, "Report of Committee", Speaker: Mr. J.R. Sutton.

called the focus on price stability “a misguided and dangerous initiative” (Kelsey 1996, p.163). Professor Dalziel highlighted the risk of hysteresis of unemployment resulting from an anti-inflation policy, and argued for recognition of the need to coordinate monetary and income policies in the bill (Kelsey 1996, p.162). Opponents to the bill argued to keep the status quo with the RBNZ pursuing multiple objectives including employment and output growth. A number of witnesses also questioned the wisdom of limiting prudential supervision to registered banks.

In December 1989 the Committee returned the bill to Parliament substantially unchanged. Opposition Finance spokesperson Ruth Richardson (later Finance Minister) convinced the National Party to support the Labour Government's legislation, despite the continued opposition of Sir Robert Muldoon who called it a 'foolish piece of legislation' (McLeay 1991, p.87). In December 1989, the *RBNZ Act 1989* was passed by Parliament with the support of government and opposition, without a single vote being registered against it (Brash 1996b).²⁷

The degree of political consensus surrounding the RBNZ Act was evident during the October 1990 election as none of the political parties made any mention of the *RBNZ Act 1989*. The National Party won with a large majority, capturing 69% of the seats in Parliament – the biggest electoral majority since 1935. As promised, bi-partisan support for the *RBNZ Act 1989* continued, although the Policy Target Agreement was renegotiated with Governor Brash to extend the time horizon for achieving price stability to December 1993. Finance Minister Richardson continued the reforms, pushing through the *Fiscal Responsibility Act 1994* that laid out the principles of sound government finances. She also introduced long-awaited labour market reform. Both

reforms were designed to support monetary policy by giving it 'some friends' in the fight against inflation.

Economic Performance Following *RBNZ Act 1989*

The reforms introduced by the *RBNZ Act 1989* had greater economic success, but at the cost of a disinflation and painful adjustment in early 1990s. Inflation fell faster than anyone expected, reaching 2.1 per cent by September 1991 then remained between 0 and 2 percent until June 1995. Inflationary expectations were also sharply reduced as seen in long-term bond yields in New Zealand, which were consistently lower than comparable rates in Australia and the UK. After peaking at 10.9 per cent in September 1991, unemployment fell to 6.2 percent in 1996. From 1993 the economy began to recover strongly with GDP rising by 5.6 percent in 1993 and 6.2 percent in 1994 – the fastest growth rates in the OECD during this two-year period (Brash 1996b). The fiscal deficit, which reached nearly 7 percent of GDP in budget year 1983/84, was gradually reduced so that by the 1989/90 budget it was down to just 1.3 percent of GDP. Net government debt fell from a peak of 52 percent of GDP in 1992 to around 33 percent in 1996.

5.4 Explaining Timing and Design

This section looks at the New Zealand reforms from the point of view of the four hypotheses outlined in chapter 3. These hypotheses are explained in the following order: lobbying by domestic interest groups, pressure from international financial markets, the ideas promoted by an epistemic community and politicians 'tying their hands' for electoral gains.

²⁷ Two National Party MPs did not attend the vote, Sir Robert Muldoon and one other National Party opponent who was sick in hospital.

Interest Group Lobbying

The facts of this case speak for themselves. Central bank independence did not result from lobbying by domestic interest groups, either in favour or opposed to central bank independence. While domestic interest groups had proved successful in lobbying the Muldoon government, they lost all influence with the appointment of Finance Minister Douglas. Of the many accounts documenting interest group reactions to Labour's economic reforms, only a few look at the RBNZ reform in any depth.²⁸ Based on a review of these works, it is possible to paint a broad picture of the lobbying activity under the Labour government, in order to demonstrate the limited effectiveness of interest group activity during debates on the *RBNZ Act 1989*.

Douglas was ideologically opposed to what he saw as the rent-seeking activity of interest groups, and viewed them as part of the problem (Douglas and Cullen 1987). Associate Finance Minister Prebble puts it bluntly: "Interest groups, so influential under Sir Robert Muldoon, had little sway over the Lange government. I rarely met with them... Their advice was self-serving. It was a waste of time".²⁹

Douglas adopted a 'crash through' strategy to economic reform designed to shut interest groups out of the process. Reform would advance in quantum leaps, not allowing interest groups time to mobilise to slow the process down (Douglas 1993). Instead economic policy reform was determined by a small policy community in the Cabinet, the Treasury, and the Reserve Bank (Bolland 1993; Douglas et al. 1987; Easton 1989; Goldfinch 2000; Goldfinch et al. 1993; Jesson 1989; Whitwell 1990).³⁰ While interest

²⁸ For general accounts of the economic reforms, see Bolland 1993, Bremer 1993, Castles, Gerritsen, and Vowles 1996, Deeks 1992, Easton 1987, Gold 1989, Goldfinch 1998, Jesson 1989, Kelsey 1996, Mulgan 1993, Nagel 1998, Roper 1992, Roper 1993, Whitwell 1990. For discussion of the RBNZ reform, see Dalziel 1993, Evans et al. 1996, Goldfinch 2000, Lawn 1994.

²⁹ The Hon. Richard Prebble, former Associate Minister of Finance, correspondence dated 2 August 2001.

³⁰ Douglas's key supporters in Cabinet were his Associated Finance Ministers, David Caygill and Richard Prebble.

groups in general were ineffective for influencing the economic reforms, the New Zealand Business Roundtable ("NZBR") is seen as providing valuable support to the reforms, under Director Roger Kerr - one of the authors of *Economic Management 1984* - who left the Treasury in 1986 to take up this post.

Apart from Douglas's disposition against their efforts, interest group lobbying was hampered by collective action problems. The associations representing business, the financial sector and trade unions suffered from fragmentation, overlapping memberships and a lack of consensus on policy direction. Business was represented by the Federated Farmers, the Manufacturers Federation and New Zealand Bankers' Association which overlapped with the Employers' Federation, on one hand, and industry-wide associations like the NZBR and the Chambers of Commerce on the other.³¹ The trade unions were equally fragmented, represented by the Federation of Labour, the Combined State Unions and the Public Service Association among others (Bray et al. 1996, p.71). The situation improved in 1987 following the merger of the Federation of Labour with the Combined State Unions to form the NZCTU, but this new association could not control its affiliated unions.³² None of these groups was represented by a peak association capable of speaking with one voice, mitigating its influence in the policy process.

In addition, the trade unions had no special access to the Labour government. Unions had weak institutional links with the NZLP. Union affiliates controlled less than half the votes at the NZLP annual conference, leaving policy formulation in the hands of the

³¹ Around one-third of the NZBR's members were from the financial sector.

³² A number of blue-collar unions refused to join, leading to the formation of a competing peak organisation, the Trade Union Federation (Bray et al. 1996, p.79).

Cabinet.³³ The trade unions also had few personal links with the NZLP leadership, making them an ineffective voice for organised labour (Bray et al. 1996, p.68; Easton et al. 1996, p.35). As a result unions were excluded from the process of policy formation during the 1980s when Labour was in power (Castles et al. 1996, p.11).

Business groups were divided over central bank independence. Export-oriented groups led by the Manufacturers' Federation were opposed to RBNZ independence and a narrow mandate of price stability.³⁴ Their submission to the Committee on the bill was so critical, that the RBNZ took the unusual step of rebutting these views in a separate submission to the Committee (Lawn 1994, p.49). By contrast, the Federated Farmers, the New Zealand Business Roundtable and the financial sector associations endorsed the proposed changes (NZBR 1989). The trade unions were predictably vocal critics of central bank reform. The NZCTU argued in its submission that the shift to a narrow mandate of price stability was misguided and dangerous as greater independence would favour a recessionary policy (Kelsey 1996, p.163). The NZCTU, together with the Public Service Association and the Service Workers Federation, painted an independent RBNZ as 'anti-democratic'. Based on the final outcome, it is clear that the voice of organised labour was not influential in this debate.

³³ In fact, the NZLP had unsuccessfully tried to disaffiliate unions following the 1981 electoral defeat (Bray et al. 1996, p.73).

³⁴ These exporting branches later accused the RBNZ of causing an overvaluation of the New Zealand dollar in 1995, which contributed to the current account deficit (Caesar 2000)

Table 40: Interest Group Submissions to the Committee on RBNZ Independence

In Favour	Opposed
Reserve Bank of New Zealand	Manufacturers Federation
New Zealand Treasury	New Zealand Council of Trade Unions
Federated Farmers	Public Service Association
New Zealand Business Roundtable	Service Workers Federation
New Zealand Bankers Association	National Council of Women
Financial Services Association	
Mortgage Lenders Association	

Source: Brash (1996), Kelsey (1996), Lawn (1994)

International Financial Markets

RBNZ independence may be seen as a reform designed to signal the creditworthiness of New Zealand to international financial markets. The related argument can be made that New Zealand's left-wing politicians were pressured to introduce these reforms by international creditors who were suspicious of the NZLP's partisan biases. International financial markets have the ability to sanction policy through two main avenues: pressure on the exchange rate and the interest premium charged on foreign debt. An examination of these two channels suggests that the 1984 currency crisis was influential in stimulating Finance Minister Douglas's reform program, but it did not dictate the content of reform or determine the timing of individual reforms. Likewise the cost and size of New Zealand foreign debt may have been a significant constraint on the government's room to manoeuvre, but it did not lead the government to introduce central bank independence. This reform was designed to send a signal concerning the NZLP's anti-inflationary credibility, but this signal was directed at a domestic audience composed largely of actors in the real economy, not the financial one. These arguments will be developed below.

The 1984 currency crisis is portrayed as a primary source of international pressure that forced the Labour government to adopt neo-liberal reforms. This position is overstated. First, it fails to recognise that the source of speculation on the exchange rate is believed

to have been domestic, not international. New Zealand businesses, banks and citizens appear to have been the major actors speculating against the currency prior to the election (Brash 1996a). Floating the currency in 1985 was designed to reduce this source of pressure, by eliminating the external anchor that served as a focus for speculation (Deane 1985, p.14). Second, it is inaccurate to say this policy was forced on the Labour government. Douglas favoured reform as did the Treasury and the RBNZ. He took steps to make the currency float inevitable by removing exchange controls, which then created momentum behind a broader reform process.

The importance of the 1984 currency crisis was as a catalyst for reform. It forced the public to recognise the need for reform and created an opportunity for a policy entrepreneur like Douglas to pursue it (Bollard 1994; Goldfinch 2000). Under the Muldoon government, domestic industries and interest groups had grown accustomed to being protected from competition. New Zealand's 'cradle to the grave' welfare system had led to the same expectation among the public. These arrangement became increasingly unsustainable during the 1970s and early 1980s, as witnessed by rising public debts and budget deficits. Douglas and other reformers within the Treasury and the RBNZ recognised the need for reform, but this view was not shared within the NZLP as seen by their reaction to his Economic Policy Package (Douglas and Cullen 1987; Goldfinch 2000, p.88). The currency crisis following the election, accompanied by the so-called 'constitutional crisis' during the 10-day interregnum, changed the public mood. It vividly demonstrated to the public and reluctant politicians that New Zealand's interventionism and 'cost-plus' economy were no longer viable. Douglas and his Treasury advisers seized this window of opportunity to push forward with rapid and widespread deregulation, first announced in the November 1984 budget four months

after the election. This reform then created its own momentum as discussed in the section on interest groups.

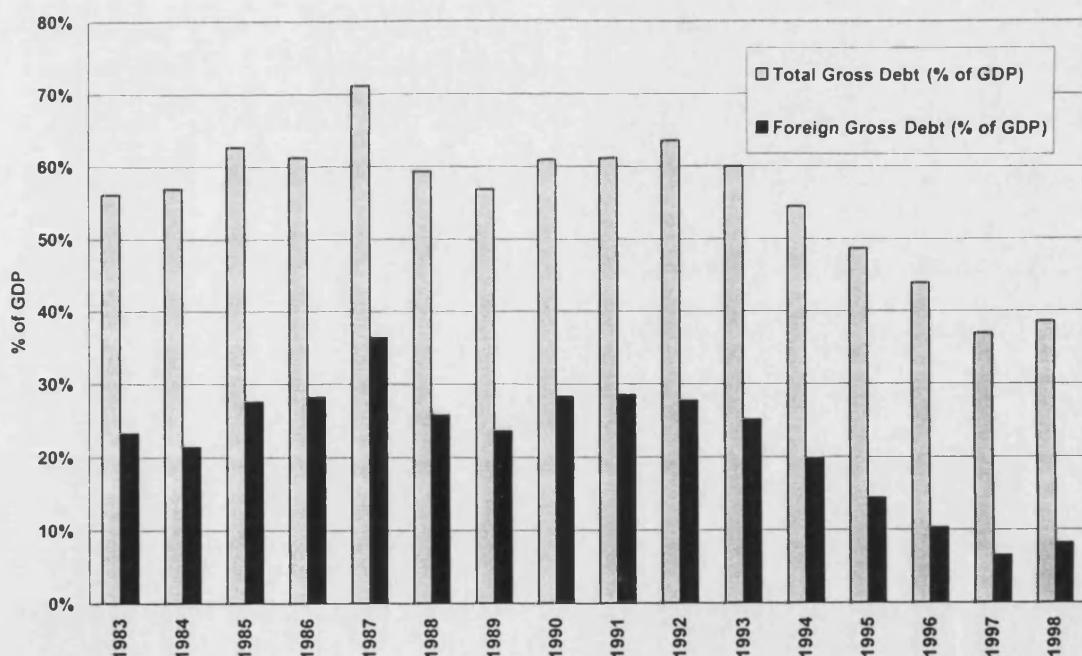
While the currency crisis was the catalyst for reform, it did not explain the content of policy reform or the timing of RBNZ independence (Bollard 1994; Goldfinch 2000). Douglas had outlined his proposals in 1980 in his pamphlet *There's Got To Be A Better Way*. Likewise the Treasury had put together 352-pages of post-election briefings providing a comprehensive economic reform program. These proposals were combined and determined the substance of Rogernomics. The content of reform was therefore put together in the years leading up to the 1984 election, not in the weeks following the currency crisis. The crisis only gave Douglas the opportunity to pursue his reform proposals. By the time the RBNZ bill was introduced in 1988, currency pressure was not a concern as the New Zealand dollar was floating and had appreciated steadily from 1985 to 1988.

The second potential channel for international financial market pressure was through New Zealand's external debt, which was high and rising during the early 1980s, as seen in table 6. This situation led the rating agencies to downgrade New Zealand's foreign currency rating repeatedly between 1983 and 1986. In 1984, New Zealand total government debt was NZ\$ 22 billion or 57% of GDP, of which almost 40% was borrowed overseas. By 1987 total debt had risen to over 70% of GDP, due to the government assuming the debts from Muldoon's 'Think Big' energy project, of which 50% was borrowed overseas. Following the 1984 devaluation, the spread on New Zealand government debt relative to the US increased dramatically from 0.50 per cent to almost 9.0 per cent by 1986. From this peak it halved to 4.25 percent in 1988. This incremental cost represented a significant penalty on such a significant debt load.

Table 41: New Zealand Exposure to International Financial Markets

Year	Exchange rate per USD	Total Debt, Gross (NZ\$ bln)	Foreign Debt, Gross (NZ\$ bln)	Total Debt % of GDP	Foreign Debt % of GDP	Current Account Balance % of GDP
1975	0.8323	4.2	0.9	36%	8%	n.a.
1980	1.0267	10.3	3.6	45%	16%	n.a.
1984	1.7640	21.9	8.2	57%	21%	n.a.
1985	2.0234	45.0	12.4	63%	28%	n.a.
1986	1.9132	52.2	14.7	61%	28%	n.a.
1987	1.6946	59.7	21.7	71%	36%	-5.0%
1988	1.5264	65.9	17.0	59%	26%	-1.0%
1989	1.6722	69.9	16.5	57%	24%	-3.9%
1990	1.6762	72.8	20.6	61%	28%	-3.3%

Source: IMF, New Zealand Debt Management Office, and OECD.

Figure 7: New Zealand Public Sector Debt

The size of the external debt and its associated cost was a significant source of weakness for the New Zealand government, and one that could not be ignored. Former RBNZ Deputy Governor Deane recalls:

New Zealand politicians certainly needed to be responsive to international financial markets at the time of the 1984 currency crisis and the election, if for no other reason that our overseas borrowing was so huge, our external deficit

probably the highest in the OECD region relative to GDP, and of course it coincided with a huge fiscal deficit. In the weeks leading up to the July 1984 Election, we were faced not just with a huge borrowing programme but with a number of international banks who were either unwilling to lend to us or proposed to do so on terms which were patently unacceptable and non-commercial, thus giving us a powerful signal about the need to abandon Muldoon's 'borrow and hope' policy.

The cost of foreign borrowing and the downgrades by the rating agencies signalled the need for economic reform, but they did not dictate the content of economic policy. International financial markets did, however, change the incentives facing politicians by charging an interest rate penalty on government borrowing. However, provided New Zealand politicians were willing to pay this penalty, they retained the ability to pursue distinctive macroeconomic policies (Garrett 1998; Mosley 2000, Oatley 1999). The Labour government did pay this penalty in the short run, and so introduced economic reforms based on domestic political imperatives such as deregulating the financial markets and traded sector but protecting the labour market from reform. Finance Minister Douglas also took steps to reduce the external debt by selling state owned enterprises, introducing a GST and reducing government deficits. By the end of the 1980s the budget was in surplus and total debt was brought down to around 60 per cent of GDP, where it remained until 1994.³⁵ Likewise foreign debt was stabilised and remained constant in absolute terms, but declined as a share of both GDP and total debt.

³⁵ Following the introduction of the Fiscal Responsibility Act in 1994, the debt declined steadily reaching 38% of GDP in 1998.

The *RBNZ Act 1989* was not designed to signal the government's creditworthiness to international capital markets.³⁶ Instead, central bank reform was directed at a domestic audience and was designed to signal the government's anti-inflationary commitment to primarily non-financial actors. Deane states:

I did not see [international financial markets] as a major pressure point with respect to the decision to give the Reserve Bank independence in 1989, which arose much more from the... need to not only reduce inflation but to ensure that it remained at a sustainably low level in the belief that this would create more satisfactory conditions to enhance our international competitiveness on the one hand and our rate of economic growth on the other hand.

Governor Brash agrees, arguing that neither the *RBNZ Act 1989* nor the *Fiscal Responsibility Act 1994* were enacted with foreign investors primarily in mind. However, both pieces of legislation were hugely important for maintaining the confidence of overseas investors in New Zealand (Brash 1996a).

Ideas of an Epistemic Community

This case study of the RBNZ supports the hypothesis that politicians give independence to their central banks in response to academic ideas promoted by an epistemic community of monetary experts. During the late 1980s, a new paradigm came to dominate monetary policy that prescribed delegating to an independent central bank with a single mandate of price stability. This paradigm was promoted in New Zealand by an epistemic community located in the RBNZ and the Treasury, and championed through parliament by Douglas and his supporters. Each of these points will be addressed in turn.

³⁶ Former Associate Finance Minister Prebble points out that if international financial markets had been hostile to an independent Reserve Bank, it might not have happened.

First, the detail of the *RBNZ Act 1989* reflected the state of the economic paradigm circa 1988, particularly the work on time inconsistency and principal-agent problems. The choice of price stability as the sole goal of monetary policy reflected the monetarist view that monetary policy could not affect real variables in the long run. It also reflected the neo-classical view that delegation to an independent central bank would bolster the government's anti-inflationary credibility. The literature on principal-agent problems led to the contracting arrangement agreed between the Governor and the government, whereby the Governor is held personally responsible for outcomes. During the debate over the RBNZ bill, Associate Finance Minister Neilson made reference to this new ideological paradigm. "It appears from the discussion this afternoon that there is considerable consensus within this body about the way in which monetary policy, at least in an institutional framework, should be carried out. I believe that that in part reflects the generation that makes up the composition of the House".³⁷

Second, this paradigm was promoted in New Zealand by an epistemic community of monetary experts located in the RBNZ and the Treasury.³⁸ Experts at the RBNZ came up with the main features of the institutional design and later drafted the legislation. This design was then debated with the Treasury and a compromise was reached. This domestic epistemic community actively sought the advice from international experts, bringing in external advisers from the UK and the OECD, and speaking to officials at the BIS and other central banks. What is striking about this case is the lack of involvement of New Zealand academics, apart from Professor Holmes of Victoria University. In fact, most New Zealand academics opposed the reform. The epistemic community that supported RBNZ independence was therefore transnational in

³⁷ Hansards, 12 December 1989, "Report of Committee", Speaker: Hon. Peter Neilson.

³⁸ The key officials involved were Dawe, Grimes, Nicholl and Brash at the RBNZ; Scott, Fancy and Atkinson at the Treasury; and former RBNZ Deputy Governor Deane.

composition, but not all embracing. It was elitist, with its members sharing both an understanding of the problem and a prescription for fixing it. The influence of this epistemic community increased following the 1984 currency crisis and the deregulation of the financial sector, both of which created a high level of uncertainty in the conduct of monetary policy over this period.

Third, this policy reform suited the worldview of Finance Minister Douglas and his desire to 'Muldoon-proof' monetary policy (Brash 1996b). Political interference in interest rates was seen as one of the principal causes of New Zealand's economic underperformance over the previous two decades. Douglas had made clear his desire to fix this damage to the New Zealand economy and to see that it could not be repeated (Douglas 1980, Douglas and Cullen 1987). During the debate over the RBNZ bill, Douglas outlined his view of this reform:

Under the National Government the Reserve Bank was given instructions by the Minister of Finance [Sir Robert Muldoon] day by day, and that more than anything else was the reason that between 1975 and 1984 New Zealand had an inflation rate of up to four times that of its trading partners. In the name of so-called fine-tuning the National Government continually interfered with the operations of the bank between 1975 and 1984, and that interference destroyed any chance of achieving price stability. It became well known that monetary policy would fluctuate with the electoral cycle; that every 3 years there would be a phoney boom that would give the appearance of prosperity, to persuade some people to vote for the National Party, irrespective of the costs that were laid on

the community in the medium term. That is why New Zealand's position deteriorated so disastrously during that time.³⁹

Political business cycles had entrenched inflationary expectations, causing inflation to ratchet higher each time as any tightening following an election was never enough to return the economy to its previous state, leading to cumulative inflation between 1974 and 1988 of 480 per cent (Brash 1998, p.221). Accordingly, Douglas asked the RBNZ and the Treasury to look into a framework for this purpose. The *RBNZ Act 1989* was the result. Douglas and later Caygill championed the reform through the legislative process.

Tying the hands

The reasons given by Douglas for pursuing central bank independence are compatible with the 'tying the hands' hypothesis. Echoing the comments by Douglas, Deputy Prime Minister Palmer stated:

The vital origins of the Bill have to do with the behaviour of the Minister of Finance in the National Government. That is the explanation for the Bill, and it is a matter of public record. We have only to look at the dispute in early 1984. There was a public row between the Minister of Finance at the time and the Reserve Bank over monetary policy advice that the bank had been giving to that Minister in the previous 9 months... The advice of the Reserve Bank was ignored, and the results for the New Zealand economy were disastrous... That is the essence of the reforms in the Bill.⁴⁰

The view that independence for the RBNZ would act as a constraint on a future National Party government suffers from a major weakness. There was nothing to stop a future National government from reversing the central bank's independence. The

³⁹ Hansards, 4 May 1989, "Reserve Bank of New Zealand Bill – Introduction", Speaker: Hon. Roger Douglas.

⁴⁰ Hansards, 4 May 1989, "Reserve Bank of New Zealand Bill – Introduction", Speaker: Rt. Hon. Geoffrey Palmer.

unitary political system in New Zealand concentrates power in the hands of the executive with no effective checks and balances. In fact the National Party had made some political suggestions during the debate over the RBNZ Act to amend the RBNZ's statute.⁴¹ While these comments were more for public consumption than meant in earnest, the risk of backtracking in the future remained.

Another possibility may be that Douglas saw a need to 'tie the hands' of his own party in order to prevent Labour opponents of Rogernomics from subsequently undoing his reforms. Economic reform had won the NZLP few converts, evidenced by rising unemployment and stalled real GDP growth during its two terms. While voters gave the incumbents the benefit of the doubt during the 1987 election, Labour trailed consistently in the polls following the stock market crash in October 1987 (McLeay 1991, p.20; Vowles and Aimer 1993). Under these circumstances, "An increasing number of ministers, caucus and party members, motivated by a mixture of genuine concern and electoral expediency, sought to slow, stop or even reverse the restructuring process. The monetarist goal to eliminate inflation, which accepted the side-effects of high interest and high unemployment rates as inevitable, was at particular risk from political intervention" (Kelsey 1996, p.159).

Cracks in the solidarity of the Labour caucus that had been hidden during its first term began to show during this period.⁴² Prime Minister Lange had been willing to support Douglas and his team during the first term, but he grew increasingly concerned with the impact of Douglas's policies on Labour's traditional supporters. These splits were exposed in 1988 when Lange forced Douglas and Prebble to resign from Cabinet

⁴¹ Hansards, 12 December 1989, "Second Reading of RBNZ bill", Speaker: Hon. J. Falloon.

⁴² Strict party discipline had been required in order to keep Cabinet united behind a set of policies that were not representative of the party (Boston et al. 1996, p.52; Castles et al. 1996; Jesson 1989).

before stepping down himself in 1989. The return of Douglas to Cabinet led Jim Anderton to desert Labour in 1989 to form the New Labour Party, that competed for the allegiance of left-wing voters in the 1990 election. Douglas and his supporters may have recognised the credible threat presented by the left-wing within the NZLP to undo his reforms. It made political sense for Douglas to embed a commitment to fighting inflation by delegating monetary policy to the RBNZ.

There is a major problem with these explanations for RBNZ independence. First, the 'tying the hands' hypothesis as it exists in the literature is based on the assumption that politicians are motivated by the desire to be re-elected. This premise informs both political science and public choice theories of political behaviour. However, Douglas and other members of his faction resigned from the government after the *RBNZ Act 1989* was safely through Parliament, and did not contest their seats in the 1990 election (McLeay 1991, p.6).⁴³ They did not wish to be re-elected, removing the main incentive for this hypothesis. Second, the partisan version of the 'tying the hands' hypothesis predicts that left-wing governments will introduce these policy reforms upon taking office, in order to reduce the cost of financing government debt. In the case of New Zealand, the reform was introduced towards the end of their second term in office, when electoral polls indicated that they were clearly behind the opposition. Third, a left-wing party may have an incentive to introduce this reform to reduce the interest rate penalty on its borrowing. By the time the RBNZ bill was introduced, New Zealand's total and foreign debt had been reduced substantially, and interest rates were low. So the incentives for delegation at this point were absent. Finally, the non-partisan version of 'tying the hands' is premised on a desire to increase the stability of the Cabinet. Far from leading to greater Cabinet unity, independence for the RBNZ promoted greater disunity,

as it was opposed by the trade unions and the left-wing within the NZLP caucus. For these reasons, it is possible to reject these hypotheses and to accept that Douglas introduced this reform for ideological reasons.

5.5 Putting it All Together

The accepted view is that RBNZ independence was undertaken primarily for ideological reasons. Douglas and his supporters had been convinced by the academic arguments that political interference in monetary policy was damaging. Their own experiences during the 1970s and the 1980s confirmed this view. Former Associate Finance Minister Prebble puts it this way: "I was also persuaded that Sir Robert's reckless [monetary] creation was the cause of inflation. Prior to the 1984 election I was giving strong monetarist speeches. It is just wrong that inflation is bad for growth or that sound money is not in the interests of those on low and fixed incomes. A prime cause of inflation is printing money - that's not a left versus right argument - it is an economic fact".

The government of Prime Minister Muldoon and its legacy for New Zealand's economic performance, appears to have shaped the thinking of politicians across the political spectrum. As Goodhart puts it, the left and the right had no more meaning in New Zealand after Muldoon.⁴⁴ Studies of voting behaviour over this period confirm the view that traditional support for political parties based on partisanship did not apply over this period, as the partisan differences between them became blurred (Nagel 1997; Vowles and Aimer 1993). Traditional National Party supporters among business and the wealthy classes voted against Muldoon in the 1984 election due to his interventionist policies. Traditional Labour party supporters abandoned the NZLP in the 1987 and 1990

⁴³ In 1994, Douglas formed the Association of Consumers and Taxpayers (Castles et al. 1996, p.14).

⁴⁴ Professor Charles Goodhart, LSE, interview 29 August 2001.

elections, as different groups voted based on their view of Rogernomics and its impact on social policies.

In this context, the RBNZ Act was not designed to tie the hands of the left or the right. It was designed to take politics out of monetary policy. As former Deputy Governor Deane explains: "The paradox [of a left-wing party introducing central bank independence] was not really a paradox in the context of that time, since the Labour Government was anxious to pursue a remarkably clean mix of policies based on sound economic analysis, one of those windows of opportunity which countries typically get for only a few years out of every 50 years". A private sector bank economist recalls, "Tying the hands of the National party was not the point. [The *RBNZ Act 1989*] was done for its own sake, as a piece of economic policy. It was simply believed on ideological grounds to be the best thing to do".⁴⁵

How do we explain the timing of this reform, which was introduced in 1988 after a financial crisis had passed and inflation had been brought down, at the end of the Labour government's second term? Although the RBNZ bill was not made public until this point, work had begun on the issue from mid-1986. The debates between the Treasury and the RBNZ over the institutional design delayed the legislation, as both sides agreed on a framework that was both independent but accountable. Introduction of the RBNZ Act was also delayed because politicians were busy with other reforms that had to take priority, particularly financial sector deregulation.⁴⁶ Deane explains:

The timing [of the Reserve Bank Act reform] was really determined by the practicalities of the huge amount of policy reform we were undertaking post the

⁴⁵ Stephen Toplis, Bank of New Zealand, correspondence dated 6 August 2001.

⁴⁶ The Hon. Richard Prebble, former Associate Minister of Finance, correspondence dated 2 August 2001.

1984 Election, and the issue was how could the major topics be prioritised and how could the political risks around each of them be minimised. That meant in the financial sector that deregulation ...[was] given higher priority than the reform of the Reserve Bank Act which was regarded as quite a tricky topic politically and for which considerable scene setting needed to be established by way of the other reforms.⁴⁷

Therefore the timing of the bill is not explained by the looming 1990 election, or by the time frames of politicians. It was due to sequencing of economic reforms which were needed in order to make central bank independence viable (Evans et al 1996; Grimes 1996).

In summary, central bank independence resulted from the ideas of an epistemic community being adopted by an ideological politician who championed them through the legislative process. This epistemic community was empowered by the economic uncertainty that followed financial deregulation and the float of the currency. The disastrous inflation record, the unsustainable state of New Zealand's external debts and its decade-long record of economic underperformance created a public consensus around the need for reform, but did not dictate the content. This reform is not explained by signalling creditworthiness to international financial markets or the lobbying of domestic interest groups. In fact, this reform was passed against the opposition of domestic academics and interest groups representing business and the trade unions. New Zealand's political institutions had an important effect on this outcome, as the lack

⁴⁷ Roderick Deane, former RBNZ Deputy Governor and Head of the Public Service, correspondence dated 24 August 2001.

of checks and balances offered few obstacles making radical and unpopular reform possible.

Ch. 6 Bank of Canada: The Pursuit of Price Stability

The Bank of Canada (“BoC”) was founded in 1934 as a privately-owned corporation, then nationalised in 1938, at which time the BoC’s share capital was transferred to the Finance Minister (BoC 1978). As Canada’s central bank, the BoC has day-to-day responsibility for the conduct of monetary policy, which the BoC has interpreted to mean the pursuit of price stability.¹ The preamble states that the purpose of the BoC is to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade prices and employment, so far as may be possible with the scope of monetary action, and generally to promote the economic and financial welfare of Canada.

The formal mandate of the BoC appears today an anachronism, providing as it does for a confusing and potentially incompatible array of objectives. This mandate reflected the state of economic knowledge in the 1930s, but makes the operation of monetary policy in the modern context less accountable due to the lack of clear objectives. Operationally, the key policy instrument is a short-term interest rate – the Bank Rate – which is set to target a range for inflation jointly agreed by the BoC and the federal government.²

Despite being outdated, the legislation concerning the governance of the BoC – the *Bank of Canada Act* – has been changed only once, as a result of the Coyne Affair of

¹ The other functions of the Bank of Canada are managing currency in circulation, acting as banker and advisor to the federal government, and acting as lender of last resort for the banking system.

² An inflation target was adopted in February 1991 then reaffirmed in 1993, 1997 and 2000.

1961.³ James Coyne, the second Governor of the BoC, clashed with Conservative Prime Minister John Diefenbaker over the BoC's restrictive monetary policy that conflicted with the expansionist fiscal policy of the government. Diefenbaker found himself in a difficult position, being criticised by Coyne in a series of public speeches but not having the power to fire the Governor who served during 'good behaviour' and could only be dismissed by Parliament, not the executive (Canada 1992, p.9). When Coyne refused the Finance Minister's request to resign, Diefenbaker trumped up accusations concerning the Governor's pension that questioned Coyne's integrity. Diefenbaker then pushed a bill through parliament declaring the Governor's seat vacant, which went to the opposition controlled Senate for final approval. The Liberals in the Senate made the most of this scandal, and negotiated a compromise with Coyne whereby the Governor would have a platform to respond formally to Diefenbaker's charges in the Senate. The Senate would then reject the government's bill in exchange for Coyne's resignation. Diefenbaker's credibility was damaged by this affair, which contributed to his defeat in the 1963 federal election.

The final chapter to the Coyne Affair was written by the incoming Liberal government who reformed the *Bank of Canada Act* in 1967 to allow a government override of monetary policy. In case of a disagreement, the Finance Minister was given the authority to issue a directive to the BoC Governor, provided the directive was in writing, in specific terms, applicable for a specified period and published forthwith. Coyne's successor as Governor, Louis Rasmovsky, made it clear that if a directive were issued by the Finance Minister, the Governor should resign as a directive would only be necessary if the Governor felt unable in good conscience to carry out the government's

³ There are a number of interesting and sometimes contrasting accounts of this affair (Canada, 1992 ; Fleming, 1985 ; Howitt 1993; Rymes 1994; Smith 1995).

favoured policy.⁴ No directive has ever been issued, but the new power made clear the government's ultimate authority over monetary policy.

The case of the BoC raises four issues for the study of central bank independence. First, given the trend in central bank independence over the 1990s, it is puzzling that the BoC's legal independence and mandate have not been changed since the 1960s. Unlike most countries, Canada has had a floating exchange rate regime with capital mobility for most of the post-war period, rendering monetary policy a powerful tool of economic management. In fact, the government debated changes to the BoC's legislation in 1991 as part of the debates over Canada's constitution only to have the proposals dropped. Why the BoC's legislation came to be included in the government's constitutional reforms is a second puzzle. Nor did the issue of BoC independence go away. It resurfaced during the 1993 election when the Opposition Liberals openly criticised Governor Crow's pursuit of price stability in the face of higher unemployment and significant disinflationary costs. Following the Liberal victory, the debate over Crow's reappointment became tied up with international financial market fears concerning the Canada's debt as well as the political instability surrounding Quebec separation. Given the high foreign ownership of Canadian debt, the government was portrayed as hostage to international financial markets that supported Governor Crow. Assessing the influence of international financial markets over the government's decision is a third issue that will be addressed in this chapter. Finally, this study of the BoC raises the question of whether legal measures of central bank independence matter, or whether there are alternatives to delegation for achieving anti-inflationary credibility.

⁴ While this recommendation is generally ascribed to Governor Rasminsky, the proposal was first made by the BoC's first Governor, Graham Towers, and reiterated by Governor Coyne in a letter to Finance Minister Fleming in June 1961 (Canada 1992, p.9; Smith 1995, p.402).

The chapter proceeds as follows. The first section assesses the degree of independence of the Bank of Canada, and provides important background information on Canadian political and economic institutions. The second section sets the context by reviewing the conduct of monetary policy over this period and the public debates it aroused over the appropriate framework and objectives for the central bank. The third section reviews the distributional conflict caused by the governor Crow's pursuit of price stability and reviews the political debates concerning the BoC and its independence, focussing on the 1991 proposal to change the *Bank of Canada Act* and the 1994 reappointment of Governor Crow. The fourth section assesses the importance of the outcome of these debates, from the point of view of the four hypotheses put forward by the literature. The fifth section concludes.

6.1 How Independent is the Bank of Canada?

Academic economists cannot agree on the degree of independence of the Bank of Canada (table 1). In the literature developing legal indices of central bank independence, the ranking of the BoC shows the greatest variation among OECD central banks after Australia. Bade and Parkin (1988) rank the BoC as one of the more politically controlled central banks based on the government's ultimate control over monetary policy authority and BoC appointments, a view shared by Eijffinger and Schaling (1993).⁵ "The balance between finance ministry and central bank found in France and Germany is lacking in Canada, with the finance ministry dominant" (Coleman 1996, p.77). By contrast Grilli et al (1991) argue that the BoC is one of the most independent central banks, in the company of the Bundesbank, the Swiss National

⁵ This paper was an updated version of a 1978 research report by the same authors (Bade et al. 1978).

Bank and the Federal Reserve.⁶ Cukierman et al (1992) see the BoC as relatively independent, placing it 7th out of 25 countries.

In support of the view that the BoC is politically controlled, economists highlight the government's involvement in appointments and policymaking, and the multiple objectives of monetary policy. The government appoints the Board of Directors (12 out of 14 members) who then appoint the Governor and Senior Deputy Governor of the BoC, subject to cabinet approval. The government has demonstrated its ability to control the Governor's office, as seen in table 2, by appointing the first Governor, forcing the second to resign, failing to reappoint the fourth and finally naming a former Deputy Finance Minister, David Dodge, as the sixth Governor in January 2001. The Deputy Finance Minister sits as an ex officio member on the BoC Board of Directors and Executive Committee. The *Bank of Canada Act* requires regular consultation between the Governor and the Finance Minister, which in practice occurs weekly.⁷ Since 1967, the government has the ability to issue a directive to the BoC in the event of a disagreement over monetary policy. The BoC has multiple objectives, providing flexibility in the interpretation of which objective to pursue and making it harder for outsiders to detect political interference. The BoC is required to present an annual report to the Finance Minister and the Governor is subject to questioning by the House of Commons Standing Committee on Finance. The government may seek short-term advances from the BoC, and can force the BoC to monetize its debts through the debt management and foreign exchange operations run by the BoC (Laidler et al. 1993, p.44). Finally, the Finance Minister holds the entire share capital issued by the BoC

⁶ Grilli et al reach this assessment after considering 15 political and economic variables (Grilli et al. 1991).

⁷ In addition to formal avenues, Laidler (1997) outlines a number of informal links between the BoC and the Department of Finance.

whose annual profits are remitted to the government's Consolidated Revenue Fund.⁸

On this basis, researchers conclude, "while the Bank of Canada does have substantial policy latitude, in the final analysis it is responsible to the Cabinet" (Courchene 1976, p.12).

Table 42: Bank of Canada Governors

Period	Governor	Professional Background
1934 – 1954	Graham Towers	Formerly worked at Royal Bank of Canada. Represented chartered banks on Macmillan Commission.
1955 – 1961	James Coyne	Joined BoC's Research Department in 1938, left the following year and returned in 1944. Named Governor after 11 years.
1961 – 1973	Louis Rasminsky	Worked for League of Nations 1930 until joined BoC's Foreign Exchange Board in 1940. Named Governor after 21 years.
1973 – 1987	Gerald Bouey	Joined BoC's Research Department in 1948 from university. Named Governor after 25 years.
1987 – 1994	John Crow	Worked from 1961 as IMF economist at the IMF until joined BoC's Research Department in 1973. Named Governor after 14 years.
1994 – 2001	Gordon Thiessen	Joined BoC's Research Department in 1963 from university. Named Governor after 31 years.
2001 – present	David Dodge	Academic and civil servant. Served as Deputy Finance Minister 1992-1997, and sat on BoC Board. Appointed Governor in 2001.

Proponents of independence argue that the BoC operates with a large measure of *de facto* independence, setting interest rates without government interference. The government has never used its power to direct the BoC nor would it risk the public controversy if it did. Thus the directive is seen as giving the BoC *greater* independence (Laidler 1991, p.13). The government does not directly appoint the Governor or Senior Deputy Governor, who are selected by the outside directors who themselves serve overlapping three-year terms. The Governor and Senior Deputy Governor serve long terms - seven years – and hold office during 'good behaviour', not at the pleasure of the government, making it difficult for the executive to fire them. The Deputy Finance

⁸ This section draws on BoC (1978), Canada (1992) and Crow (1993).

Minister sits as an non-voting member on the BoC Board and Executive Committee, which are not policy-making bodies of the BoC. The BoC does not require government approval of public expenditures or the hiring of staff. Finally, the BoC is audited by external auditors appointed by the Cabinet, and not by the Auditor General who audits other government agencies.

The BoC has largely remained neutral in debates about its legal relationship with politicians. Governor Crow was at pains to avoid the term ‘independence’ in his discussion of the BoC’s relationship with the government:

You may note that I have not used the popular term “independence” in setting out the issues relating to institutional arrangements. This is because I do not find the concept of independence a terribly helpful starting point in discussing these issues. If the notion of independence is not set carefully in context, it can leave the impression that a central bank can, or should, operate without institutional constraints. That, of course, cannot be the case. Simply put, in a democratic society a central bank has to be accountable in some way to the elected representatives of the people – the government and/or parliament – for some reasonably clear responsibilities (Crow 1993b, p.27).

A government inquiry enquiry into the role and mandate of the BoC concluded that the BoC is neither dependent nor independent (Canada 1992). “[In] our own typically Canadian way, we have evolved a system in which the Bank of Canada is neither totally independent nor is it totally under the control of the Department of Finance. The BoC is, if you like, independent if necessary, but not necessarily independent. This, in essence, is the genius of the consultation-directive approach” (Canada 1992, p.ix).⁹

⁹ A similar arrangement existed for the Netherlands central bank, although the statute was reformed in order to comply with the ECB legislation.

6.2 Distributional Conflict over 'Zero Inflation'

The Bank of Canada became the subject of political debate following two painful disinflations that both ended in recession, the first in 1981-82 under Governor Bouey and the second in 1990-91 under Governor Crow. In both cases, the BoC raised interest rates to high levels in order to squeeze out inflationary pressures under monetary policy frameworks considered to be at the vanguard of economic thought – monetary targeting under Governor Bouey and inflation targeting under Governor Crow. An angry public and press blamed the BoC for rising unemployment and a slow recovery, which led to calls to rein in the Governor who was forced publicly to defend the BoC's actions. While the government refused to be drawn into the public debate under Governor Bouey, the BoC's actions under Governor Crow were seen as beyond its mandate and led to a confrontation between politicians and the Governor. This episode culminated in the appointment of a new Governor in 1994. These issues will be discussed in greater detail below.

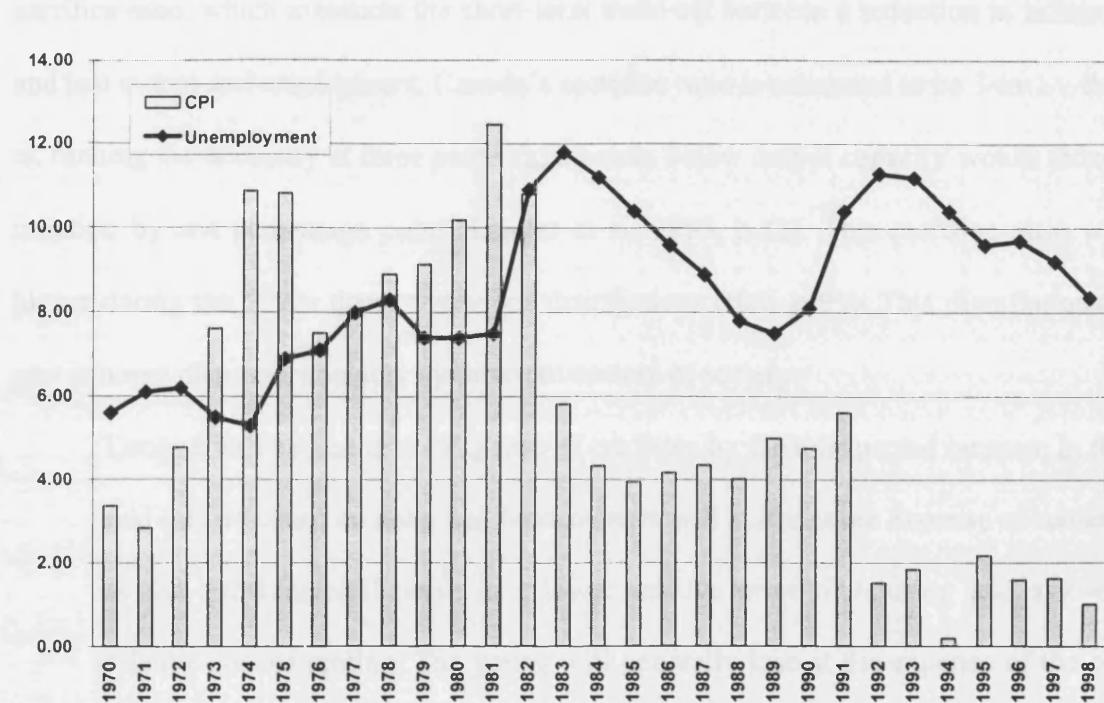
Crow's Pursuit of Price Stability

The public controversy surrounding Governor Crow began shortly after he was named Governor in 1987. Under Governor Crow, the BoC began pursuing price stability more directly, placing it above other objectives. Crow has joined the BoC's Research Department in 1973 from the IMF, where his work on Latin America had demonstrated the damaging effects of inflation. Governor Crow described the costs of inflation as "pervasive and insidious" (BoC 1991b, p.9). He first made this policy focus clear in the 1988 Hanson lecture (Crow 1988).¹⁰ In remarks on this topic, Crow is reported to have said that no level of inflation is credible and would lead to "a state of confidently held expectations about the absence of inflation" (Laidler 1997, p.73). His critics interpreted

¹⁰ While the pursuit of price stability is closely identified with Governor Crow, it has been among the BoC's objectives since its foundation in 1934, and was a source of controversy under Governors Coyne and Bouey. See Smith (1995) and Howitt (1986).

this comment to mean that the Governor would not be satisfied with any level but ‘zero inflation’, a phrase that was picked up by the media and academics but was never used by either Governor Crow or the BoC. Academics warned that the pursuit of price stability was “a radical, perhaps even dangerous, notion” (Laidler et al. 1993, p.91).

Figure 8: Canadian Inflation and Unemployment



Despite Governor Crow’s speech, there were no concrete signs of a decisive shift in the BoC’s policy during the months that followed and the BoC itself gave no timetable for action (Laidler et al. 1993, p.93).¹¹ In fact, the Department of Finance’s own medium-term inflation projections continued to exceed the BoC’s projections for three years, until the inflation target was jointly agreed in February 1991 (Johnson 1990).

Measuring the Costs of Disinflation

The focus on price stability soon embroiled the BoC in public controversy, centring on the costs of disinflation. The debate concerned who was paying for this painful

¹¹ It is unclear to what extent the contents of this speech were discussed with the Department of Finance, although Laidler and Robson believe this must have been the case (Laidler et al. 1993, p.123).

adjustment and who stood to benefit from price stability. To make the transition from a high rate to a lower rate of inflation, the economy needed to undergo a period of disinflation to reduce the excess demand for money. “Experience has shown that it takes a massive recession to get inflation down even to 3 to 4 percent after several years in double digits” (Howitt 1986, p.31). The costs of disinflation are captured by the sacrifice ratio, which measures the short-term trade-off between a reduction in inflation and lost output and employment. Canada’s sacrifice ratio is estimated to be 3-to-1 – that is, running the economy at three percentage points below output capacity would reduce inflation by one percentage point (Laidler et al. 1993, p.22). This sacrifice ratio was higher during the 1990s than in previous disinflations (Ball 1993). This disinflationary cost is borne disproportionately by different sectors of society.

Debtors will be hurt at the expense of creditors by the unexpected increase in the real rate of return on debt, and homeowners will suffer at the expense of renters, as the transition will result in a lower relative price of housing and a lower relative cost of renting. The young will generally lose at the expense of the old because of the increased real value of unindexed pension benefits. And, if the transition is achieved very rapidly, the increased real debt may cause serious problems of bankruptcy, or even financial collapse (Laidler et al. 1993, p.95).

Not mentioned is re-distribution through the tax system, which in Canada is not indexed for inflation (York 1990, p.22). Regional-disparities are also evident as the provincial economies are dependent on different industries, which leads to varying output gaps, levels of unemployment and sensitivities to interest rates and the exchange rate. The pursuit of one monetary policy geared to the manufacturing provinces of Ontario and Quebec therefore pushes many costs of adjustment on the other regions in Canada. This situation aggravates the tensions between the Provinces and the federal government.

A second concern raised by opponents to ‘zero inflation’ was the possibility of hysteresis of unemployment, where short-term job losses can become permanent (York 1990, p.25).¹² This issue was particularly important in the context of the adoption of the Canada-US Free-Trade Agreement (“FTA”), which was anticipated to cause a structural change in Canadian labour markets creating temporary unemployment as workers switched among industries.¹³ The risk was that the pursuit of price stability at this point of structural change would leave many of these workers unemployed, leading to an anti-USA backlash within Canada and pressure for increased protectionism (York 1990, p.148).

Battle Lines in ‘Zero Inflation’ Debate

Strong views were expressed on both sides of a debate that lasted from 1989 until 1994. This debate took place in the press, in academic conferences, in the Governor’s speeches, and in parliament. On one side stood the monetary policy ‘elite’ that supported the pursuit of price stability and Crow’s reappointment. This coalition consisted of BoC officials, the Conservative Finance Minister, academic economists, conservative think tanks, the Business Council on National Issues (“BCNI”)¹⁴ and an epistemic community of financiers and foreign central bankers. Internally, Governor Crow’s price stability policy had the support of the intellectual atmosphere within the BoC, which used its research and its connection with central banks abroad to build support for the pursuit of price stability. Externally, Canada’s two major conservative think tanks, the CD Howe Institute and the Fraser Institute, supported price stability. The CD Howe Institute sponsored two major conferences on the debate, and published

¹² For example, a worker who is temporarily out of work might become unemployable after some length of time due to the loss of job experience and relevant skills, leading to a permanently higher level of unemployment

¹³ The FTA had been the focus of an intense political public debate in the late 1980s and the central issue in the 1988 federal election (Lipsey 1990, p.56).

¹⁴ The BCNI is composed of the chief executive officers of 150 leading Canadian corporations representing every major sector of the Canadian economy.

the proceedings as Zero Inflation – The Goal of Price Stability and Taking Aim: The Debate on Zero Inflation (Lipsey 1990; York 1990). Both conferences were designed to provide a platform for academic economists to endorse Governor Crow's independence and policy stance, offsetting the attacks by his critics (Lipsey 1990, p.v). Governor Crow also had the support of an epistemic community. Internationally, *The Economist* hailed Crow's performance while *Euromoney* named commented favourably on the BoC's approach. The credit rating agencies and international investment banks also commented favourably. Finally, foreign central bankers demonstrated their high regard for Governor Crow by appointing him chairman of the G-10 committee of central bankers, the first non-European to hold this post.¹⁵

Critics of Crow's price stability policy far outnumbered its supporters, and represented a coalition of monetary policy 'outsiders' led by the Canadian media, organised labour, a few 'heterodox' economists, the opposition Liberal Party and the provincial Premiers. Leading critic Professor Pierre Fortin used his Presidential Address to the Canadian Economics Association to argue that the BoC's price stability policy had caused the greatest employment and output losses since the Great Depression, causing twice the job losses of the 1982-86 recession (Fortin 1996). The left-of-centre Canadian Centre for Policy Alternatives sponsored a conference of BoC critics, leading to the publication Hard money, hard times: why zero inflation hurts Canadians (Fortin et al. 1998). The contributors noted that the BoC's price stability policy was not imitated from other countries, and resulted in a 'Made in Canada' recession.

By raising interest rates and thereby engineering a 21 per cent increase in the exchange value of the Canadian dollar, monetary policy precipitated a collapse in aggregate demand. Excessively tight monetary policy worsened the severity

of the recession from 1989 to 1992 and destroyed the debt stabilisation plans of Canadian governments. The debt-to-GDP ratio soared to new heights, and by 1995, Canadian governments perceived no alternative but to cut program expenditures severely (Fortin et al. 1998, p.164).

Federal and Provincial politicians were vocal in their opposition to Crow's policies. At the First Minister's Conference in August 1988, the provincial Premiers objected to the high level of interest rates imposed by the BoC, pointing out that inflationary pressures were lower and unemployment higher outside central Canada (Lipsey 1990, p.54; York 1990, p.180). These economic disparities aggravated the regional divisions surrounding Canada's constitutional debates that were raging at the time. “[What] is the long-term political cost for Canadian unity of starting an economic slowdown or a recession in all provinces when the unemployment rate is 5 percent in one over-heated region and 9 percent in the rest of the country?” (York 1990, p.148).

The timing of the BoC's pursuit of price stability was controversial for business. High interest rates pushed up the Canadian dollar at a time when many industries were rationalising and downsizing to take advantage of the Canada-US Free Trade Agreement (“FTA”) signed in 1986 (Howitt 1993, p.494). Business had been strong supporters of the FTA and had made massive investments only to see their competitiveness deteriorate relative to the US as the appreciating Canadian dollar undid many of the benefits of the FTA. By 1989, Canadian industry was about 20 per cent less competitive relative to its US counterparts than it was when the FTA was signed (York 1990, p.162).

¹⁵ “The Governor awaits his fate”, *Financial Post Magazine*, November 1993, p.14-17.

6.3 Political Debates over Bank of Canada Independence

The public controversy over the BoC's price stability set the stage for the political debate over BoC independence. "When a major national institution, such as the Bank of Canada, makes a systematic series of decisions that substantially decrease the economic well-being of Canadian society, calls for radical change are to be expected" (Fortin et al. 1998, p.176). The extent to which Governor Crow was personally identified with the BoC's pursuit of price stability and the suggestion that the Governor was unaccountable called into question the legitimacy of the BoC and raised concerns about the credibility of monetary policy even among BoC supporters. As a direct result, both the ruling Progressive Conservatives and the opposition Liberals introduced a set of proposals that would fundamentally change the independence of the BoC.

Setting the Agenda

The debate over the BoC's legislation began with the publication of a pamphlet by Professor David Laidler, entitled How shall we govern the governor?, which effectively set the agenda for the ruling Conservative government (Laidler 1991). Written in May 1991, this pamphlet was part of a series conceived by the CD Howe Institute to contribute to the debate on renewing Canada's constitution, following the failure of the government's Spicer Commission.¹⁶ Significantly, the pamphlet followed the joint announcement of the inflation targets in February 1991. Laidler recommended three amendments to the *Bank of Canada Act*: the mandate should be changed to one of price stability, the Board of Directors should be restructured to decrease the power of the Governor (along the lines of a Monetary Policy Committee), and the composition of the Board should be changed to increase regional representation.

[A] systematic re-examination of the Bank's role in Canada's economic and political life is overdue. The Bank's current mandate is outdated and vague, and

the Bank's governance, reflecting its status as an exclusively federal institution, ignores the interests of provincial governments in the conduct of monetary policies. Current arrangements confer on the Bank a high degree of independence from day-to-day political pressure. That, as I shall argue, is very desirable. They also ensure, however, that the power which such independence confers is perceived to be concentrated in the hands of the Bank's governor. The desirability of this is less obvious... (Laidler 1991, p.1).

The BoC mandate was vague and obsolete making it impossible for the BoC to be held accountable, and should be replaced with a clear mandate of price stability along New Zealand lines (Laidler 1991, p.19). Laidler saw the joint adoption of the inflation targets as a step in this direction, but one that did not go far enough to institutionalise this policy change. The Board should be strengthened and given a greater say in monetary policy, in order to get away from 'personal attacks on the governor' that undermined the political legitimacy of the BoC (Laidler 1991, p.21). A stronger board with greater regional representation would make it harder to level ill-informed and irresponsible charges of regional insensitivity at the BoC (Laidler 1991, p.22). Laidler concluded that the strengthened Board and a clear mandate of price stability would strengthen, *not weaken*, the ability of the BoC to resist political pressure while ensuring greater accountability of monetary policy.

Laidler's pamphlet caught the attention of the House of Commons Standing Committee on Finance, a cross-party committee of backbenchers responsible for parliamentary oversight of economic policy. The Finance Committee had its own concerns about the BoC witnessed by periodic clashes between Finance Committee members and Governor

¹⁶ The Spicer commission report made no mention of the Bank of Canada, focussing instead on the deficit and regional disparities (Canada 1991b).

Crow during his testimony over the BoC's annual report.¹⁷ The Finance Committee was concerned "that one of the most significant federal government institutions was increasingly being called into question" and formed a Subcommittee on the Bank of Canada ("the Subcommittee") in June 1991 to look into Laidler's proposals (Canada 1992).¹⁸

Conservatives' Reform Proposals

However before the Subcommittee got started, the Conservative government under Prime Minister Mulroney published its proposals for reform of Canada's constitution in September 1991. Entitled Shaping Canada's Future Together: Proposals, this document featured twenty-seven proposals, with one specifically addressing the statute of the BoC:

The Government of Canada proposes to amend the *Bank of Canada Act* to make it clear that the mandate of the Bank is to achieve and preserve price stability. To ensure regional representation on the Board of Directors of the Bank of Canada, the Government will solicit the views of provincial and territorial governments and consult with them before making appointments to the Board. In addition , the Government proposes to create regional consultative panels to advise the Directors of the Bank on regional economic conditions. The Government will also solicit the views of provincial and territorial governments with respect to the membership of the regional panels. Moreover, the appointment of the Governor of the Bank of Canada would be subject to Senate ratification (Canada 1991c).

¹⁷ In testimony over the BoC's 1990 annual report, Liberal MP Herb Gray repeatedly challenged Governor Crow's discussion of the BoC's policies. See: Minutes and Proceedings of the House of Commons Standing Committee on Finance, 18 March 1991, p.158:12.

¹⁸ The Subcommittee consisted of five MPs, two from the ruling Progressive Conservatives, two Liberals and one NDP.

A companion volume, *Canadian federalism and economic union: partnership for prosperity*, elaborated on these proposals (Canada 1991a). The government's suggestions echoed Laidler's, focussing on the BoC's mandate and the composition of the Board of Directors. The government acknowledged that considerable confusion existed concerning the objectives of monetary policy, resulting in the perception that monetary policy was being designed for central Canada. "Clarifying the Bank's mandate and formalising and strengthening communications would help to eliminate some of the misperceptions...And a clearer mandate would be consistent with the independence of the implementation of monetary policy on an ongoing basis" (Canada 1992, p.38). A focus on price stability would mean the elimination of other objectives "that history has taught us a central bank cannot achieve or that can only be achieved through price stability" (Canada 1992, p.39). Monetary policy would be made more transparent by requiring the Governor to testify twice a year before Parliament and to meet with the federal and provincial Ministers of Finance. The Board of Directors would also be given a greater role, chairing new regional consultative panels and publishing reports on regional conditions in the Board's minutes.¹⁹

The Manley Report

In November 1991 the Subcommittee began hearings on three issues: the BoC's independence in setting monetary policy, the nature of its mandate and the way in which it reached policy decisions (Laidler et al. 1993, p.122). The Subcommittee heard testimony from the Governor and BoC officials, as well as twenty-five witnesses "including experts on the central banks of Japan, U.S. and the UK, business and academic economists, a former federal Finance Minister and a former provincial Treasurer" (Canada 1992, p.xiv). Academic economists were the largest group to give

¹⁹ The report also recommended setting up an independent agency to monitor and evaluate the macroeconomic policies of the federal and provincial governments (Canada 1992, p.40).

testimony, representing over a third of the witnesses, including David Laidler, Pierre Fortin, David Howitt and William Coleman. Next in line were witnesses from banking and financial services who made up one-fifth of the witnesses with testimony from the Canadian Bankers Association (“CBA”), Royal Bank of Canada, Toronto Dominion Bank, the Trust Companies Association of Canada and the Confédération des caisses populaires et d'économie Desjardins du Québec.²⁰

The Subcommittee's report (“the Manley Report”), published in February 1992 came to a unanimous and surprising set of recommendations. The Manley Report recommended leaving the BoC's mandate unchanged. While a large majority of witnesses had endorsed price stability as the appropriate goal of monetary policy, few were prepared to incorporate such a narrow goal in legislation. A number of reasons were given. First, a change of mandate was unnecessary as the BoC was already pursuing a firm, anti-inflation policy under the inflation-targeting framework. Second, effective central bank independence – not the central bank's mandate – was viewed as more significant for delivering low inflation. Third, a narrow focus on price stability would encourage adverse fiscal policies, as politicians would not feel responsible for price stability. Fourth, other objectives had been the focus of monetary policy in the past, suggesting that other targets than price stability might be desirable to pursue in the future, such as exchange rate stability. Fifth, the timing of this proposal was wrong. The issue was divisive and including this reform in an already overloaded constitutional agenda would only increase political friction. Finally, monetary policy has powerful short run effects that should not be ignored, such as stabilising exogenous shocks to demand. After considering these positions, the Subcommittee decided that confining monetary policy

²⁰ Foreign central bankers also waded into this debate, with Bundesbank President Schlesinger voicing support for the proposal to give the BoC a mandate of price stability. “Bundesbank backs new mandate”, *The Globe and Mail*, 18 January 1992, p.4.

to price stability would be a sharp departure from the past and would reduce policy flexibility while ignoring the other objectives of public policy (Canada 1992, p.24). “In sum, a broad mandate is superior to a narrow one, and the present preferable to the one proposed” (Canada 1992, p.xiv).

The second recommendation dealt with the independence of the BoC and endorsed the status quo. The BoC should continue to formulate monetary policy day-to-day, but ultimate responsibility should remain with the government backed by the power to issue a directive. Some witnesses argued for greater political control, arguing that the Governor had too much power and that monetary policy lacked legitimacy. Other witnesses argued for greater independence, pointing to studies linking independence with low inflation and discussing the propensity for politicians to set policy for short-term political gain. Opinion was split on whether a directive could be used or not – some witnesses argued it would “trigger serious, adverse consequences in Canadian financial and foreign exchange markets” while others believed the policy debate and publicity surrounding it would “enable the market to pass appropriate judgement” (Canada 1992, p.28). A majority of witnesses felt the current arrangement between the BoC and the Department of Finance was effective, leading the Manley Report to endorse the existing system of dual responsibility. “In Canada we have struck a balance between day-to-day independence of the Bank with ultimate responsibility resting with the federal government. The more legitimate is the Bank of Canada’s policy making process, the less likely is the government to interfere in its operations and the more real is this independence” (Canada 1992, p.xv).

The remaining recommendations addressed the accountability and governance of the BoC. To increase accountability, the report recommended amending the *Bank of*

Canada Act to require the BoC to report to Parliament twice a year, with the Governor giving a hearing to explain the choice and direction of monetary policy. While there was substantial consensus in favour of changing the governance of the BoC to diffuse the power of the Governor, the Subcommittee was not convinced of the superiority of any of a number of models, nor did it feel the concentration of power in the hands of the Governor was excessive.²¹ To increase regional representation, the Manley Report argued for legislating a regional balance on the Board of Directors. Some Board and Executive Committee meetings should also be held in locations outside central Canada in order to foster better public understanding of the workings of monetary policy.

Table 43: Government Documents on Bank of Canada Independence

Year	Title
1933	Royal Commission on Banking and Finance (Macmillan Commission)
1964	Royal Commission on Banking and Finance (Porter Commission)
1978	Royal Commission on Financial Management and Accountability (Lambert Commission)
1991	<i>Shaping Canada's Future Together</i> , Government of Canada <i>Canadian federalism and economic union: partnership for prosperity</i> , Government of Canada.
1992	<i>The Mandate and Governance of the Bank of Canada</i> (Manley Report), House of Commons Standing Committee on Finance, Subcommittee on the Bank of Canada.

Changes following the Manley Report

Publication of the Manley Report attracted little attention in Canada, likely due to the constitutional reforms being debated at the time that dominated the headlines (Laidler et al. 1993). More pressing was Quebec's Belanger-Campeau Commission that had recommended a second referendum on sovereignty-association be held in Quebec before the end of 1992. Elsewhere the Mulroney government was putting the final touches on the Charlottetown Accord of constitutional changes, approved by both federal and provincial leaders, which was strongly rejected in a national referendum in

²¹ On the issue of governance, the Subcommittee studied the operation of the Federal Reserve, the Bundesbank, the Banque de France, the Bank of England and the preliminary plans for the ECB.

October 1992. Not surprisingly, reform of the *Bank of Canada Act* was dropped from an overloaded constitutional agenda as it was felt that the Act could be changed at any time by a simple act of Parliament.

Despite this outcome, proposals to reform the BoC continued to be made throughout the 1990s by both opponents and supporters of the BoC.²² There were proposals to incorporate the inflation targets into the Act, to modify the governance of the BoC and to change the terms of the Governor's appointment. More radical proposals suggested effectively delegating monetary policy to the Fed by entering a monetary union with the USA; transforming the BoC into a full government department; or replacing the BoC with a system of free banking (Laidler 1997, p.202).

Aftermath: Liberal Showdown with Crow

The opposition Liberal Party had its own ideas for the BoC. Crow's term was due to be renewed on 31 January 1994, less than three months after a federal election was set to be held on 25 October 1993. In March 1993, Conservative Finance Minister Mazankowski had floated the idea of reappointing Crow early before the election – an unprecedented move that was resisted by a BoC that wanted to remain non-partisan. The main election issues were job creation and federal finances as unemployment was over 11 per cent and the deficit was set to exceed C\$40 billion for the first time. During the election campaign, Opposition Liberal leader Jean Chrétien directly challenged the independence of the BoC, threatening not to reappoint Crow unless the BoC pursued an easier monetary policy to put the 1.6 million unemployed Canadians back to work.²³ Chrétien's populist threat reflected the public mood at the time. CLC President Bob

²² Fortin continued to argue that the management structure of the BoC be reorganised, and the mandate should be re-worded to take explicit account of the costly trade-off between inflation and unemployment at very low inflation rates (Fortin 1996, p781). Fortin and Osberg recommended replacing the Governor

White called Crow the “architect of our current difficulties” and argued Crow should not be reappointed as his policies had led to massive unemployment, a depressed economy and rising deficits.²⁴ White described the BoC’s price stability policy as “at root a policy to maintain a very slack economy with unacceptably high levels of unemployment almost indefinitely”.

On the whole, the participants in this debate were the same who had spoken out during the 1991 debate over the BoC’s mandate. Vocal opponents of Crow’s reappointment were Professor Fortin, the Canadian Centre for Policy Alternatives, the Canadian Manufacturer’s Association, provincial Finance Ministers in Ontario and BC from Canada’s left-wing New Democratic Party (“NDP”), and a newly founded protest group called the Bank of Canada for Canadians Coalition, composed principally of Reform Party members.²⁵ Crow was supported by the financial press, academic economists such as Laidler, the CD Howe and Frasier Institutes, the business community represented by the BCNI and the Canadian Federation of Independent Businesses (“CFIB”), financial market actors and the international banking community.²⁶

Following the Liberal election victory, Prime Minister Chrétien named Paul Martin – another vocal critic of Crow – as Finance Minister. Martin had responsibility for appointing the next BoC Governor. In November 1993, Finance Minister Martin polled his provincial counterparts on the subject of Governor Crow’s reappointment and found

²² Fortin continued to argue that the management structure of the BoC be reorganised, and the mandate should be re-worded to take explicit account of the costly trade-off between inflation and unemployment at very low inflation rates (Fortin 1996, p781). Fortin and Osberg recommended replacing the Governor with a governing council (Fortin et al. 1998, p.175).

²³ “Liberal threat to sack bank chief may prove hollow after election”, *The Financial Post*, 23 July 1993.

²⁴ Robert White “Crow the architect of current difficulties”, *The Globe and Mail*, 7 April 1993.

²⁵ Jordan Grant, “Why John Crow should not be reappointed”; *The Globe and Mail*, 17 Dec 1993, p.A23; “Inflation fighter” *Maclean’s*, 13 Dec 1993, p.24.

²⁶ “Crow’s critics come under fire”, *The Globe and Mail*, 4 Nov 1993, p.B3; “Crow’s future becomes cloudy”, *The Globe and Mail*, 1 Dec 1993.

them mostly indifferent. In December, a special appointment committee of the BoC's Board of Directors – controlled by the opposition Conservatives – recommended that Crow be reappointed.²⁷ Finance Minister Martin rejected the Board's suggestion. For the Liberals, a major obstacle was Crow's pursuit of price stability that conflicted with the Liberal's campaign rhetoric to let inflation grow by 5 to 6 per cent in order to create more jobs. At the time of the reappointment, Canadian inflation was one of the lowest in the industrialised world at 1.9 per cent.²⁸ Finally, on 22 December, Finance Minister Martin announced that Crow would not be reappointed, but would be replaced by Senior Deputy Governor Gordon Thiessen, a 30-year BoC veteran.²⁹ The appointment of a 'Crow clone' satisfied both the Liberal's objectives – it assured international financial markets that the BoC's monetary policy would remain the same, and it symbolically met Chrétien's electoral promise to get tough with the BoC by getting rid of the architect of 'zero inflation', Governor Crow. At the time of the announcement, Finance Minister Martin and Governor Thiessen jointly agreed to extend the inflation target of 1 to 3 per cent to the end of 1998.³⁰ Governor Thiessen had made this endorsement a criteria for his accepting the job.

BoC Changes under Thiessen

Governor Thiessen introduced a number of significant changes following his appointment in answer to the BoC's critics. First, Thiessen created a Governing Council to decentralise the decision-making responsibility of the BoC and reduce the concentration of power in the hands of the Governor. The six-member council, chaired by the Governor with the participation of the Senior Deputy Governor and four Deputy Governors, would share collective responsibility for managing the bank. Second,

²⁷ "Martin advised to reappoint Crow", *The Globe and Mail*, 4 Dec 1993, p.B13

²⁸ "The Indispensable Mr. Crow", *Western Report* 20 December 1993, p.8

²⁹ While press reports suggest that Crow asked not to be reappointed, this statement conflicts with reports on his wishes several months prior to the announcement.

³⁰ "Crow out, Thiessen in" *The Globe and Mail*, 23 December 1993, p.1.

Thiessen changed the appearance of the BoC's Annual Report, to make it more accessible and understandable to the public (Bernanke et al. 1999, p.127). Third, Thiessen launched a semi-annual report on monetary policy, the *Monetary Policy Report*, which would provide more information on how decisions were reached and bring greater transparency and accountability to monetary policy. Fourth, Thiessen launched a public awareness campaign to repair the damaged image of the BoC. Fifth, Thiessen acted to co-opt one of the BoC's critics by inviting David Laidler to be the first academic-in-residence at the BoC. Sixth, Thiessen changed the language used to describe the inflation targets, substituting the phrase 'inflation reduction program' introduced in 1991 with the phrase 'inflation control program' (Bernanke et al. 1999, p.127; Laidler 1997, p.2). Finally, Thiessen sought greater input from the provinces by increasing the role of its regional offices.

In combination with these organisational changes, Governor Thiessen introduced a number of changes in the BoC's operating framework designed to increase the transparency and accountability of monetary policy. In mid-1994, the BoC began to set a formal, unambiguous 50 basis point band for the overnight rate, later designating its upper band as the Bank Rate.³¹ To remove confusion concerning the relationship of interest rates and exchange rates, the BoC developed a Monetary Conditions Index, formalised from May 1995, to signal the direction of monetary policy. From January 1996 the BoC began issuing press releases to announce changes in this band that were announced at the same time each day. By educating the public and making policy more transparent and accountable, Thiessen hoped to gain public approval while increasing BoC credibility with financial markets (Bernanke et al. 1999, p.128).

³¹ Because the message to the market from the BoC's management of the overnight rate had been 'somewhat inarticulate', the BoC had previously intervened in money markets to signal its intentions more clearly (Grant 1997).

Table 44: Bank of Canada Stages in Pursuit of Transparency

Date	Event
December 1993	Inflation targeting regime extended through 1998
1994	Governing Council formed to share management responsibility for BoC. Press release used to announce change in the band for the overnight rate. New semi-annual Monetary Policy Report announced.
1994	Public adoption of Monetary Conditions Index as a guide to policy stance
June 1994	Adoption of a formal band for the overnight rate
May 1995	First issue of new, semi-annual <i>Monetary Policy Report</i> New appearance for BoC Annual Report Monetary conditions index given higher profile in policy decisions.
November 1995	Bank of Canada web site launched on the internet.
February 1996	Bank Rate tied to the top end of the band for the overnight rate.
July 1996	Seek greater input from BoC's regional offices

Source: Grant (1997)

6.4 Explaining Policy Continuity

Chapter 3 outlined four hypotheses for explaining the timing when politicians will reform a central bank's legislation. The Bank of Canada provides an interesting counter-factual test of these hypotheses, as the *Bank of Canada Act* was not changed during the 1990s. Each of these hypotheses is discussed below.

Vocal But Ineffective Financial Lobbying

The discussion of domestic interest group preferences in chapter 3 and 4 argued that Canada's chartered banks would support greater BoC independence and a mandate of price stability. This reform should be opposed by organised labour and certain segments of the business community. However, an assessment of the effective political influence of these groups in chapter 4 concluded that the financial sector would be most influential in determining the outcome, due to the lack of political power of organised labour and the collective action problems affecting the business community. The review of political debates concerning BoC independence largely supports the predicted pattern of preferences, but does not support Posen's hypothesis concerning the effective influence of the banking sector.

Organised labour, represented by the Canadian Labour Congress and the Canadian Auto Workers, publicly opposed the reappointment of Governor Crow on the basis that his price stability policy destroyed jobs and reduced the social wage. This opposition was voiced through the media and publications by leftist think tanks, and may have influenced the positions of the left-wing NDP Premiers in several provinces. However organised labour was not invited to give testimony to the Subcommittee, nor were its views attributed in the Manley Report. Surprisingly, the federal NDP were also relatively silent on this debate. These findings support the view that organised labour had no political influence in this debate.

Big business stood on both sides of the debate over Governor Crow's policies and reappointment. While exporters, manufacturers and small businesses were vocal in their opposition to high interest rates and the BoC's quest for price stability, the BCNI was among the most public supporters of Governor Crow. As predicted, those businesses most exposed to the traded sector, who paid the short term costs of adjustment, were opposed to greater BoC independence. The CEOs of Canada's largest firms, who could afford to take a longer term view, supported it. Small business represented by the CFIB opposed the BoC's high interest rate policy, but then supported Crow's reappointment suggesting no consistent position in these debates. The fragmentation of business interests and the lack of a coherent voice undermined the political effectiveness of business on this debate, as seen in their lack of representation in the Manley Report.

Canada's chartered banks were active in this debate, with the Royal Bank of Canada, Toronto-Dominion Bank and the CBA giving testimony in support of greater BoC independence to the Subcommittee. They also voiced support for Governor Crow in the debate over his reappointment. Both positions are consistent with Posen's claim that the banking sector will prefer price stability to job creation. However, in both cases

politicians did not endorse the preferred position of the chartered banks, choosing instead not to change the BoC's mandate nor to reappoint Governor Crow. This result clearly rejects Posen's predictions, particularly as Canada meets all the criteria specified by Posen for determining the effective of financial opposition to inflation. One explanation may be that the chartered banks did not hold unitary preferences. Chief Economist for Toronto-Dominion Bank, Douglas Peters, was one of Crow's fiercest critics.³²

Another explanation for this outcome is that the power of the financial sector over politicians is overstated. Despite their ability to organise through the CBA and to embed themselves in the policy network, the influence of the chartered banks may be restricted to certain issue areas such as financial regulation. Certainly Finance Minister Martin's rejection of their merger proposals in 1998 was a stunning defeat for the chartered banks, and demonstrated that the government is still able to make policy autonomously. The government's room to manoeuvre continued even as it became more dependent on the chartered banks for financing the government debt, with direct and indirect chartered bank holdings of Government of Canada securities growing from around 20 per cent in 1985 to over 40 per cent in 1995.

³² Given that Douglas successfully ran as a Liberal Party candidate in the 1993 election, his policy preferences may reflect more the position of his party rather than the financial sector.

Table 45: Domestic Holdings of Government of Canada Securities (%)

Year end	Chartered & other banks ¹	Life Ins./ Pensions	Bank of Canada	All levels of Govt	Individuals	Corps.	Total
1980	26	13	22	6	33	1	100
1985	21	18	9	6	43	4	100
1990	24	22	8	8	33	5	100
1995	42	26	7	8	13	4	100

1. Includes credit unions, trust companies, mortgage loan companies, investment dealers, mutual funds, insurance companies, and other financial institutions.

Source: Statistics Canada, The National Balance Sheet Accounts.

Signalling International Financial Markets

Central bank independence is seen as a mechanism for signalling the anti-inflationary credibility of governments that need attract foreign capital and that wish to reduce the interest-rate charged on their foreign borrowing. Based on this hypothesis, the government of Canada should have changed the mandate of the BoC to award it independence with a mandate of price stability, based on the state of Canada's finances during the early 1990s, the downgrading of Canada's sovereign debt by the major bond rating agencies, and the threats of international financial panic in the event Governor Crow was not reappointed.

Table 46: Federal Government Finances (C\$ in billions)

Fiscal Year Starting	Operating surplus or deficit (-) ¹	Public debt charges	Budgetary surplus or deficit (-)	Borrowing needs (-)	Gross public debt as % of GDP	Premium to US interest rates (%)	Non Resident Holdings ²
1970	0.9	1.9	-1.0	-1.0	n.a.	0.56	n.a.
1980	-3.9	10.7	-14.6	-9.9	n.a.	1.03	n.a.
1990	10.6	42.6	-32.0	-24.5	64 %	2.30	25 %
1991	6.8	41.2	-34.4	-31.8	68 %	n.a.	28 %
1992	-2.2	38.8	-41.0	-34.5	72 %	n.a.	27 %
1993	-4.0	38.0	-42.0	-29.9	75 %	n.a.	26 %
1994	4.6	42.0	-37.5	-25.8	76 %	n.a.	26 %
1995	18.3	46.9	-28.6	-17.2	77 %	0.25	25 %
1999	53.9	41.6	12.3	14.6	n.a.	0.75	n.a.

1. Budgetary revenues less program spending.

2. Shown as % of market, where market debt averaged 75% of total government debt over 1990s.

Source: Statistics Canada.

First, Canada's public sector debt was high and rising during 1985 to 1995, as shown in table 6, increasing from 57 per cent of GDP to 77 per cent one of the worst relative debt positions among the G-7 nations (Martin 1994). By 1995 the interest charges alone were more than C\$45 billion a year, creating large and unsustainable fiscal deficits. International investors held roughly 40 per cent or \$280 billion of the total Canadian debt, and about 26 per cent or C\$110 billion of Government of Canada debt.³³ However only about two per cent or \$8.5 billion of the federal debt was denominated in foreign currencies. Given Canada's poor financial situation, Finance Minister Paul Martin announced plans in 1994 to cut the deficit to 3 per cent of GDP by 1996-97, as an interim target towards balancing the budget and reducing the public debt (Martin 1994). By 1994 the operating budget was in surplus, but the high charges on the public debt meant the overall budget was not in surplus until 1999.

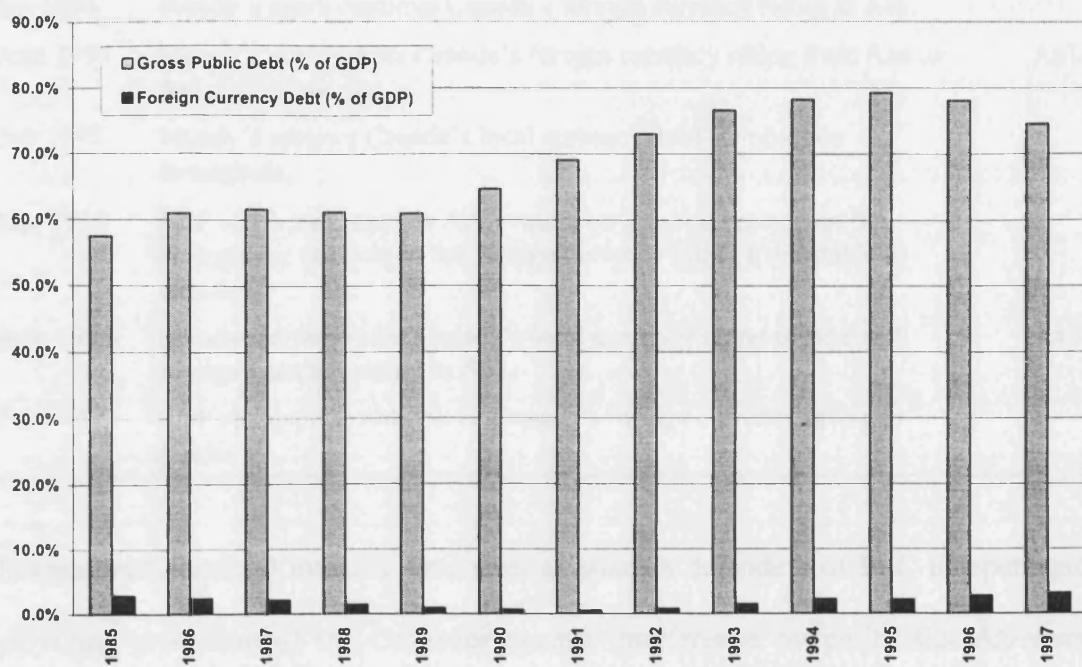
Canada's exposure to the international financial markets gave international creditors the power to punish the Canadian government by demanding an interest rate premium as compensation for rising levels of government debt and increased sovereign risk (Fortin et al. 1998, p.43). Between 1992 and 1995, Canada's sovereign and provincial ratings were downgraded by both major bond rating agencies, with the foreign currency rating falling from Aaa/AA+ to Aa2/AA+. The rating agencies cited the country's deteriorating balance of payments, the doubling of the national debt over the past decade, the rising provincial debt load and Canada's dependence on international investors.³⁴ The downgrades of the provincial governments forced them into fiscal austerity as their access to foreign capital more expensive or more limited. In September 1995 Moody's

³³ Japanese institutions owned more than \$50 billion or about 22 per cent of all foreign-owned Canadian bonds. See "The Fear Factor", *Maclean's*, 12 October 1992, p.14; "The Debt Beats" *Maclean's*, 29 March 1993, p.2.

³⁴ The downgrade took place less than two weeks before the October referendum on the Charlottetown Accord.

downgraded Canada's local currency debt and its foreign currency shortly after Finance Minister Paul Martin had tabled one of the most austere budgets in Canadian history. These downgrades made dramatic headlines in the Canadian press, and led to the view that the New York bond rating agencies were setting fiscal policy in Canada.³⁵

Figure 9: Canadian Public Sector Debt



³⁵ "The Debt Beats" *Maclean's*, 29 March 1993, p.2.

Table 47: Sovereign Ratings History for Canada

Date	Event	Foreign Rating
Oct 1992	S&P downgrades Canada's foreign currency rating from AAA to AA+.	Aaa/AA+
Nov 1992	Moody's reviews Canada's foreign currency rating for possible downgrade.	
Feb 1993	Moody's confirms Canada's foreign currency rating at Aaa after the end of the Charlottetown Accord constitutional crisis.	
Jan 1994	Moody's again confirms Canada's foreign currency rating at Aaa.	
June 1994	Moody's downgrades Canada's foreign currency rating from Aaa to Aa1.	Aa1/AA+
Feb 1995	Moody's reviews Canada's local currency debt for possible downgrade.	
Mar 1995	S&P confirms Canada's AAA rating on local currency debt but changes the outlook on the foreign currency rating from stable to negative.	
June 1995	Moody's downgrades Canada's local currency rating to Aa1 and foreign currency rating to Aa2.	Aa2/AA+
Feb 1997	S&P changes the outlook on Canada's foreign currency rating to stable.	

International financial markets were seen as staunch defenders of BoC independence, providing protection of the Governor against interference by politicians. *Maclean's* columnist Newman notes “[Attempts] by any politician, including the Prime Minister, to interfere with Bank of Canada policies would almost automatically result in the governor's resignation. That, in turn, would shake the confidence of world money traders in our currency, triggering a major financial crisis”.³⁶ Fortin admitted that any attempt by the government to overrule the Governor would “immediately trigger a financial and currency market crisis” (Fortin 1996, p776).

Supporters of Governor Crow's reappointment couched their arguments in terms of financial crisis. A *Globe and Mail* editorial suggested that Crow was a vital bulwark against a dreaded loss of confidence on the part of international investors. William

³⁶ Peter Newman, “It's time to bounce Crow out on his ear”, *Maclean's*, 10 April 1993.

Robson of the CD Howe Institute suggested there would be a violent reaction in the market if Crow were not reappointed, leading to a dramatic drop in the Canadian dollar.³⁷ An economist at Salomon Brothers in New York predicted a severe backlash.³⁸ The *Financial Post* noted that “the Canadian and international financial community consider Governor Crow something of a demi-god”.³⁹

Given the power ascribed to international financial markets, it comes as somewhat of a surprise to learn that none of the feared consequences occurred. Sovereign downgrades were never treated as a serious threat by the federal government, due to its ability to force the Bank of Canada to provide financing (Fortin et al. 1998, p.61).⁴⁰ In the 1970s, the Bank of Canada held more than 20 per cent of the federal debt, but by the 1990s that level was less than 8 per cent suggesting the government had room to manoeuvre. Nor did a rating downgrade from Aaa to Aa2 significantly raise the cost on federal borrowing, with Canada paying from a quarter to half of one per cent over US Treasuries on its borrowings. And while the Moody’s downgrade in June 1994 had negative repercussions on the Canadian dollar and on Canadian equity markets, a similar downgrade in June 1995 had little impact as the cost had been priced in and the markets were impressed by Martin’s austere budget. Credit downgrades only proved to be a serious concern for the smaller provinces. For example, debt-ridden Ontario was able to raise funds easily in the Euromarkets in the 1990s, contrary to the claims of doomsayers. The Liberals’ failure to reappoint Governor Crow did not spark a crisis. Quite the opposite, Thiessen’s appointment – synonymous with the extension of the inflation target – received a strong endorsement from the financial markets, with both

³⁷ “The Indispensable Mr. Crow”, *Western Report* 20 December 1993, p.8

³⁸ “Inflation fighter” *Maclean’s*, 13 December 1993, p.24.

³⁹ “Liberal threat to sack bank chief may prove hollow after election”, *The Financial Post*, 23 July 1993.

⁴⁰ Krehm’s (1993) populist attack on the BoC written prior to the 1993 election reached the same conclusion.

the Canadian dollar and Canadian bond prices rising following the announcement.⁴¹

These events demonstrate that international financial markets are not as constraining as suggested.

On the basis of this evidence, it appears that the power of international financial markets is overstated. The Canadian government rejected proposals for greater BoC independence and a mandate of price stability at a time when it was most exposed to international investors. The fact that a financial crisis was averted, despite Canada's reliance on foreign capital and deteriorating finances, demonstrates that other methods exist to signal anti-inflationary credibility than central bank independence. It may be that centrist parties such as the Liberals and Progressive Conservatives do not pose an inherent threat to financial markets. A left-wing NDP government, should it ever be elected, may be forced to legislate greater BoC independence similar to the case of the UK's New Labour.

Ideas Influence the Agenda

How significant were the ideas of an epistemic community of economists, central bankers and think tanks for determining the outcome? At first glance, it appears that ideas did matter for the case of the Bank of Canada. The ideas of economists like Laidler created a focal point around the need for reform of the BoC's legislation, and pointed to a set of potential policy options. Panels of monetary policy experts, convened by the CD Howe Institute and invited to give testimony for the Manley Report, were crucial for explaining this complex issue area. Academics also played a significant role in moulding the preferences of policymakers and in creating coalitions of domestic and international actors with shared policy preferences. In short, this epistemic community

⁴¹ "Choice of Thiessen rallies dollar", *The Globe and Mail*, 23 December 1993, p.B1.

set the agenda and provided a road map that politicians could use when considering this complex issue area.

However it is easy to show that this epistemic community did not succeed in determining the outcome due to a lack of consensus on both the need for this reform and the form it should take. Academic and business economists took positions on both sides of the debate, in favour of greater independence and in opposition to it. Fortin, Rymes and economists at the CLC built a successful coalition opposed to BoC independence, by highlighting the costs of disinflation, explaining which groups were paying the costs, and pointing to the lack of academic consensus on the supposed gains of price stability. In addition, the range of alternatives presented by the experts in favour of changing the BoC legislation was itself confusing and varied, creating enough uncertainty amongst policymakers that they preferred the status quo to any change. And when the issues were more concrete, politicians chose the policy that was most salient to their interests in re-election.

While dismissing the effectiveness of the epistemic community on the issue of BoC independence, it is important to highlight that the ideas of economists were significant for determining the alternatives to central bank independence that were pursued by the BoC and the federal government. On the surface, Canada did not follow the trend advocated by the economic orthodoxy which was to delegate to an independent central bank with a mandate of price stability. This interpretation perhaps misrepresents the state of the academic debate, as delegation was seen as only one of several solutions to the time-inconsistency problem. Rogoff (1985) suggested that an alternative to delegation is to appoint a conservative central banker who has a reputation within the financial community for defending price stability (Rogoff 1985). The Canadian case

offers an example of this strategy in practice. Recognising that the Bank of Canada would not be given greater independence, Rogoff's ideas may have provided a road map to a viable solution. From the time he became Governor in 1987, Crow set about building a reputation as a conservative central banker, revealing his preference for price stability over job creation in his Hanson lecture in 1988. Crow then demonstrated his toughness from 1988-1991, by pursuing a restrictive monetary policy to disinflate the Canadian economy (Debelle 1996). Governor Crow made a point of aiming for *inflation clearly below 2%*, which the Bank's critics took to mean 'zero inflation', insisting that not even a low level of inflation was credible and leaving no room to question his conservativeness. The cost of Crow's toughness, critics argue, was the 1990-91 recession which was deeper and more painful than it needed to be, a reality confirmed by the loss in output in Canada during the disinflation as measured by the sacrifice ratio. The adoption of an inflation target in 1991 signalled that the Bank had gained the government's support in the pursuit of price stability, removing any doubt in the minds of private actors as judged by the subsequent fall in inflationary expectations.

This study of the Bank of Canada raises the question of whether legal measures of central bank independence matter, or whether there are alternatives to delegation for achieving anti-inflationary credibility for monetary policy. Unlike the case with New Labour and its 1997 reform of the Bank of England, Canadian politicians did not need to legislate greater operational independence to the central bank in order to gain policy credibility (King 2001b). The ability to pursue reputation as a substitute for delegation may be due to the fact that Canada has never had a left-wing government. It appears that a conservative government's policies are viewed with less suspicion by international financial markets and the public commitment to price stability embodied in an inflation target may be enough to provide monetary policy with credibility. Canada's

Conservative government adopted an inflation target in 1991. Prior to this date, only the Reserve Bank of New Zealand had an official inflation target, although both the Bundesbank and the Swiss National Bank – the two most independent central banks in the world – are seen as having an implicit inflation-targeting framework (Bernanke et al. 1999). The joint announcement of inflation targets in 1991 was intended to bolster the credibility of the BoC's anti-inflationary policy and the focus at this time was to build public support in order to buttress the BoC's commitment to price stability (Bernanke et al. 1999, p.120).

6.5 Measuring Electoral Gains and Costs

Given the trend in central bank independence over the 1990s, why has the *Bank of Canada Act* not been updated to give the BoC greater independence with a narrow mandate of price stability? The answer is that this change did not provide politicians with electoral gains and only suggested electoral costs. By 1992, Canada's economy was recovering and inflation had come down to below 2 percent. During this process, the BoC had been a useful scapegoat for the Conservatives who shared the belief that inflation must be brought down. While Governor Crow is portrayed as crusading alone for price stability, this policy was agreed and supported by the Conservative government.⁴² It would have been discussed in the weekly meetings between the Finance Minister and the Governor. At the height of the debate in January 1990, a *Maclean's* article confirmed that "Crow's high-interest campaign has enjoyed unwavering political support from [Conservative] Finance Minister Michael Wilson".⁴³ "In short, the Bank's very autonomy from politicians made it an easy target for those same politicians, who could disown its policies whenever these were unpopular" (Laidler et al. 1993, p.48). In exchange for the Conservative government's support of

⁴² "The Indispensable Mr. Crow", *Western Report* 20 December 1993, p.8

⁴³ "Policy under fire", *Maclean's*, 8 January 1990, p. 28-30.

price stability, the BoC accommodated the Conservative government's fiscal policy including absorbing the inflationary shock from the introduction of the GST. In other words, despite the Governor Crow's commitment to price stability, monetary policy accommodated federal fiscal policy during this period even at the cost of higher short-term inflation. Given this accommodation and policy flexibility, the Conservatives had no incentive to make the BoC more independent or to give it a narrower mandate.

The BoC's legislation only came to be included in the government's 1991 constitutional proposals due to the public outcry over Governor Crow's high interest rate policy and the suggestion that monetary policy lacked political legitimacy. But when the Subcommittee met, its members recognised that the timing for pursuing such a reform was wrong due to the constitutional debates that were dividing the country. On this basis, the Conservative government dropped its proposals judging the electoral costs of pursuing BoC independence as too high. Laidler argues the Manley Report rejected reforming the *Bank of Canada Act* because the Subcommittee recognised how ephemeral received wisdom is among economists (Laidler 1997, p.197). Canada had been through exchange rate targeting under Bretton Woods, monetary targeting under Bouey, and had only recently introduced inflation targeting earlier that year – a framework that was untested and unproven. Embedding a narrow mandate of price stability that was not fully endorsed by other central banks or academic economists was a political risk that was not worth taking.

The Conservative government's defeat was ensured by their support of Crow's price stability campaign, their own fiscal austerity programs and the unpopular GST tax. In the 1993 election, the Conservatives suffered the worst defeat in Canadian electoral history, being reduced from the ruling party with 169 seats to only 2 seats. This

electoral lesson was not lost on the opposition Liberals under Jean Chrétien, who attacked the BoC's policy during the 1993 election campaign, threatening to get rid of Crow if they were elected. When the Liberals were elected, their view of the electoral costs of such a move changed, perhaps due to press speculation that international financial markets would revolt if Governor Crow were not reappointed. However Prime Minister Chrétien weighed the costs of giving in to this market pressure versus the political backlash if he reversed on his campaign promise. The Liberals saw Governor Crow's insistence on price stability as too politically costly, and it did not leave room for the Liberals to deliver on their electoral pledge to create jobs, even at the cost of higher inflation. For this reason, the Liberals faced down the threat from international investors and replaced Crow, who would not accommodate the Liberal government's agenda.

Recognising that international financial markets were most concerned with low inflation, Finance Minister Martin announced Governor Thiessen's appointment while at the same time extending the inflation target through 2001. The target range of 1-3 per cent did not include zero, but it confirmed the commitment to price stability albeit at a higher level of inflation. In recognition of financial market concerns about the government debt and Quebec succession, Finance Minister Martin appointed Thiessen, a career central banker and 'Crow clone' who would continue Crow's policies under a gentler guise. In this manner, the Liberals had their preferred choice of policies. They maintained flexibility, they symbolically asserted their control over the BoC and they reassured international financial markets of their commitment to price stability.

This study of the BoC raises the question of whether legal measures central bank independence matter, or whether there are alternatives to delegation for achieving anti-

inflationary credibility. The government's introduction of inflation targets in 1991 and Governor Crow's campaign to develop a reputation as a conservative central banker were alternatives to changing the legislation of the BoC. This combination of policies gave credibility to the anti-inflationary pledges of the government, but at the cost of high disinflationary costs as measured in a higher sacrifice ratio. Unlike the case with the UK, the Liberals and Progressive Conservatives did not see the need to legislate greater central bank independence, similar to their political counterparts in the UK. Were an NDP government to be elected, however, it may be that the threat of a financial crisis led by suspicious international investors might lead to a more institutionalised commitment to price stability, as was the case for New Labour in the UK.

Ch. 7 Reserve Bank of Australia: The Importance of Electoral Gains

The history of the Reserve Bank of Australia (“RBA”) has much in common with the Bank of Canada. The statute governing the RBA has not been significantly altered since the legislation was first passed in 1959, despite Australia’s central bank being seen by some economists as among the more politically influenced central banks. Both Australia and Canada have adopted inflation targeting frameworks during the 1990s following a joint announcement between the government and the central bank. In addition to the similarities in monetary institutions, Australia and Canada have similar political institutions, as both are federal states with bicameral legislatures. The main area where Australia and Canada differ is in politics, as the government in Australia was dominated by a left-wing party – the Australian Labor Party (“ALP”) – that formed a majority government from 1983 to 1996. It is these features that make the study of the Australian case so interesting for testing hypotheses about central bank independence. Given the similarities between the two countries, we would expect to find the same outcome.

The chapter will proceed as follows. The first section assesses the degree of independence of the central bank. The second section provides important background detail on the conduct of monetary policy in Australia and reviews the country’s inflationary performance. The third section discusses the political debates involving the central bank. The fourth section provides an assessment of four hypotheses suggested by the literature. The fifth concludes.

7.1 Status of Reserve Bank of Australia

In 1911, a left-wing Australian government established the Commonwealth Bank of Australia as a state-owned commercial and savings bank to compete with private

commercial banks for the public's business. In 1959, *the Reserve Bank of Australia Act* ("RBA Act 1959") divided the Commonwealth Bank into two, creating the Reserve Bank of Australia to act as the country's central bank, while the commercial and savings banking functions continued under the old entity. The RBA was given responsibility for monetary policy, as well as financial system stability, the safety and efficiency of the payments system, and the monopoly on the issuance of Australian currency. Its main counterpart is the Treasury, which has responsibility for economic policy advice and exchange rate issues.

The statutory objective of the new central bank were set out in section 10(2) of the *RBA Act 1959*:

It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank ... are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:

- (a) the stability of the currency of Australia;
- (b) the maintenance of full employment in Australia; and
- (c) the economic prosperity and welfare of the people of Australia.

Like the Bank of Canada, the RBA's mandate combines goals for employment, growth and price stability, allowing flexibility in the interpretation of these objectives. The RBA acts as agent for the government in its domestic debt issues, and prior to 1986 was the major holder and market maker in the secondary market for Treasury securities. The RBA has sole responsibility for foreign exchange operations and owns Australia's foreign exchange reserves that form part of its balance sheet (Committee 1993b,

p.154).¹ Under the original *RBA Act 1959*, the RBA did not have responsibility for supervising banks, although it developed this responsibility informally over time and had a statutory responsibility between 1989-1998 as discussed below. Finally, under section 30 the net profits of the RBA are transferred to the Treasury.

Under section 8A (2), the Reserve Bank Board is responsible for the RBA's monetary and banking policy and for the Bank's policy on all other matters, except for payments system policy. Monetary policy decisions are made by majority vote of the nine-member Board, with the RBA Governor acting as Chairman and holding the casting vote. The Secretary to the Treasury also sits on the Board. The government appoints all Board members – the Governor and Deputy Governor for seven-year terms and the other Board members for five-year terms. The Governor and the Deputy Governor hold office subject to good behaviour and may be reappointed.

Measuring the Independence of the RBA

Like the Bank of Canada, neither experts nor market participants can agree on the degree of independence of the RBA. Bade and Parkin (1988) and Eijffinger and Schaling (1993) view it as one of the more dependent central banks among industrial countries, while Grilli et al (1991) view it as having relatively high independence. Cukierman et al (1992) place it in the middle of twenty-eight countries, ranking it 12th. The index used by Hall and Franzese (1998), which averages other indices, ranks Australia last out of 18 industrial countries making it the most dependent central bank in their sample. Standard & Poor's MMS *Guide to Central Banks* provides rankings of central bank independence from a financial market perspective, and places the RBA 15th out of 30 central banks, behind the central banks of Hungary, Slovakia and Colombia.

¹ The RBA engages in foreign exchange intervention with – as a practical matter – no prior consultation with the Treasury, although the RBA keeps the government informed of major developments.

In summary, these legal indices place the RBA in the middle to the lower half of the spectrum, a ranking indicative of the lack of consensus.

Table 48: Standard & Poor's MMS Ranking of Central Banks

Country	Score	Country	Score	Country	Score
Canada	91.67	Hungary	76.60	Hong Kong	56.60
Denmark	86.67	Slovakia	73.30	Indonesia	55.00
Japan (post-98)	86.00	UK (post-97)	65.00	Singapore	50.00
ECB	85.00	Colombia	63.33	Philippines	50.00
Czech Rep	83.30	Australia	63.33	Thailand	45.00
USA	81.60	Romania	61.67	Argentina	41.60
Switzerland	80.00	Russia	61.67	China	38.30
N.Zealand (post-89)	80.00	Mexico	61.60	Taiwan	31.60
Sweden	80.00	Poland	61.60	S.Korea	30.00
S.Africa	78.30	Norway	60.00	Brazil	26.60

The argument that the RBA is politically dependent rests on a number of provisions in the *RBA Act 1959* which give the government direct and indirect power over the RBA.

First, under section 14(1) the Secretary to the Treasury is a voting member on the RBA Board of Directors, which has the legislated responsibility for making interest rate decisions. Like the majority of central banks, the government makes all appointments to the Board, and the membership of the Board ensures that the government appointees form the majority.² While the voting of the Board is recorded, the minutes of these meetings are not published and are effectively unavailable to the public.³ Board members are appointed for 7 year terms, significantly longer than Australia's 3-year election cycle.

² The Board has nine members: the RBA Governor (who is also Chairman), the Deputy Governor, the Secretary to the Treasury and six other members. Of the remaining six members, at least five must be persons who are not officers of the RBA or of the Australian Public Service.

³ A request to publish the Board minutes is regularly raised by the House of Representatives Select Committee, chaired by David Hawker. See press comment on this issue for the period July-August 2000.

Section 11(1) of the *RBA Act 1959* requires the RBA Board to inform Government of the RBA's monetary policy. Section 13 states "the Governor and the Secretary to the Department of the Treasury shall establish a close liaison with each other and shall keep each other fully informed on all matters which jointly concern the Bank and the Department of the Treasury". In practice the Governor and Treasurer consult regularly through weekly telephone calls and monthly meetings timed to coincide with RBA Board meetings (Committee 1993b, p.154). Before announcing a change in monetary policy, the Governor advised the Treasurer of the decision taken by the Board. The respective responsibilities for Australia's monetary policy were clarified in a joint statement issued in 1996 by the Treasurer and the newly-appointed RBA Governor, a *Statement on the Conduct of Monetary Policy* ("the 1996 Statement"). Until this time, both the RBA and the Treasurer issued press releases announcing a change in monetary policy, but this practice was ended as it led created the potential for confusion.⁴

Second, the Government has the right to issue a directive to the RBA in the event of a disagreement over monetary policy, under section 11 of the *RBA Act 1959*. This directive is public and must be laid before Parliament within 15 sitting days.⁵ This directive establishes the government's ultimate control over monetary policy similar to the case of the Bank of Canada. A directive has never been issued and – again similar to the Bank of Canada – this power is seen as a knife that cuts both ways, either increasing or decreasing central bank autonomy based on how it is interpreted.

⁴ The Treasurer will commonly hold a press conference to discuss the implications of rate changes for the economy, but this arrangement is ad hoc.

⁵ If the Treasurer and the Board cannot reach agreement, a formal process exists allowing the Treasurer to determine the policy to be adopted by the Bank. The process involves a number of parties, and ensures such an action is made in a transparent fashion.

Third, government intervention in the Australian financial system prior to the 1980s meant that the monetary instruments available to the RBA were limited.⁶ The financial sector was heavily controlled through government restrictions on interest rates and bank loans, and the Australian dollar was pegged to the US dollar. Debt management dominated monetary policy, as the Treasury would set the interest rates on securities sold to the public, making up any shortfall in its deficit financing by placing Treasuries with the RBA (RBA 1993). To further complicate matters, the government often sold securities to offset the monetary effects of foreign exchange movements. The RBA needed the Treasurer's permission to change its monetary instruments as the government regulated both interest rates and the quantity of bank loans. The RBA gained greater operational independence from government in the 1980s following financial sector deregulation (Capie, Goodhart, and Schnadt 1994, p.224). From 1979 the government began auctioning Treasuries, and in 1985 it negotiated an overdraft facility with the RBA. Finally in 1986, the Treasury recognised that it needed to finance its deficit entirely with auctioned securities, and in an exchange of letters the Treasurer informed the RBA that the government would no longer place Treasury bills with the RBA.⁷ Only when these changes were in place could the RBA make effective use of open market operations as the main instrument of monetary policy without Treasury interference. However these agreements remain informal, and technically the government could force the RBA to monetize its debt. Such a situation would inevitably lead to a public confrontation between politicians and the RBA, as it would compromise the inflation target. On this basis of these legal and operational provisions, the RBA is portrayed as having only a tenuous form of independence.

⁶ The RBA relied on moral suasion and more direct controls on the banks, as opposed to the more indirect instruments used today.

⁷ The RBA continues to purchase government debt, but only to replace maturing issues or in the course of open market operations.

7.2 Challenging Economic Background

Political debates concerning RBA independence emerged during the 1980s against the backdrop of a challenging external environment. Australia, like New Zealand, faced difficulties with government finances, the balance of payments and the traded sector. In 1983, the incumbent Liberal-National coalition under Prime Minister Fraser was defeated by an untested Australian Labor Party ("ALP") led by Prime Minister Hawke that took power after nearly a decade out of office. The new ALP government was faced with two immediate problems – a larger-than-expected budget deficit of A\$9.1 billion and speculation against the currency in international markets. Prime Minister Hawke and Treasurer Keating were forced to make an about-turn on their election promises, dumping the government's expansionary policy that had been paraded in the election campaign, and devaluing the currency by 10 per cent (Carew 1992, p.90). Like their counterparts in New Zealand, the ALP subsequently instituted a series of neo-liberal reforms that went far beyond what the previous conservative government had thought possible - reforms described as a hybrid of neo-liberalism and neo-corporatism (Castles et al. 1996; Higgott 1991; Keating et al. 1989).

Treasurer Keating's mini-budget in May 1983 signalled the start of the ALP's conversion to 'economic rationalism'. The ALP began a radical deregulation of the financial sector along the lines proposed by the Campbell Inquiry into the Australian Financial System – reforms which the ALP had opposed in opposition and were seen by the incumbent conservative government at the time as too radical (Carew 1992, p.97; RBA 1989b). The highlight of the reforms was the decision taken in December 1983 to float the currency and to remove exchange controls - a decision forced on the ALP government by speculation against the exchange rate peg. Prime Minister Hawke recalls how the inflow of foreign capital into Australia in 1983 and early 1984 forced the ALP government to introduce these reforms, despite opposition to this move by Treasury

Secretary John Stone. "With hundreds of billions of dollars washing around the world every day it was futile to believe that our little economy could say to the rest of the world: 'Listen and learn, this is going to be our exchange rate today, like it or lump it'" (Hawke 1994, p.246). The extent of the ALP's neo-liberal turn was highlighted in 1984 when both *Institutional Investor* and *Euromoney* magazine named Treasurer Keating as the Finance Minister of the Year (Carew 1992, p.122).

The main plank of the ALP's strategy was the 1982 Prices and Incomes Accord ("the Accord"), agreed with the peak organisation for the unions, the Australian Council of Trade Unions ("ACTU").⁸ Prime Minister Hawke had actually negotiated the terms of the Accord when he served as ACTU President during the late 1970s, with then ALP party leader Bill Hayden and Shadow Treasurer Ralph Willis. The details were then finalised in late 1982 (Carew 1992, p.78) The Accord was approved by the ACTU membership at a special conference in February 1983 and adopted by the newly elected government following a national economic summit in April 1983 (Carew 1992, p.77).⁹ The ACTU agreed to nominal wage restraint in exchange for a government promise of a tax cut to benefit the unions, which was delivered as part of the August 1984 budget (Carew 1992, p.83). The Accord covered public sector and private sector workers alike and held base pay hikes below inflation during the 1980s. The Accord was renegotiated eight times between 1983 and 1996, with later versions contained allowances for second-tier wage hikes based on productivity increases (Schwartz 1994; Stilwell 1993). By promoting voluntary wage restraint under encompassing unions, the Accord allowed

⁸ Trade unions were willing to consider wage restraint under an ALP government due to the anti-union rhetoric of the incumbent conservative Fraser government that had imposed wage indexation in response to inflation (Bray et al. 1996, p.72).

⁹ The four-day summit was held in the House of Representatives and was attended by 33 delegates representing government, industry and the trade unions.

real unit labour costs to fall along with unemployment, which declined from a post-war peak of 10 per cent in 1983 to a low of 6.3 per cent in 1989.

The ALP government faced financial difficulties on all fronts. Domestically, a sharp wage explosion in 1982 accompanied by a sharp depreciation of the Australian dollar was followed by a severe recession in 1982-1983.¹⁰ The government then faced rising current account deficits that reached 6 per cent of GDP in 1989. In May 1986, Treasurer Keating suggested in a radio interview that Australia may become a 'banana republic' and warned of an impending financial crisis – a statement that captured headlines, caused a sharp fall in the currency and opened a rift with Prime Minister Hawke (Carew 1992, p.172; Castles et al. 1996, p.15).

Internationally, rising current account deficits led to historically unprecedented foreign debt levels that quadrupled between 1983 and 1989, reaching 45 per cent of GDP, leading Moody's to downgrade Australia's foreign currency rating from Aaa to Aa1 (Higgott 1991).¹¹ Foreign currency debt issued in international capital markets represented 30 per cent of Australian government debt by June 1987 (Johnson 1997).¹² In July 1989, Treasurer Keating banned Treasury and RBA staff from speaking to Moody's officials when they conducted their review of Australia's rating, which did not help Australia to avoid a second downgrade from Aa1 to Aa2 (Carew 1992, p.261).

Table 49: Australian Gross Debt Levels (% of GDP)

¹⁰ In the area of trade, Australia and New Zealand were caught up in a trade conflict between the US and its main trade partners, Japan and the European Community, over agricultural subsidies (Higgott 1991).

¹¹ More than three-quarters of foreign debt was issued by the private sector (Higgott 1991, p.16).

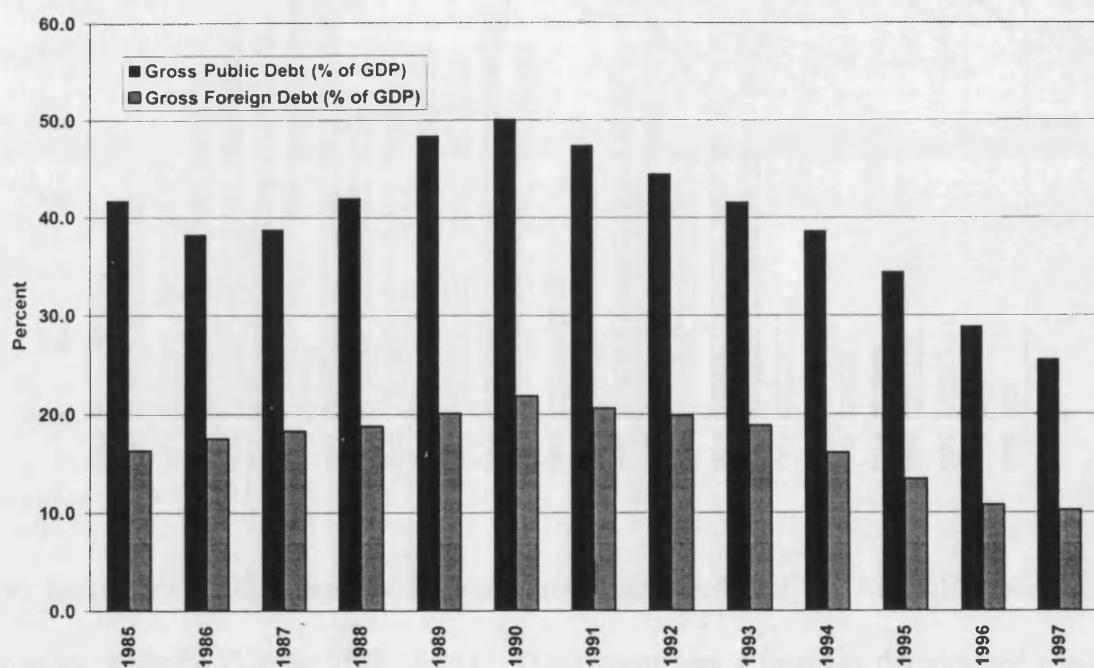
¹² This amount does not include foreign currency borrowing by private Australian companies, or government-owned entities.

Date	Private Sector	Public Sector ¹	Total Debt	Of which Foreign Debt
1989	92.2	41.8	133.9	45.1
1990	94.4	38.3	132.6	49.1
1991	94.8	38.8	133.6	50.9
1992	93.3	42.0	135.4	51.9
1993	90.0	48.4	138.4	54.0
1994	88.4	50.1	138.5	54.1
1995	89.9	47.4	137.4	55.1
1996	94.1	44.5	138.7	54.4
1997	96.9	41.6	138.6	56.7
1998	100.7	38.7	139.4	60.0
1999	108.2	34.5	142.7	61.1
2000	114.1	28.9	143.0	64.8
2001	121.7	25.6	147.2	76.4

1. Debt issued by Commonwealth and states.

Source: Australian Bureau of Statistics

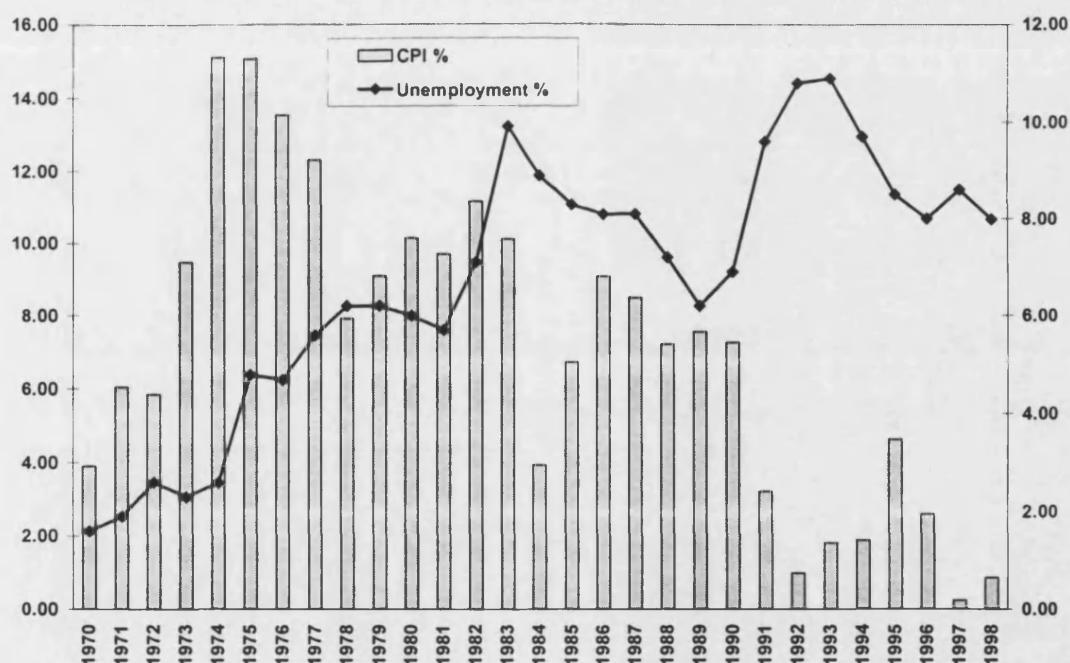
Figure 10: Australian Public Debt Levels



However, the measures introduced by the ALP succeeded in turning around the government's finances. In September 1987 Treasurer Keating was able to announce a balanced budget, the first in 17 years (Carew 1992, p.229). A budget surplus followed

in August 1988 - the first surplus in 35 years - allowing the government to start paying down the Commonwealth's foreign debts (Carew 1992, p.245).¹³ Despite success in controlling the government finances, headline inflation remained stubbornly high, above 7 per cent at the end of the 1980s. Driven by financial deregulation and the unindexed tax system, speculation had pushed up asset prices in real estate and equity (Grenville 1997, p.138). In response to these inflationary pressures, the RBA pushed up short term interest rates by 7 per cent between April 1988 and July 1989 in order to support the currency and to cut off inflation, bursting the asset bubble, and contributing to an unexpectedly severe recession in 1990-91.

Figure 11: Australian Inflation and Unemployment Performance



By November 1990, Treasurer Keating finally admitted that the Australian economy was in recession (Carew 1992, p.284). The government's finances deteriorated again, running from a surplus of 1.8 per cent of GDP in 1989-1990 to a budget deficit of 4.2 per cent of GDP in 1992-1993 (Singleton 1997, p.118). Despite its negative effects on

¹³ In Australia, the budget moved from a deficit of over 4 per cent of GDP in 1983-84 to a surplus of over 2 per cent in 1989-90 (Debelle 1996, p.65).

the government's finances, the recession succeeded in bringing down inflation to around 2 per cent by 1992, where it remained for the remainder of the 1990s. Official interest rates declined by 5 per cent over 1991. The Australian currency depreciated by 20 per cent between 1988 and 1993. Currency depreciation further worsened Australia's foreign debt situation by pushing up its value in Australian dollars, although Australia's net foreign liabilities remained unaffected due to an off-setting inflow of foreign equity investment.

This brief review has highlighted the complicated interaction of monetary policy and international economic policy for a small, open economy like Australia. The ALP and the RBA were forced to take radical steps to bring the government finances and inflation under control. The ALP introduced nominal wage restraint in cooperation with the trade unions under the Accord. It floated the currency and deregulated the financial system. The ALP also introduced tax reform and pursued a tight fiscal policy through spending cuts in combination with a disinflationary-monetary policy. These reforms, together with a restrictive monetary policy, contributed to a recession that finally brought down inflation, but these changes played havoc with Australia's export sector and foreign currency debts, and pushed up unemployment.

7.3 Political Debates over RBA Independence

Greater RBA independence was publicly debated in Australia on a number of occasions between 1989 and 1996. The issue gained prominence following the 1989 reforms in neighbouring New Zealand. An off-hand remark in February 1989 by ALP Treasurer Keating to the effect that the RBA 'did what he told it to do' led to accusations from the press and the opposition that the RBA was under the influence of the ALP government. The debate heightened in 1989 with Treasurer Keating's appointment of Treasury Secretary Bernie Fraser as RBA Governor. This debate was politicised from 1991-1993

when the opposition Liberal-National coalition campaigned for greater RBA independence and with a mandate of price stability. The debate ended in 1996 when the newly elected Liberal-National government issued a joint statement with Governor-designate Macfarlane that endorsed the RBA's inflation target and reiterated the government's support of the RBA's independence. Each of these political episodes will be described in turn.

Appointment of Governor Fraser

The issue of RBA independence took on political significance following the appointment in 1989 of former Secretary of the Treasury Bernie Fraser as RBA Governor, a move that was seen as reducing the independence of the RBA. Fraser was known as a close confidant of the ALP Treasurer (and later Prime Minister) Keating, who had appointed Fraser as Secretary of the Treasury in 1984 (Debelle 1996; Fraser 1996; Macfarlane 1998). Shadow Treasurer (and later Opposition Leader) John Hewson alleged that the government had pressured the RBA to ease interest rates in the run-up to the March 1990 election, which was won by the incumbent ALP (Macfarlane 1998).¹⁴ In a press release on 15 May 1991, Hewson stated: "It is absolutely essential that the Reserve Bank be free of political interference so as to be able to implement monetary policy in a sustainable, consistent, and transparent manner".¹⁵ These accusations of government interference were rejected publicly by RBA Governor Fraser on numerous occasions. He denied them shortly after his appointment in 1989 and continued his denials with his last speech as governor in 1996 (Fraser 1989, 1991, 1996). "We can and do pursue our statutory responsibilities without political

¹⁴ The conservative opposition had levelled similar accusations RBA Governor Johnston between 1986 and 1989 (Fraser 1991, 1996). See also the letter to the Editor in the *Australian Financial Review* on 7 October 1988.

¹⁵ Hansards, 15 May 1991, "Question without Notice: Employment", p.3769.

interference. But we seek to do this in close consultation with the government – to exercise *independence with consultation*” (Fraser 1993, original emphasis).

Predictably, Governor Fraser downplayed the need to legislate greater independence for the RBA or give it a narrower mandate of price stability. Governor Fraser’s voiced three objections to independence. First, increased central bank independence does not necessarily lead to low inflation without the support of fiscal and wage policies. Second, credibility cannot be legislated - it must be earned. And third, multiple monetary policy objectives combined with policy flexibility are important in the Australian context given the need to respond to domestic and international shocks (Fraser 1994b). The suggestion that low inflation is the result of central bank independence, Fraser argued, was over simplistic. In support of this view he cited the anti-inflationary sentiment of the German people and the performance of the politically controlled Bank of Japan (Fraser 1989). Governor Fraser argued that the RBA has not been inhibited from raising interest rates under the current framework, as had occurred over 1988-89. He concluded that “the quality of the Bank’s analysis and its capacity to persuade the Government...count for more than enhanced legislative ‘independence’” (Fraser 1989).

Nor did Governor Fraser feel the RBA’s mandate should be narrowed to the pursuit of price stability, as the effects on the real economy could not be ignored. “As a practitioner, rather than a theoretician, I believe a central bank has to be concerned about growth as well as inflation objectives...[There] is always a good deal to be said – from the practitioner’s perspective – for retaining a wider margin of flexibility and discretion than is normally available with targets” (Fraser 1991, p.5). Focussing solely on price stability by adopting an inflation target would lead to ‘unacceptable recessionary costs’ and would unnecessarily constrain the RBA. On these points,

Governor Fraser had the full support of Deputy Governor Phillips, a known inflation hawk and career central banker (Phillips 1992). Given that inflation had been brought down to 3.5 per cent by 1991, the urgency of such a reform was not apparent.

Fightback! and Inflation Targeting

RBA independence became politicised when this proposal was included in the Liberal-National coalition's *Fightback!* package, unveiled in November 1991. *Fightback!* formed the basis of their 1993 electoral platform and was portrayed by critics as the Australian equivalent of the 'economic rationalism' introduced in New Zealand (Easton et al. 1996, p.24). *Fightback!* featured a proposal to amend the *RBA Act 1959* to legislate greater central bank independence and a single objective of price stability. Liberal MP Reith outlined the opposition's proposals:

The changes to tackle inflation will have to be extensive. Firstly, the incoming government will have an unshakeable commitment to beating inflation. Secondly, we will set a clear target for eradicating inflation...of nought to 2 per cent... Thirdly, we will secure real independence for the Reserve Bank by amending the Reserve Bank Act 1959. I have already prepared a first draft, which will be an exposure draft in due course, of the amendments on which we will seek comment, and which we will eventually introduce. The legislation will establish a new charter for the Reserve Bank with price stability, beating inflation or taking on inflation as its principal objectives.¹⁶

The Liberal-National coalition proposal, as envisaged, would 'tie the hands' of the government and eliminate any future political interference in the setting of interest rates.

The proposals contained in *Fightback!* owe much to Liberal leader Hewson's professional and academic background. Hewson completed a PhD in economics at John

Hopkins University and worked at the IMF, before returning to Australia to serve as Visiting Economist at the RBA from 1974-76. This academic training and professional work experience shaped his belief in free-markets and his opposition to political intervention in the economy (Abjorensen 1993, p.64). In 1976 Hewson became Economic Advisor to the Liberal government and, together with Liberal MP John Howard (later Prime Minister), wrote the terms of reference for the Campbell Inquiry into the Australian Financial System (Abjorensen 1993, p.81). Hewson then took up his post at the University of New South Wales, which he supplemented in 1985 by serving as Chief Economist of the newly founded Macquarie Bank. Hewson successfully ran for Parliament in 1987 for the Liberal Party, was named Shadow Minister for Finance in the Howard opposition in 1988, being named Liberal party leader following the 1990 election defeat. The *Fightback!* package unveiled halfway through the parliamentary term in November 1991 was put together by Hewson, Peter Reith and John Howard. Apart from legislative independence for the RBA with an inflation target, *Fightback!* featured a proposed 15 per cent Goods and Services Tax ("GST"), a major cut in the size of government, reduction in trade protection and wage-setting reforms (Barnett et al. 1997, p.579). It was accompanied by a set of industrial relations proposals under a second document, *Jobsback*.

The ACTU was strongly opposed to *Fightback!*, viewing it as doctrinaire and inappropriate in the Australian context. As an ACTU representative recalls: "We did not publish any 'research' defending the multiple goals of the RBA. Our 1983 'Accord' with the then Labor government was premised on fighting unemployment and inflation simultaneously and rejecting 'fight inflation first' monetarism. It has always been our position that the Bank can and should pursue full employment and low inflation in

¹⁶ Hansards, 15 May 1991, "Price Stability: Discussion of Matter of Public Importance", p.3780.

maximising the welfare of the nation's people." A formal inflation target was unnecessary, as the 1990 Accord included an agreement to achieve wage settlements at a level consistent with Australian inflation remaining in line with that of our trading partners. In practical terms, that meant keeping inflation in a 3% - 4% range.¹⁷

The ALP's initial failure to adequately respond to the Liberal-National coalition's *Fightback!* economic package led the ALP caucus to depose Hawke as party leader and Prime Minister in favour of Keating in December 1991 (Barnett et al. 1997, p.583; Carew 1992, p.299).¹⁸ Prime Minister Keating rejected greater independence for the RBA on the grounds of parliamentary accountability during parliamentary debates in 1991 and 1992. He argued that the current division of responsibilities between the Treasury and the RBA and the multiple objectives for monetary policy was appropriate, citing retiring Deputy Governor Phillips views in support.¹⁹ Keating went on to claim that the RBA had independence, and that the opposition's interpretation of the situation – and Keating's comments about 'his pocket' – were false. Keating stated:

I have said in the Parliament on a number of occasions that governments and parliaments should be the supreme and accountable bodies to the public of Australia and that the right balance exists between the powers of the Reserve Bank under its legislation and the prerogatives of the government. That is an appropriate balance between the prerogatives of the government and the rights and entitlements of the Reserve Bank board. I have said that the existing arrangements work well, that the Reserve Bank Act is crafted well to encourage the board and the government to agree, and that price stability and full

¹⁷ Grant Belchamber, Senior Research Officer of ACTU, correspondence dated 13 and 14 August 2001.

¹⁸ After unsuccessfully challenging Hawke as ALP leader in June 1991, Keating resigned the Treasury portfolio and retired to the backbench.

¹⁹ Hansards, 26 March 1992, "Question without Notice: Reserve Bank of Australia", p.1232.

employment are the dual objectives. They were well constructed when the Act was written and they remain well constructed.²⁰

The ALP argued that the proposals in *Fightback!* would lead to a rise in interest rates and unemployment. ALP Treasurer Dawkins argued: "What [Hewson] knows is that, as a consequence of trying to target, amongst other things, inflation between zero and 2 per cent and, as a result, put up interest rates and therefore make Australian industry and Australian jobs the chopping block of the Opposition's policy, unemployment must go up".²¹ Prime Minister Keating responded to *Fightback!* by launching a jobs-based package, *One Nation*, in February 1992. At the time, unemployment stood at 11.2 per cent. *One Nation* included proposals aiming for higher inflation in the range of 3 to 4 per cent, in contrast to the 0 to 2 per cent proposal in *Fightback!*.

In the 1993 election, the ALP was re-elected with a sizeable majority. Political scientists attribute the result to the failure of Hewson's *Fightback!* to offer any solution for the rising unemployment. Instead their program looked set to make the situation worse (Singleton 1997, p.114). Following this defeat, Hewson was replaced as opposition party leader in May 1994 and the proposal to change the RBA's legislation was subsequently dropped by the Liberal Party.

Market Pressure and the 1996 Joint Statement

Developments in the bond markets appeared to cast doubt on the RBA's commitment to price stability. Despite having a significantly lower debt than either Canada or New Zealand, the long term interest rate differential between Australia and the USA rose during late 1993 and early 1994 to a level higher than Canada or New Zealand (Debelle

²⁰Hansards, 9 September 1992, "Question without Notice: Reserve Bank of Australia", p.596.

²¹ Hansards, 24 March 1992, " Question without Notice: Reserve Bank of Australia ", p.938.

1996). Bernanke et al (1999) highlight financial market concerns with the government's credibility:

While it became clear in early 1994 that the Australian economy was rebounding strongly from the 1990-91 recession, the bond market downturn over the first half of 1994 sent 10-year government yields from 6.4 per cent to 9.6 per cent. That was twice the increase in long-term yields in the United States, and 1 per cent more than in New Zealand, suggesting that the Reserve Bank's commitment to price stability was not fully credible among financial market participants (p.222).

Debelle (1996) suggests that this premium may be due to Australia's "lower anti-inflationary credibility" (p.71). Meanwhile the Australian dollar was being described in the financial markets as the 'peso of Asia'.

Governor Fraser was on the defensive, making two major speeches on the topic of central bank independence towards the end of the year (Fraser 1994a, 1994b). He argued that a central bank with multiple objectives such as the RBA, the Fed or the Bank of Canada was not by definition 'soft' or 'wimpish' on inflation. Governor Fraser repeated his view that "[Underlying] inflation of around 2 to 3 percent is a reasonable goal for monetary policy", describing such a rate as "not dramatically different from the more formal targets in the United Kingdom, Canada and New Zealand" (Fraser 1994a). He concluded by noting that the RBA had gained significant instrument independence in the 1980s through deregulation in the financial sector and the separation of debt management from monetary policy. Fraser repeated these points more forcefully in the second speech in which he gave his strongest criticism of central bank independence to date (Fraser 1994b).

The issue of RBA independence re-emerged during the 1996 election. Prime Minister Keating painted the opposition's position in terms of a distributional conflict over inflation in a radio interview:

If this Government were to be defeated, the Accord goes, the sensible wage outcomes go. So the only way you run the economy is then through higher interest rates. A Liberal Government would turn straight to the Reserve Bank. When they talk about Reserve Bank independence - you know this expression they use - that's just code for higher interest rates. Every percentage point on the inflation rate is one percentage point on interest rates, and they would run a low-growth, low-employment society. (Source: Hansards)

The opposition, led by Liberal MP Howard, refuted these claims, with Shadow Treasurer Peter Costello announcing that a Liberal-National coalition, if elected, would not seek to change the statute governing the RBA.

In March 1996, the centre-right coalition of the Liberal and National Parties was elected under Prime Minister Howard, ousting the ALP that had been in power for thirteen years. Bill Kelty, ACTU Secretary and a member of the RBA Board, resigned his position in protest only to be replaced by a representative of the powerful mining industry. Given that Governor Fraser's term was set to expire, Prime Minister Howard nominated a new RBA Governor, Ian Macfarlane, who had served as Deputy Governor under Fraser. Then in August 1996, the Liberal government issued a joint *Statement on the Conduct of Monetary Policy* with Governor-designate Macfarlane – a statement that was prepared without Fraser's knowledge (Fraser 1996; Macfarlane 1996). “The Government recognises the independence of the Bank and its responsibility for monetary policy matters and intends to respect the Bank's independence as provided by statute” (RBA 1996, p.1). However, the statement went on to cite the governments

right under the Act to direct the RBA and the RBA Board's requirement to inform the Government of the RBA's policy. Treasurer Costello publicly endorsed the RBA's inflation target of 2 to 3 per cent over the business cycle.²² Governor Fraser's reaction was suitably sardonic: "[While] I see no particular need to be further emphasising the inflation objective, that will, no doubt, be welcomed by many in the central banking fraternity, the financial markets and at least some parts of the media" (Fraser 1996). The inflation target was to be supported by arrangements to ensure transparency and accountability, such as semi-annual statements on monetary policy and appearances by the Governor before a Standing Committee of the House of Representatives. Finally, the government ended the practice of making parallel announcements of monetary policy changes, reinforcing the RBA's control of this instrument.

The 1996 joint-statement was intended to increase the anti-inflationary credibility of monetary policy by specifically addressing the concerns of international financial markets concerning the RBA's independence from politicians (Australia 1998, p.23). In a press conference following the announcement, Treasurer Costello made this clear, stating:

The purpose of this statement is not only for Australia but internationally. To underline the independence of the Bank, the responsibilities that come with that, and the accountability that comes as a consequence. I want to make it entirely clear, that the statement is designed to enhance the independence, the transparency and the accountability of the Bank and indeed the Government.

²² By 1995, ALP Treasurer Willis was openly endorsing the RBA's inflation target, but nowhere was this endorsement formalised (Macfarlane 1998). It was also included in the June 1985 agreement between the ALP government and the ACTU over the Accord Mark VIII.

statute governing the central bank in order to remove the threat of political interference (Hendy et al. 1995). Opponents of central bank independence argue that the current arrangements provide too much independence and undemocratic accountability for the RBA (Eichbaum 1993; Gangopadhyay 1996). For the purposes of this thesis, the failure to change the RBA's legislation must be seen as an exception to the overall trend in the 1990s towards legislating greater operational independence for the central bank, narrowly conceived. The RBA still has multiple goals for monetary policy, a Treasury official sits on the Board, and the government has the ultimate power to issue a directive to the central bank in case of a disagreement on monetary policy. Rather than giving the RBA more independence, the 1996 Statement endorsed the RBA's intermediate target and its *de facto* independence in the setting of monetary policy. Given this interpretation, which theories from the literature best explain the failure of politicians to change the legislation of the RBA?

Domestic Interest Group Lobbying

Financial Sector

Posen's hypothesis concerning effective opposition by the financial sector has not been supported, despite the Australian case satisfying most of the criteria Posen argued would render financial sector opposition effective: a federal political structure, a stable dual-party system with low fractionalisation, and a concentrated financial sector with shared preferences opposed to inflation. The development of the Australian financial sector has concentrated economic power in the hands of four, oligarchic commercial banks – ANZ, Westpac, National Australia Bank and the Commonwealth Bank – that are represented by an encompassing trade association, the Australian Bankers Association. The market position of these domestic banks was protected from international competition by a ban on foreign banks that was only lifted in 1986 when

²³ Hansards, 14 August 1996, "Speech by the Hon. Peter Costello, MP. Commonwealth Treasurer".

The statute governs the Bank's responsibilities. The Government does not propose any change to the statute.²³

The joint statement obviated the need to reform the *RBA Act 1959*. Governor Macfarlane gave his own view of events, saying “The Statement...at the time of my appointment was a means of clearing up any remaining ambiguity about the relationship between the Government and the Reserve Bank” (Macfarlane 1996). He went on to acknowledge that “it is not possible to point to an exact date when the Reserve Bank passed from being dependent to independent” but he sees it occurring as a result of the institutional changes taken by the government between 1983 and 1996 (Macfarlane 1998).

That the incoming conservative government saw the need to publicly re-assert the independence of the central bank suggests that the current arrangements lacked the transparency that private actors desired. By endorsing the RBA's inflation target as the operational guide for monetary policy, the government created a more transparent framework by which to judge monetary policy decisions. This endorsement effectively narrowed the RBA's mandate to the pursuit of price stability. This change was consciously taken without amending the RBA Act 1959 and without narrowing the statutory goals of the RBA. While the joint statement does not qualify as a legal or *de jure* change in the RBA's institutional framework, it clearly reflected a *de facto* move towards greater central bank independence.

7.4 Assessment of Hypotheses

The Australian case represents something of an unsatisfactory conclusion for research into central bank independence, as it does not present a clear victory for either side of the debate. Some economists continue to argue that there remains a need to change the

16 foreign banks were granted licenses. The banking market was also protected from domestic competition by government controls on bank lending and interest rates, and legal restrictions on the activities of different classes of institutions. These criteria should have translated the commercial bank's economic power into significant political influence.

This does not appear to be the case, judging from the evidence. Under the ALP, Treasurer Keating overcame opposition within his party to allow the entry of foreign banks, on the basis that refusing foreign entry would only benefit the domestic banks who were the traditional enemies of the left (Hawke 1994, p.253). Foreign entry put pressure on domestic banks' profits leading to bankruptcy of a number of smaller institutions when the business cycle turned. Then in 1990, Treasurer Keating vetoed a proposed merger between the ANZ Bank and National Mutual Life in 1990, arguing that it was contrary to the national interest (Carew 1992, p.271). Finally in 1990 Treasurer Keating announced an inquiry into competition in the Australian banking sector, on the basis that the banks were earning excessive profits by failing to reduce their interest rates in line with the official rate even as the economy began to stall (Carew 1992, p.279). Nor did the commercial banks fare better under the Liberal government elected in 1996, as Treasurer Costello vetoed more proposed bank mergers.

The failure of Australian banks to realise their political influence may be explained by their failure to meet two of Posen's criteria for effective influence. During the period being studied, these banks did not operate as universal banks, due to the historical and legal separation of financial services. However they did gain significant exposure to investment banking over the course of the 1980s, as deregulation allowed them to become more involved in investment banking. A second barrier identified by Posen was

the regulatory structure. The commercial banks may have faced a conflict of interest in supporting greater independence for the RBA, which had primary responsibility for banking supervision up until 1998. Still researchers note that the closed network of Australian banking, with limited participation by foreign banks and an informal regulatory structure prior to 1989, created a strong set of ties between the banks and the RBA that only eroded over the 1990s. In this view, the regulatory structure should not have prevented the banks from lobbying for greater central bank independence.

Business

Business had little political influence over the ALP government, although it fared better under Prime Minister Hawke than it did under Prime Minister Keating. Prime Minister Hawke developed a harmonious relationship with business without betraying the Australian Labor tradition (Castles et al. 1996; Singleton 1997). He established independent bodies such as the Economic Planning Advisory Council, the Industrial Relations Commission and the Australian Manufacturing Council as public forums for developing a consensus around the need for economic reform. By contrast, Treasurer Keating had made his antagonism towards business clear, stating on the eve of the 1989 election that any business executives who backed the Liberal-National coalition would be cut off from government. This vindictiveness may have resulted from the role played by business associations in sinking Keating's proposed consumption tax at a Tax Summit held in July 1985.²⁴

Prime Minister Keating preferred to deal with individuals rather than groups, and under his term as Prime Minister he showed no interest in meeting with business representatives or of formal tripartite bargaining arrangements. He froze out the

influence of Economic Planning Advisory Council set up by Prime Minister Hawke as the main forum for interest-group consultation on the economy, then remodelled it as the Prime Minister's Economic Round Table, staffed by experts rather than interest-group representatives. True to his word, Keating refused to deal with the Australian Chamber of Commerce and Industry ("ACCI") following the 1993 election due to this group's public endorsement of the Labor-National coalition's *Fightback!* proposals. When asked about the ACCI's role in government policy, Prime Minister Keating commented that the ACCI could put in all the submissions it liked, but they would go 'straight into the wastepaper basket' (Singleton 1997, p.144). Business groups like the Business Council of Australia, the Metal and Trades Industry Association and the ACCI did retain contact with the ALP government, but only at the bureaucratic and ministerial level and only on a non-partisan basis.

Organised labour

The failure to legislate greater central bank independence for the RBA may be explained by opposition to such a move by the trade unions, acting through the ACTU. Organised labour assumed considerable political influence following the election of the ALP in 1984. The trade unions were in a position to control ALP policy as they held significantly more than half the votes at ALP conferences where party policy is decided (Castles et al. 1996, p.13). Senior ALP officials had close, personal links with the unions, especially with Prime Minister Hawke who had worked for the ACTU for more than two decades. While at the ACTU, Hawke has sat on the RBA Board for a number of years, later to be replaced by ACTU Secretary Bill Kelty. Kelty had a close personal and working relationship with Prime Minister Keating, which developed during the

²⁴ The summit was attended by 160 delegates with business associations representing a third of the delegates, represented by the Business Council of Australia, the Confederation of Australian Industry, and the ACCI (Carew 1992, p.135).

early years of the Accord that they renegotiated together a number of times to adapt to changing external circumstances (Carew 1992).

Institutional ties between the ALP and the ACTU allowed the ALP to pursue 'bilateral-corporatism' with the trade unions, rendering the process of Australian policy reform more consensual, slower, and less painful to organised labour (Castles et al. 1996, p.11).

The Accord is given much of the credit for Australia's relatively costless disinflation relative to Canada, New Zealand, and the UK (Debelle 1996). Wage restraint combined with fiscal austerity allowed the ALP government to reduce inflation and public debt levels, without a large loss increase in unemployment. The preferences of the ACTU towards economic policy, as embodied in the text of the 1983 Accord, were opposed to the adoption of monetarist solutions and in favour of job creation. The Accord called for the use of a combination of fiscal, monetary and exchange rate policies to achieve these goals, and supported increased government intervention in the economy as opposed to measures that pushed up interest rates. The 1989 and 1991 ACTU Congresses opposed the government's tight monetary policy. In place of high interest rates, the ACTU called for a return to the regulation of money flows, and rejected the adoption of monetary targets. An independent RBA with a single objective of price stability was clearly opposed to this policy preference.

Following the 1996 defeat of the ALP, the ACTU was forced to make its opposition to central bank independence public, due to the loss of insider access to policymakers. The 1997 ACTU Congress condemned the use of inflation targets and the effect of the disinflation on unemployment. "The social impact of the Howard Government's 'fight inflation first economic strategy' is becoming more and more devastating for ordinary Australian families. The Federal Government's abject failure to develop far sighted

economic and industrial policies is hastening the jettisoning of jobs and the closure of Australian industries".²⁵ The ACTU repeated its earlier call for a progressive mix of policy and government intervention in the economy to create jobs and reduce unemployment below 5 per cent, but did not mention the Reserve Bank directly.

Pressure from International Financial Markets

The evidence for the power of international financial markets to direct policy reform in Australia is mixed. The neo-liberal reforms introduced by the Hawke government from 1984 were in response to a currency crisis following the election of the ALP, which led to a ten per cent devaluation in the currency. Inflows of capital forced the ALP to float the currency and remove exchange controls, which opened the door to the subsequent financial sector reforms. Seen from this point of view, international financial market pressure was effective in stimulating institutional reform. However, this source of international pressure did not extend to the design of the central bank and its relationship with the government. The ALP did not face any international financial market pressure when it appointed Treasury Secretary Fraser as RBA Governor in 1989. Nor did the electorate's rejection of the conservative coalition's reform proposals in the 1993 election – which included an independent RBA with a narrow inflation target – lead to a financial crisis. Instead the ALP was able to convince international investors of its policy credibility by negotiating wage restraint with the trade unions and introducing financial sector reform based on the recommendations of the Campbell Committee. These policy choices, combined with fiscal austerity leading to a budget surplus in 1988 and 1989, convinced international investors of the ALP's anti-inflationary credentials.

²⁵ See: "1997 ACTU Congress Resolutions", available for download from the ACTU website www.actu.asn.au.

Australia's foreign currency debt was a source of concern, as seen by the downgrades by Moody's Investor Services in 1986 and in 1989. However, at no time did the Australian Commonwealth have significant debt levels by industrial country standards, with net public debt to GDP peaking at 35 per cent in fiscal year 1994-95 (table 3). By the time of the second downgrade, the ALP had already recognised the risk inherent in this exposure and had brought the government's finances under control. Budget deficits in the late 1980s were used to pay down Australia's foreign debt and the Commonwealth has not issued debt offshore since 1987. Instead government deficits have been funded entirely in the domestic financial markets, which are deep, liquid and efficient. By 1997, only 1 per cent of Australian government debt was funded abroad, however currency swaps had been used increasing the exposure to foreign currencies to 11 per cent (of which 97 per cent was US dollars). These steps mitigated this potential source of international financial market pressure.

Table 50: Net Public Sector Debt

Budget	% of GDP	Budget	% of GDP	Budget	% GDP
1987-88	32.8	1991-92	30.2	1995-96	31.2
1988-89	27.2	1992-93	34.4	1996-97	28.4
1989-90	24.9	1993-94	34.4	1997-98	23.1
1990-91	25.7	1994-95	34.7	1998-99	19.5

Source: Australian Bureau of Statistics

The success of this strategy is evident from the bond market's reaction. As the credibility of Australia's fiscal and monetary policy frameworks has been established with financial markets, long-term interest rates have fallen, both absolutely and relative to other economies. The 1999-2000 Commonwealth Budget noted that the interest rate differential between Australian and United States 10-year Treasury bonds averaged around 70 basis points over the final three years of the 1990s, compared with an average of around 350 basis points over the 1980s.

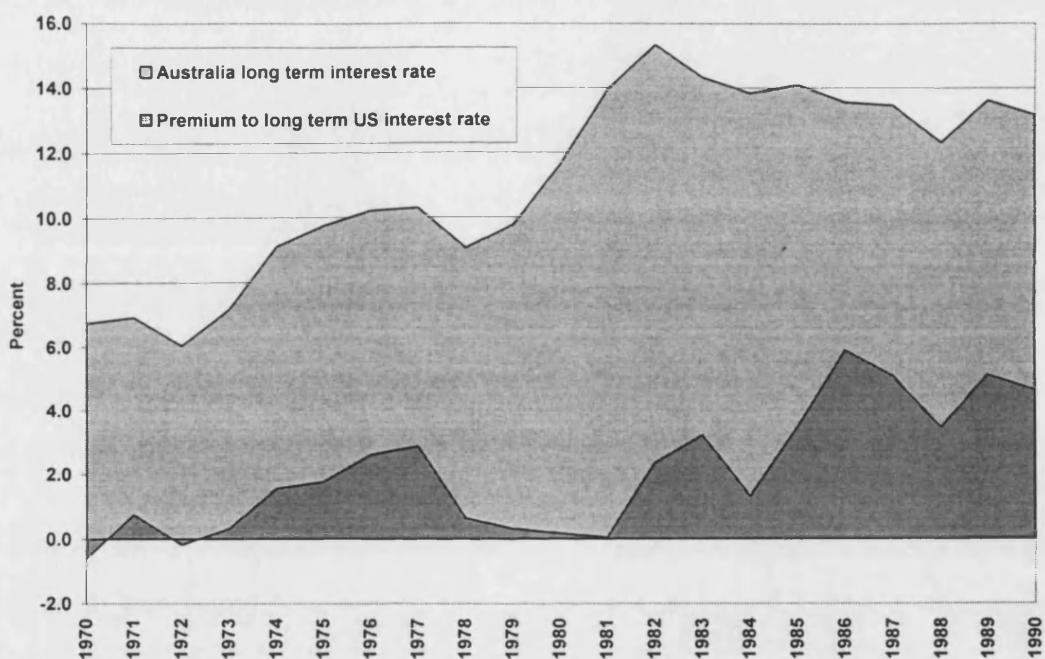


Figure 12: Australian Long Term Interest Rates Relative to US

By floating the currency the ALP removed a second potential source of international financial market pressure. Whereas Treasury Secretary Stone predicted a sharp appreciation of the Australian dollar, the currency depreciated after 1984 as speculators unwound their bets (Hawke 1994). The operation of monetary policy under a floating regime has further reduced the impact of foreign exchange flows on the government's economic policy. In contrast to Canada and New Zealand, Australia does not respond to short-term fluctuations in the exchange rate, believing such changes reflect shifts in the terms of trade, rather than changes in inflation expectations or business cycles

(Bernanke et al. 1999, p.226). In addition, Australia's foreign exchange reserves are owned by the RBA that has sole responsibility for currency intervention, removing this potential avenue for political pressure as politicians do not bear the responsibility for any external shocks. The RBA has made it clear that monetary policy is determined based on the needs of the domestic economy, and not in response to pressure from international financial markets (Australia 2000, p.1).

It is not entirely accurate to say that Australian politicians were not concerned about international financial markets. The Australian government has clearly responded to international market pressure at certain points. A sharp fall in the Australian dollar in early 1985 led Treasurer Keating to hastily renegotiate the Accord with the ACTU – dubbed Accord Mark II – in order “to show domestic and overseas financial markets that the government was taking a tough line on wages policy” (Carew 1992, p.84). During the 1990-1991 recession, with government debt rising, the judgement of domestic financial markets became more influential.²⁶ The lack of monetary policy credibility under the existing framework was reflected in the rise in inflation expectations and the premium charged on government debt following the recovery beginning in 1993 (Bernanke et al 1999; Debelle 1996). And the Liberal-National coalition elected in 1996 was paying attention when it issued the 1996 Statement in support of RBA independence upon assuming office. This joint statement, including the endorsement of the inflation target, was intended to signal the government's commitment not to interfere in monetary policy – a signal that was explicitly directed at an international audience. However, the Howard government stopped short of changing

²⁶ In 1993, Governor Fraser noted how international financial markets respond to perceptions of large ongoing budget deficits and borrowing requirements, which were unfounded, but these perceptions can create major instability as occurred with the Australian dollar over 1992 and 1993 (Fraser 1993).

the RBA's legislation, as originally suggested in the Fightback! proposals, due to opposition from the electorate over this proposal.

In summary, Australia has not been hostage to pressure from international financial markets despite its high level of openness, both in terms of trade and in terms of capital mobility, and its significant exposure to foreign borrowing in the late 1980s. Australia has avoided this pressure by putting in place institutional frameworks that mitigate the ability of international financial markets to pressure policy, such as negotiating the Accord with the trade unions to reduce inflationary pressures or floating the currency and delegating foreign exchange policy to the RBA. And when the ALP did experience financial market pressure, the government took action to consciously reduce this potential point of weakness.

Ideas of the Epistemic Community

How influential were the ideas of the epistemic community of academics, central bankers and business economists for explaining this outcome? Prior to the period being studied, commentators describe Australian monetary policy as influenced by monetarism with the Treasury adopting informal monetary targets during 1976-1985 independent of the RBA.²⁷ When monetary targeting and the subsequent 'checklist' (introduced briefly in 1985) both failed, the Treasury and RBA became suspicious of the economic paradigm and did not introduce a formal framework for monetary policy until 1996. This long interregnum is partly a result of the domestic epistemic community failing to agree on a clear alternative, leading policymakers to stick with the status quo.

Over this period, academic critics described Australia as inflation-prone and attacked the RBA for a lack of independence, calling for a “radical reform of the legislation to create some new type of central bank subject to some form of binding monetary rule” (Macfarlane 1998). A large group of economists were in favour of monetary reform, publishing a wide range of mostly orthodox proposals between 1990-1995 (Cole 1990; Dowd 1990; Hanke, Porter, and Schuler 1992; Hartley and Porter 1991; Hendy and Evans 1995; Jonson 1990a; Jonson 1990b; Stone 1990; Stone 1992; White 1990). These proposals were backed by think tanks and were published in the in-house publications of the Australian Institute for Public Policy, the Centre for Economic Policy Research, the Centre for Independent Studies, the Institute of Public Affairs and the Tasman Institute.

This epistemic community was not successful in influencing the outcome of the debate for several reasons. First, there was no consensus among monetary experts on the need for reform. Australian economists like Eichbaum (1993) challenged support of this economic paradigm by suggesting that the RBA was too independent (Eichbaum 1993; Gangopadhyay 1996). Eichbaum argued that the RBA should retain its multiple objectives, as this situation best reflected the policy preferences of the RBA Board, which consisted of representatives from trade unions, manufacturing, retailing, and farming interests together with an academic economist.

Second, and more significantly, senior RBA officials were opposed to a change in the central bank’s mandate. Governor Fraser and Deputy Governor Phillips both opposed a narrow mandate, which they saw as inappropriately reducing the flexibility of monetary

²⁷ The Liberal-National coalition government of PM Frazer was clearly influenced by monetarism, leading to lower inflation and higher unemployment in the early 1980s than neighbouring New Zealand (Castles et al. 1996, p.9).

policy (Fraser 1989, 1994b, 1996; Phillips 1992). A single goal of price stability was not appropriate for the Australian context given the prevalence of money-demand shocks and terms-of-trade shocks (driven by changes in commodity prices) that hit the economy.²⁸ Narrow targets were seen as constraining the discretion of policymakers in an unfavourable way, particularly given the RBA's broad mandate to consider employment and output in addition to price stability. Given the historical and institutional context, the RBA supported a broad mandate and lobbied against a change in the RBA Act. Opposition to central bank independence received greater credibility from empirical work demonstrating that countries with independent central banks had higher sacrifice ratios and paid a greater cost in terms of lost output during disinflations (Debelle 1996; Debelle et al. 1994).

While opposed to changing their statute, RBA officials were in favour of adopting a formal inflation target. To their dismay, this issue became politicised before the academic community had a chance to form a consensus around the idea. With the Liberal's promoting this idea in their *Fightback!* election manifesto, the RBA was unwilling to endorse this framework publicly for fear of being drawn in to a politicised debate. As Macfarlane recalls, "It was a great disappointment for the Bank that this debate was politicised before the economics profession had time to explore it fully in an objective non-partisan way. But it would be unfair to criticise either of the two political protagonists for this – there is nothing wrong with them being quicker off the mark than the economics profession" (Macfarlane 1998). When inflation targeting was formally adopted in 1996, this framework was put in place when inflation in Australia had been brought down, mitigating the need to change the legislation of the RBA (Debelle 1996; Debelle and Stevens 1995; Stevens 1999). "In some senses, it was this that ultimately

proved decisive in confirming that it was possible to return to a low inflation environment without radical change to the Reserve Bank or its Act" (Macfarlane 1998). Events therefore moved on and mitigated the need to formally embed inflation targeting in the RBA statute.

Third, proponents of reform in the domestic epistemic community did not reach a consensus around the need for central bank independence. Nor could they agree on an alternative monetary framework, proposing instead a confusing array of alternatives (Macfarlane 1998; White 1990). Their proposals ranged from legislating New Zealand-style reforms, to adopting a currency board, to returning to monetary or exchange rate targeting, to adopting a commodity standard or to getting rid of the central bank altogether (Cole 1990; Dowd 1990; Hanke, Porter, and Schuler 1992; Hartley and Porter 1991; Hendy and Evans 1995; Jonson 1990a; Jonson 1990b; Stone 1990; Stone 1992; White 1990). By failing to agree on a new paradigm, academics failed to provide politicians with a roadmap for reform. Given the uncertainty surrounding monetary policy in Australia, it is not surprising that politicians would not endorse a reform that did not even have a consensus among the so-called experts. So instead of changing the legislation, both the ALP and the Liberal-National coalition (following election in 1996) stayed with the status quo.

Fourth, this proposal did not find a political champion among ALP politicians and did not agree with their worldviews. While reformers found a political champion for this proposal in John Hewson, the failure of the Liberal-National leader to win the 1993 election effectively led to his exit from politics. With Hewson gone Liberal leader

²⁸ These shocks also ruled out a return to monetary targeting and exchange rate targeting, as both would lead to large business cycles and a variable monetary policy (Edey 1997).

Howard dropped the proposal as too controversial prior to the election, and then did not champion this reform post-1996.

7.5 The Importance of Electoral Gains

The answer to the question 'why did Australian politicians not tie their hands by changing the legislation governing the Reserve Bank of Australia?' is simple. They did not have to. No politically influential interest group was lobbying for greater independence, while the most important lobby – organised labour – was opposed to such a reform. Nor was there meaningful pressure through international financial markets for such a reform. Instead this outcome reflects calculations by politicians of the electoral advantages to be gained from such a policy, where the costs were found to outweigh the gains. The ALP did not pursue this reform for four reasons: it was against the interests of their core constituency, it reduced unnecessarily the government's policy flexibility, it was supported politically by the conservative opposition and the incumbents benefited politically under the current institutional arrangements. For their part, the opposition Liberal Party did not consider this reform after it was elected due to the number of checks and balances in Australia's political system, which make changing legislation difficult. Each point will be addressed in turn.

Opposition of ACTU

The ALP resisted tying-their-hands during their 13 years in office because this policy did not match the policy preferences of their core constituency, the trade unions. The trade unions preferred job creation and a loose monetary policy, as expressed at annual ACTU congresses in 1989-1991 and in the various versions of the Accord between 1983-1996, and opposed any monetarist policy designed to 'fight inflation first'. Instead of delegating to an independent central bank, the ALP found alternative institutional mechanisms for controlling inflation while preserving policy flexibility. They negotiated wage restraint with the ACTU to reduce this source of pressure, leading to

the adoption of a *de facto* inflation target following the 1990 version of the Accord. And they floated the currency and deregulated the financial sector to reduce external pressure on monetary policy and to create an increased pool of domestic savings to fund government deficits. Highlighting the success of these strategies, Prime Minister Keating stated "It galls [the Opposition] to think that a cooperative process can actually reduce inflation".²⁹ Keating continued:

The Opposition would not have put together the agreed incomes approach under the accord. It would not have taken the risks we took with the floating of the spot rate and the exchange rate and the removal of exchange controls, or the absolutely revolutionary change to dividend imputation and the change to occupational superannuation. These are path breaking. We have done this in a way in which we have pulled the weaker people in society along with us.³⁰

Liberal Party MP Reith saw the ALP's political opposition to the inflation target in these terms:

"The Government has never had a real commitment to attacking inflation; in fact, it has abandoned targets for inflation. Why is that? If one wants to see what the decisions of these guys are based on, one only has to look at the most recent poll. The Government says that it is not attacking inflation because there is no constituency to tackle inflation and it is not prepared to wear what it sees as the electoral costs of it.³¹

These statements confirm the view that a policy must have political salience in order for politicians to adopt it and to champion it through the legislative process.

²⁹ Hansards, 15 May 1991, "Price Stability: Discussion of Matter of Public Importance", p.3784.

³⁰ Hansards, 15 May 1991, "Price Stability: Discussion of Matter of Public Importance", p.3784.

³¹ Hansards, 15 May 1991, "Price Stability: Discussion of Matter of Public Importance", p.3780.

Reduced Policy Flexibility

Central bank independence with an inflation target was seen as politically costly. A narrow mandate reduced government policy flexibility to respond to exogenous shocks, which has been a concern for policymakers in Australia – a concern that was shared by senior management of the RBA. A narrow goal of price stability was not appropriate given the prevalence of money-demand shocks and terms-of-trade shocks that hit the Australian economy. Nor did it suit the Australian historical context where employment and output were seen as important goals for monetary policy that should not be ignored in favour of price stability.

Political Manoeuvring

The ALP could not realistically consider proposals to adopt an inflation target or to give the RBA greater legislation because these proposals were being advocated by the opposition Liberal-National coalition. Hewson politicised these proposals with the intent of embarrassing Keating over his perceived political interference in interest rate changes and RBA appointments. Following the release of *Fightback!* in November 1991, it would have been politically costly for the ALP to endorse these proposals without admitting their guilt in politically interfering with monetary policy. In addition, such a move would have been seen as a dramatic policy reversal for the ALP that betrayed their core supporters among the trade unions. Instead, the ALP made political capital out of the proposals contained in *Fightback!* during the 1993 election campaign, successfully portraying the Liberal-National proposals as anti-democratic and opposed to worker's interests. Following their 1993 election defeat, the Liberal-National coalition also viewed their proposal to change the RBA's legislation as a political liability, which they publicly renounced prior to the 1996 election.

Benefits of Status Quo

Apart from the political costs of these reforms, the ALP saw important electoral gains from the current framework. The institutional arrangement in place allowed the ALP to appoint an RBA Governor who shared the government's preferences of full employment, output stabilisation and price stability, and who would accommodate government economic policy. Under an independent central bank as proposed by the opposition, there was a risk the central bank might be led by a conservative central banker who preferred price stability above all else, leading to a conflict with ALP government policy. Treasurer Keating stated: “[This] fight-inflation-first policy amounts to no more than a strategy to keep the economy comatose over a long period to grind inflation out of the system...We target lower inflation and other policy targets simultaneously” (Carew 1992, p.274). Both Governor Fraser and Governor Macfarlane shared the ALP's preferences for multiple objectives, and both governors understood that monetary policy acting alone could not deliver price stability without cooperation from the government over fiscal policy and cooperation from the unions on wage restraint.

Impact of Bicameral Legislature

If the Liberal-National opposition had firmly believed in the paradigm concerning central bank independence, why did they not change the RBA's legislation upon being elected in 1996? Again, the answer is that such a move generated political costs without significant electoral gains, due to the checks and balances in Australia's political system. In order to pass such legislation, the Liberal government would have needed to convince their coalition partners in the National Party of this strategy, as well as the Australian Democrats who held the balance of power in the Senate. The Australian Senate has the power to credibly bring down the government, through a double dissolution of both chambers of parliament, as seen in the 1975 episode. Given the

political ideology of the Australian Democrats, it is safe to assume they would not have supported a reduction of democratic accountability over monetary policy easily. With so many veto gates in the political system, it becomes difficult for politicians to change legislation unless conditions are supportive. In Australia, they clearly were not supportive of central bank reform. For this reason, it was much simpler for the Howard government to issue the 1996 Statement, and to adopt the RBA's inflation target. After the election, inflation was low and the economy was growing mitigating the need for such a 'radical' reform.

And when Australian politicians did agree to an inflation target, it was less stringent than the existing frameworks in New Zealand and the UK and more representative of Australia's situation and traditions (Bernanke et al. 1999). The target range for inflation at 2 to 3 per cent was set higher than in other countries, but with the same effective mid-point as the inflation target in the UK. It had an open-ended time horizon with the target expected to be met over the course of the business cycle, with no fixed dates for achieving the goal. Like Canada and New Zealand, the operational target for CPI provided some room to manoeuvre for politicians in the interpretation of the level of underlying inflation. Unlike the UK or New Zealand, in Australia there is no requirement to explain a failure to hit the target band (Bernanke et al. 1999, p.225). However, opposition politicians still are able to question the RBA Governor on this issue during his semi-annual testimony before a parliamentary committee, increasing the accountability of this framework. In short, the Australian form of inflation target was designed to minimise the conflict between the RBA and politicians, while maintaining the greatest amount of flexibility that politicians valued.

In summary, the RBA seems to have increased its independence over the course of the 1990s without the need to change the central bank's statute, similar to the case in Canada. This finding raises the question of whether legal indices of central bank independence have any substantive meaning. By failing to account for *de facto* independence (or classifying politically controlled central banks as independent), economic studies underestimate the importance of reputation, transparency and accountability mechanisms for increasing the anti-inflationary credibility of monetary policy. The real test for Australia will come following the next change of government, when the current arrangements will be tested under a more traditional left-wing party.³²

³² Elections are scheduled for 2001. The opposition ALP has said it will preserve the inflation target of 2-3%, but this support would likely need to be put into a new joint statement with the RBA.

Ch. 8 Bank of England: Partisan Politics vs. the Power of Ideas

On 6 May 1997, the incoming Labour government of Prime Minister Blair gave the Bank of England ("BoE") operational independence in the setting of interest rates. At the same time it maintained the inflation target introduced by the outgoing Conservative government that had resisted giving autonomy to the BoE for two decades.¹ Chancellor Gordon Brown announced reform of the BoE within a week of the election, without even waiting for the incoming Labour cabinet to meet, in order to establish New Labour's anti-inflationary credibility quickly with financial markets. The decision to reform monetary policy had been taken months before the election and was signalled in Labour party manifestos beginning in 1993. The financial markets responded enthusiastically to the news, sending the UK stock market to a new high, strengthening the foreign exchange value of the currency and allowing the long term yield on UK government bonds to decline. At a stroke, New Labour had shed its historical image as the 'party of devaluation' and re-launched itself as the 'party of economic stability'.

Like similar reforms in New Zealand, the paradox of this reform is that operational independence was legislated by a Labour party whose roots lie with the trade union movement, not a constituency likely to prefer price stability over job creation. At the same time, BoE independence had been resisted by a Conservative Party whose political support comes largely from business, the financial sector and the wealthy middle classes who arguably stand to benefit most from price stability. This case also appears to contradict claims than an outgoing Conservative government would seek to tie the

hands of its inflationary successors by changing the institutions of economic policy. Instead a left-of-centre party tied its own hands upon entering office despite holding the strongest parliamentary majority in the post-war period.

The chapter proceeds as follows. The first section reviews the changes made by the New Labour government in 1997 when it gave operational independence to the Bank of England. As a result of these reforms, the UK went from having one of the most politically controlled central banks to one of the more independent. The second section puts this reform in context, by reviewing the UK's economic performance over the 1980s and 1990s. The third section reviews political debates on central bank independence, which first surfaced in 1989 then re-emerged in 1992. The fourth section examines the BoE reform from the point of view of the four hypotheses put forward by the literature. This analysis shows that pressure from international financial markets and the confidence of domestic businesses were key concerns for New Labour, for which the academic ideas introduced by Brown's economic adviser provided a politically salient solution. The fifth concludes with a discussion of the circumstances when economic ideas are likely to be successful in motivating politicians to undertake central bank reform, based on the need for clear electoral gains from delegation that exceed the electoral costs of giving up control over interest rates.

8.1 Overview of Bank of England Act 1997

The BoE was given a mandate to maintain price stability – and subject to that – to support the Government's economic policy, including its objectives for growth and employment (BoE 1998, p.3). In this context, price stability meant pursuing an inflation target set by the Chancellor that was not subject to approval by Parliament. The

¹ This operational independence came into effect 1 June 1998.

Conservative government had introduced an inflation target following UK exit from the Exchange Rate Mechanism in September 1992. Following the 1997 reform, the target was set originally at 2.5 percent for retail price inflation excluding mortgage interest payments (“RPIX”). The BoE was therefore given instrument independence but not goal independence. The Treasury withdrew its power to direct the BoE, enshrined in the 1946 Bank Act following nationalisation, but maintained an escape clause allowing the government to override the BoE in ‘extreme economic circumstances’ (BoE 1998, p.13).² Greater responsibility for monetary policy came at the cost of sweeping reforms to the BoE’s institutional structure and responsibilities.³ Interest rates would be set by a nine-member monetary policy committee (“MPC”) consisting of five BoE officials and four external members nominated by the Chancellor.⁴ The Court of Directors was altered to increase the representation of domestic interest groups. The BoE was stripped of its role in debt management with this responsibility reverting to the Treasury, similar to the practice in other countries. And to the distress of the BoE’s staff and the joy of its critics, responsibility for bank supervision was transferred to the newly created Financial Services Authority (“FSA”), which was given responsibility for supervising the financial sector as a whole.⁵ These reforms were designed to de-politicise interest rate decisions, to improve the credibility of monetary policy and to demonstrate New Labour’s commitment to orthodox management of the economy.

² See article 19 of Bank of England Act 1998. There is no definition of what constitutes extreme economic circumstances.

³ The new Act places the BoE’s finances on a statutory footing by placing the cash deposit scheme on a statutory basis and expanding this scheme to include building societies (BoE 1998, p.9).

⁴ The MPC is loosely modelled on the Federal Open Market Committee of the US Federal Reserve.

⁵ This arrangement abandoned various systems of self-regulation that had failed to prevent a series of banking collapses and scandals that had tarnished the BoE’s reputation (Keesing’s 1998, May).

Brown took steps to increase the transparency of monetary policy while ensuring its democratic accountability (BoE 1999, p.7).⁶ Transparency was provided by announcing the inflation target, publishing the minutes of MPC meetings and continuing the publication of the BoE's quarterly *Inflation Report* first begun in 1993.⁷ While the Governor is not held directly accountable for missing the inflation target, he must publish an open letter to the Chancellor if inflation strays by more than one percentage point on either side of the target explaining this failure and steps being taken to correct it. Accountability is further strengthened by revamping the management body of the BoE - the Court of Directors – and requiring a committee of its Non-Executive Directors to report annually to Parliament on the BoE's performance. This report card is published as a separate section of the BoE's Annual Report and will be debated in Parliament. The Governor and other MPC members are required to give evidence before the Treasury Select Committee of the House of Commons and to make appearances before the House of Lords Committee on the MPC of the BoE.

⁶ Moran (1980) provides a history of the BoE's relationship with parliament up to the 1970s. He highlights how the lack of accountability and transparency in the conduct of the BoE's operations led to parliamentary scrutiny by the Select Committee on Nationalised Industries.

⁷ The MPC minutes must be published within six weeks, but in practice the lag has been two weeks. The minutes are attributed and record the voting record on interest rate changes.

Table 51: Comparison of Bank of England Legislation

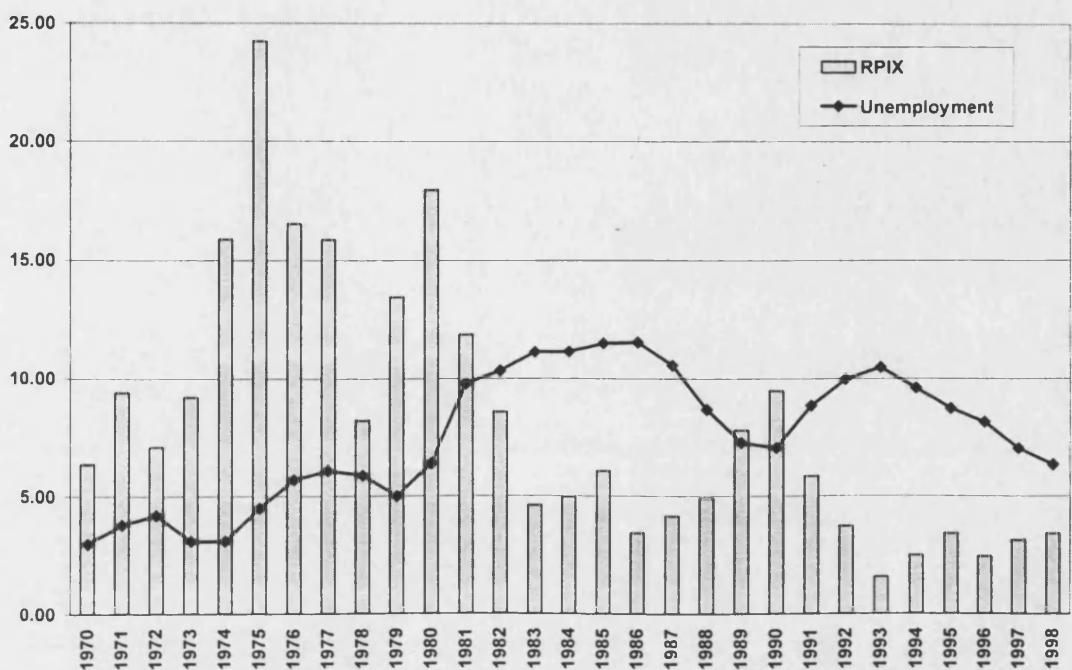
	BoE Act 1946	BoE Act 1997
Governor Term (years)	5	5
Appointed by	Chancellor	Chancellor
Decision making body	Governor	Monetary Policy Committee
Voting members	18	9
Members appointed by	Chancellor	Chancellor 5; BoE 4
% Appointed by govt.	100%	5 out of 9
Govt. officials on body	0	0
Statutory objective (s)	None stated	Price Stability
Who takes the final decision on monetary policy?	Chancellor	Monetary Policy Committee
Can the government direct the central bank?	Yes	Yes, through escape clause
Legal provisions in case of conflict?	No	Yes
Limitations on holding government debt?	No	No
Central bank responsible for banking supervision?	Yes	No

Source: HM Treasury, Bank of England

8.2 Economic Background to Reforms

In the post-Bretton Woods era, the British economy has been characterised by cycles of boom and bust overlaid with bouts of high inflation. Inflation took off in 1973-1974 following the first oil shock, rising by 48 per cent over two years. The Conservative government tried to stem inflation by introducing an incomes policy, while introducing restrictions on interest-bearing deposits under a system known as the 'Corset'. These policies precipitated an economic crisis, bursting a real estate bubble and leading to the bankruptcies among the 'second tier' banks (Moran 1984b). The Labour government elected in late 1974 was forced by circumstances to adopt a monetarist policy of monetary targeting combined with cuts in government spending. These policies led to a sharp rise in interest rates but succeeded in controlling inflation that peaked at 26.9 per cent in August 1975.

Figure 13: UK Inflation and Employment Record



Labour and IMF Loan

Despite these efforts, the Labour government was faced with a sterling crisis in 1976, forcing the government to seek an IMF stand-by loan of \$3.9 billion. As part of the package, more stringent monetary targets were adopted and restrictions on interest-bearing deposits were re-imposed, although it was dis-intermediated through the 'bill leak'. The second oil shock of 1978 led to a further sharp rise in interest rates causing the currency to become overvalued. Then public sector unions rebelled against the Labour government's incomes policy by going on strike, leading to the 'winter of discontent' in 1978-79. Given its failure to manage the economy and its inability to deal with the unions, the Labour party was ousted in the 1979 election by the Conservatives under Prime Minister Thatcher.

Thatcherism

Thatcher introduced a series of free-market reforms, beginning with the abolishment of exchange controls in October 1979. Chancellor Howe introduced a Medium Term

Financial Strategy in 1980 based on targets for £M3 and a reduction of the public sector borrowing requirement through cuts to government investment. These moves did not prevent the economy from falling into a recession from 1980-1982. The recession brought inflation, which peaked at 22 per cent in May 1980, under control. Inflation declined steadily falling below 4 per cent by 1983. Faced with a sharp appreciation in the currency in 1980, Thatcher abolished the restrictions on interest-bearing deposits in June, causing £M3 to far overshoot its range, reaching 20 per cent annualised growth by February 1981. The redrafted medium term financial strategy in 1982 raised the targets for £M3 and allowed interest rates to decline in time for the 1983 election. Thatcher was re-elected and appointed Nigel Lawson as Chancellor.

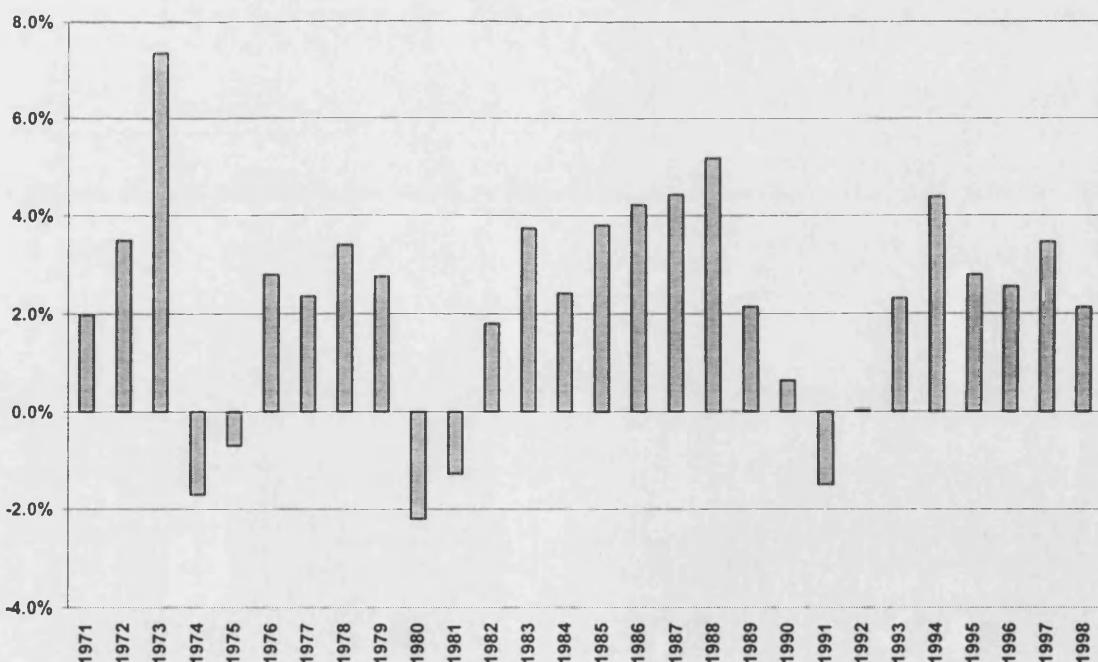


Figure 14: UK GDP Growth

Chancellor Lawson pursued a new direction in economic policy, using macroeconomic policy to target inflation while microeconomic policy targeted growth and employment.

In 1984, a sterling crisis forced Chancellor Lawson to push up interest rates. Then in 1985 Lawson suspended the broad target based on £M3, replacing it with a narrow target for M0. These changes set the stage for a rapid rise in the money supply in 1986, which combined with an expansionary fiscal policy and an accommodative monetary policy, enabled Thatcher to be re-elected for a third term in 1987. The cost of this political easing came back to haunt Lawson, as £M3 increased by 40 per cent per annum feeding a boom in real estate and share prices. The deficit in the UK balance of payments rose dramatically, hitting £20 billion in 1989 and putting pressure on the currency. Lawson raised interest rates causing the property bubble to burst and introducing a new term into many homeowners lexicon, 'negative equity'. In October 1989, Lawson resigned as Chancellor having been blamed for the real estate bubble and having lost the trust of Thatcher.

In and Out of the ERM

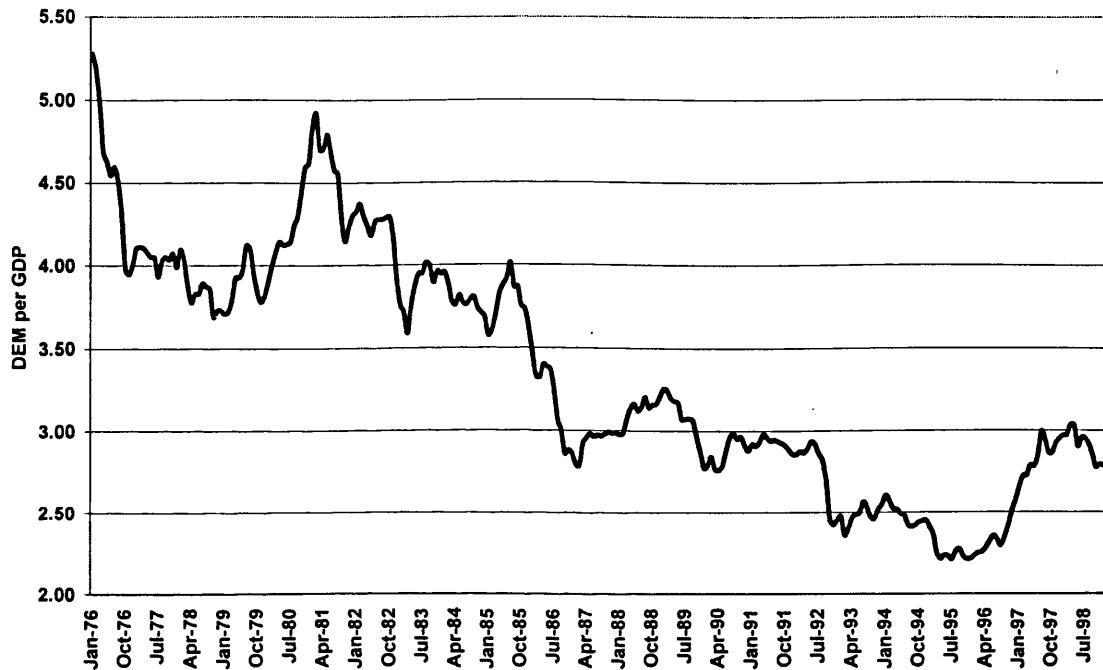
Chancellor Major's review of economic policy undertaken when he became Chancellor convinced him there was no domestic alternative in the battle against inflation to the use of high interest rates. But throughout late 1989 and 1990, Thatcher pressured against interest rate increases, despite rising inflation, in order to protect homeowners who were suffering from negative equity following the collapse of the property market in 1989 (Seldon 1998, p.106). This constituency pressured Conservative MPs to lower interest rates. “[Backbenchers] repeatedly called for reductions in interest rates and continually counselled restraint on the Chancellor, even when economic circumstances may have suggested that interest rates should be raised to account for changed economic circumstances” (Atkinson et al. 1996, p.15). Given domestic resistance to interest rate increases, Major saw membership in the Exchange Rate Mechanism (“ERM”) as providing an external anchor to monetary policy (Seldon 1998, p.111).

In 1990, Chancellor Major was given the task of introducing the hated poll tax as the economy headed into a recession that lasted until 1992. In October 1990, Major was able to convince Thatcher – weakened by the resignations in her Cabinet and increasingly unpopular due to the poll tax – to join the ERM at a parity of DM 2.95. Thatcher conceded the move at the expense of a simultaneous interest rate cut to appease mortgage holders. At the time, ERM entry had the support of the major political parties and domestic coalitions, including the City, industry, the Confederation of British Industry, the TUC and most trade unions (Seldon 1998, p.321). Financial markets were also supportive; the pound appreciated following entry despite the interest rate cut. The following November, Thatcher was ousted in a leadership contest and replaced by Major who named Norman Lamont as Chancellor. In 1991, the collapse of BCCI badly embarrassed the government and the BoE, but did not prevent Major from winning the April 1992 election.

Then in September 1992, the UK was forced to exit the ERM following massive speculation against the pound, which cost UK electorate dearly as they paid the cost indirectly through higher taxes. In November 1992, Major narrowly survived a challenge to his leadership when Tory Eurosceptics voted against the government's Maastricht paving bill that passed by 319 to 316 votes. In the aftermath of the ERM crisis, Chancellor Lamont tried to rebuild the UK's monetary policy credibility by adopting an inflation target and inviting the BoE to publish a quarterly *Inflation Report*. In May 1993 Lamont resigned, bearing most of the blame for the ERM debacle, and was replaced by Kenneth Clarke as Chancellor. In November of 1993, Chancellor Clarke gave the BoE discretion in the timing of interest rate changes decided by the Chancellor. Then from April 1994, Clarke agreed to allow the publication of the

minutes of his monthly meeting with Governor George. At this point, UK inflation had been brought down and was stable, although differences in opinion between the Chancellor and the Governor created uncertainty in the markets keeping inflationary expectations high.

Figure 15: Sterling vs. the Deutschemark



8.3 Political Debates over BoE Independence

Thatcher's 'Monetarism' and Lawson's Memo

Conservative Chancellor Lawson put independence for the BoE on the political agenda in October 1989 when he revealed in his resignation speech that he had proposed a fully worked out plan to Prime Minister Margaret Thatcher in an internal memo in 1988 (Lawson 1992, Annexe 4). Lawson viewed independence for the BoE as an alternative mechanism for securing anti-inflationary credibility following the failure of domestic monetary targeting and his strategy of shadowing the Deutschemark. Lawson's preferred strategy – to adopt the Exchange Rate Mechanism ("ERM") as an external anchor – was opposed by Thatcher who saw it as a threat to British sovereignty. Lawson

therefore worked out a plan with a high-level group of Treasury officials, being careful to keep his plans secret from the BoE. Lawson proposal was to give the BoE control over interest rate changes to pursue a mandate of price stability. The government would keep control of the exchange rate and would take over responsibility for financing the public sector. The independent BoE would be held accountable by Parliament along the lines of the Federal Reserve. Lawson made his proposal public hoping that such a move would “secure a groundswell of back-bench support” for the idea.¹

Thatcher rejected the proposal, arguing that “it would be an admission of a failure of resolve on our part” (Thatcher 1993, p.706). Independence could only be considered once inflation was low and falling. Otherwise, she argued, the government would be seen to have failed in the fight against inflation that would be politically damaging. Thatcher doubted independence would boost credibility and she had no confidence in the senior staff at the BoE, who had undermined the credibility of her monetary targets by failing to alert the Treasury to the consequences of the ‘bill leak’ when the restrictions on interest-bearing deposits were abolished.² Thatcher did not see the need to entrench counter-inflationary policy against subsequent Labour cabinets as, according to Lawson, she was incapable of foreseeing a change of government.

Thatcher’s reasons for rejecting operational independence for the BoE were political. Despite preaching the sermon of monetarism, Thatcher believed firmly in retaining the

¹ Conservative MP Michael Heseltine included it in his campaign to succeed Thatcher as party leader in 1990 - a move designed to gain the support of Howe and Lawson, not for any intrinsic appeal (Lamont 1999, p.26).

² Thatcher described senior BoE officials as Keynesians who made no secret of their hostility to her monetarist policies. The feeling was mutual. Governor Richardson is reported to have remarked: ‘She is canine; I am feline’” (Lawson 1992, p.269).

ability to manipulate monetary policy for political ends. Interest rates were politicised under Thatcher, who fought against any increases in order to protect the interests of mortgage holders. She admits in her autobiography that “I was always more sensitive to the political implications of interest rates rises – particularly their timing – than was [Nigel Lawson]. Prime Ministers have to be. I was also acutely conscious of what interest rate changes meant for those with mortgages” (Thatcher 1993, p.698) Thatcher was pragmatic. She correctly saw that the defeat of inflation was the main issue that concerned the electorate in 1979. Thatcher advocated ‘radical’ monetarist policies and won the election on a platform designed to appeal to an electorate – the defeat of inflation.³ The government’s policies would be of no avail “unless we achieve our prime economic objective – the defeat of inflation. Inflation destroys nations and societies as surely as invading armies do. Inflation is the parent of unemployment. It is the unseen robber of those who have saved. No policy that puts at risk the defeat of inflation – however great its short-term attraction – can be right” (Harris 1997, p.112). Thatcher had a clear understanding of the distributional conflict involved in the battle against inflation, and her electoral policies were designed to tap into this demand.

Backbench Conservatives were supportive of Lawson’s proposal to give the BoE independence, while Labour was predictably hostile. Labour party leader John Smith stated that his party “would not be willing to accept any system of central banks that would be independent of political control, just as we strongly oppose an independent status for the Bank of England” (Hansard 1989). Financial markets were not demanding any reform of policy, trusting in Thatcher’s monetarism and placing confidence in her widely respected Chancellor Lawson. Nor was the BoE lobbying for greater

independence, being headed by a Thatcher appointee and more pre-occupied at the time with changes in the supervision of banks, both domestically and internationally.⁴ Despite support in the financial press and moves in this direction in New Zealand and Chile, the proposal was dropped by Thatcher and not raised by Lawson's successor as Chancellor, John Major.

The ERM Crisis and Lamont's Proposals

The financial markets launched the second major political debate on BoE independence in September 1992, when the UK was forced to exit the ERM under pressure from speculators. The UK had joined the ERM in October 1990 in order to fight domestic inflation and to anchor monetary policy. The story of its exit showed how international financial markets have the power to veto government policy when it is seen as lacking credibility. In this case, the Conservative government was caught between the demand to lower interest rates from mortgage holders, business and consumers and the need to raise interest rates in order to maintain the peg against the Deutschemark. While critics argue that 'Black Wednesday' cost taxpayers as much as £20 billion, it did not lead to an immediate demand to give independence to the BoE. Instead it led to a series of small institutional changes that had the unexpected consequence of leading to this reform over time. More importantly, this second debate is at odds with Bernhard's hypothesis on the source of central bank independence.

³ In opposition, Thatcher had been converted to the monetarism of Friedman and the free market philosophy of Hayek by Keith Joseph, with whom she set up the Centre for Policy Studies in 1975.

⁴ Governor Leigh-Pemberton, appointed by Thatcher, was heavily involved in the reform of banking supervision including 1986 Financial Services Act, the 1987 Banking Act and 1988 Capital Adequacy Accord.

The UK was forced to exit the ERM in September 1992, following speculation against the pound in the financial markets.⁵ Following this debacle, Lamont pushed Major to give consideration to independence for the BoE on several occasions – in September 1992 and again in November 1992 – in order to rebuild lost credibility with the markets (Lamont 1999, p.322-325).⁶ Major refused, fearing it would “annoy the Eurosceptics” whom saw independence as a part of the European debate (Kavanagh et al. 1999, p.229; Lamont 1999, p.323).⁷ The Eurosceptics opposed central bank independence, a requirement of the Maastricht Treaty for countries wishing to join European Monetary Union in stage two. They voted against the government’s Maastricht paving bill in November 1992 and against the final reading of the Maastricht bill in May 1993.⁸ Having failed to defeat the Maastricht Treaty, the Eurosceptics tried to unseat Major by challenging his leadership to the party (unsuccessfully) in the run-up to the 1997 election.

Despite conflict within the ruling party, Major refused to consider independence for the Bank of England, risking a vote of non-confidence rather than give control of interest rates to an ‘unaccountable’ body. Lamont therefore took steps to rebuild Britain’s anti-inflationary policy on a domestic basis by introducing an inflation target, by requesting the BoE publish a quarterly *Inflation Report* and by setting up an independent panel of

⁵ On 9 September 1992, the Finnish markka was devalued 15 per cent followed by Italian lira on 14 September that pushed to pound to its floor of DM 2.77. Wholesale speculation against the pound on Wednesday 9 September led Chancellor Lamont to suspend UK membership of the ERM.

⁶ During the build-up to Black Wednesday, Chancellor Lamont discussed the possibility of leaving the ERM with Treasury officials, suggesting it was worth thinking about BoE independence (Lamont 1999, p.219).

⁷ Eurosceptics were Conservative backbenchers who opposed closer ties with Europe on the grounds that it infringed on British sovereignty. They came to prominence during the debate over the 1991 Maastricht Treaty, signed by the UK in 1991, and openly revolted against Major’s government following exit from the ERM.

⁸ On the first occasion, the bill passed by 319 votes to 316 (Seldon 1998, p.341). On the second occasion Major formed a coalition with Labour to pass the bill against opposition from a record 46 Tory MPs (Seldon 1998, p.371).

forecasters. These small steps laid the groundwork for future independence for the BoE. Lamont observed: “Ironically, in so far as it precipitated Britain’s departure from the ERM, the Bundesbank helped put the Bank of England on the path to independence” (Lamont 1999, p.266).

Like his predecessor, Lamont used his resignation speech in June 1993 to condemn the politicisation of interest rates and to call for reform of the BoE. “Markets and business men are cynical. They know that, in a fixed exchange rate system, there are certain things that Finance Ministers have to say. Credibility and confidence depend not on words but on objective conditions... Nothing would be more effective in establishing the Government’s credibility than if [Major] would have the courage to establish an independent central bank in this country. The time has come to make the Bank of England independent.” (Hansard 1993a).

Steps Towards Independence

At the same time, the backbench Treasury Select Committee began an inquiry into *The Role of the Bank of England* that revealed a similar concern with the judgement of the financial markets (Committee 1993a). The inquiry considered the case of an independent BoE in light of the 1992 ERM crisis, the 1991 BCCI scandal and the trend towards independence abroad. The Committee heard expert evidence over five months and issued its report at the end of 1993. The report called for New Zealand-style reforms – the transfer of interest rate responsibility to the BoE, the continued use of an inflation target, the creation of a MPC (styled on the reformed Banque de France) and the

inclusion of a government override – the same reforms put in place by Gordon Brown.⁹ All but one (vocal) member of the Committee endorsed this recommendation.¹⁰

Coincident with tabling of the report, the Committee sponsored a Private Member's Bill in the House of Commons to implement these reforms with the parliamentary debate taking place in January 1994. The debate revealed widespread agreement on the desirability of price stability but no consensus on the institutional steps to achieve it. Both the Government and the Opposition had concerns with democratic accountability and transparency. Conservative backbenchers focussed on the impact on mortgage holders with Eurosceptics suggesting the bill was a step towards European Monetary Union. Labour MPs argued that financial interests were over-represented in the BoE's management at the expense of industry (Hansard 1993b, p.575). Opposition from Committee member Diane Abbott particularly damaged her colleagues' case. Lacking government support, the bill died.

Despite the failure of this backbench effort, it did result in several institutional changes that would have wide-ranging, unintended consequences for this debate. While rejecting greater autonomy for the BoE due to the lack of democratic accountability, Conservative Chancellor Clarke agreed to publish the minutes of his meetings with Governor George in order to increase the transparency of the process and improve the credibility with financial markets (Committee 1994). Earlier that month the Chancellor had announced that the BoE would have discretion in the timing of the announcement of the Chancellor's changes in interest rate policy. These reforms, combined with the

earlier decision to adopt an inflation target and to publish the BoE's *Inflation Report*, were designed to satisfy critics who saw the process as politicised. Instead of increasing credibility, publication of the minutes revealed how the Chancellor was altering interest rates strategically in the run up to the 1997 election, undermining the Conservative government's credibility and providing an important political lesson to Shadow Chancellor Brown.

The Roll Report

At the same time that the Treasury Select Committee was considering this issue, the financial sector was involved in a high profile effort to directly lobby politicians on the issue of independence for the BoE. In 1993, a group of City bankers convened under the auspices of the Centre for Economic Policy Research and published a report titled *Independent and Accountable – A New Mandate for the Bank of England* (Roll 1993). The President of S G Warburg, Lord Roll, chaired the panel that included representation from Barclays de Zoete Wedd, Lloyds Bank and Prudential Corporation, as well as a number of influential (former) central bankers and high profile economists. The report summarised the theoretical case for independence and outlined a proposal for maintaining accountability and democratic control based on the model of New Zealand. The report, published at the same time as the Treasury Select Committee report, concluded by calling for action 'to strengthen both the independence of the Bank of England and the accountability of macroeconomic policy' (Roll 1993, p.65). Despite its prominent authors and the growing consensus on its findings, Major's Conservative government ignored the group's advice. New Labour officials recall reading the report

⁹ The Treasury Select Committee considered evidence from BoE staff, two former Chancellors, representatives from industry and numerous academics. In addition the Committee surveyed 19 central banks and visited the Bundesbank, the Federal Reserve, and the US Treasury.

¹⁰ Labour MP Diane Abbott opposed the report, viewing an independent central bank as essentially undemocratic (Committee 1993a, p.32).

and being pleased that it agreed with their own position, but it was not influential in their decision.¹¹

In summary, international financial market actors led the second push for central bank independence by challenging the government's unsustainable policy mix of lower interest rates for domestic reasons against higher rates for external reasons. The fall-out of the ERM exit saw a Conservative government lacking in credibility and divided against itself, with Eurosceptics in open revolt against their Prime Minister. This credible threat from backbenchers opposed to central bank independence was offset by another group of backbenchers in favour of BoE independence on the basis that it would provide greater credibility with financial markets. In the face of these contrasting pressures, the Conservative government introduced some small institutional changes that later had unexpected consequences for the independence debate. But Major held on to interest rate policy for seven years from 1990-1997, refusing to tie his hands and give up this politically useful tool for directing (and stimulating) the economy.

New Labour and New Economic Stability

By the 1990s, the Labour Party had come to be seen as the party of devaluation and instability. Labour has held power for three periods in the post-war era, two of which have been marred by a financial crisis – the sterling crisis of 1947, the devaluation of 1967 and the IMF crisis of 1976. Shadow Chancellor Gordon Brown had these facts fresh in his mind as he developed New Labour's economic policy manifesto for the 1997 election. "With memories of forced Labour devaluations of the 1970s still fresh, Brown did not want the party of the 1990s to be thought of as the party of devaluation" (Routledge, 1998 p.168). New Labour needed to reassure business and the financial

markets of its moderation once in office (Wickham-Jones 1997). In the words of one of Brown's economic team:

[Operational] independence removed one possible area of conflict between Nos. 10 and 11... But of far greater significance than that was the importance of the political signal the move sent to the City and the wider business community. It portended in the clearest possible terms that New Labour was serious. In essence, it was a political decision, supremely important and perfectly timed. (Robinson 2000, p.45)¹²

As a successful MP with 14 years in opposition, Brown recognised the need to provide policies that met the interests of his key constituents – in this case the financial markets and business. He needed to convince them that New Labour would not follow the 'soft option' of devaluation.¹³ For this reason, Brown had earlier supported British membership in the rules-based ERM during the early 1990s, despite opposition within his own party to this stance. Faced with speculation against the pound in late 1992, Brown had refused to soften Labour's opposition to 'unilateral devaluation' that meant that Labour bore part of the blame for the subsequent events (Routledge, 1998 p.154). But Brown was adamant, and told the TUC conference before Black Wednesday that "There is no policy for devaluation on the part of the Labour Party" (Routledge, 1998 p.170). When the UK was finally forced out of the ERM, Brown did use it as an opportunity to paint the Conservatives as the party of devaluation (Routledge, 1998 p.171). The message to be carried into the next election was that Conservatives could not be trusted on the economy, whereas Labour could.

¹¹ Interviews with Ed Balls, HM Treasury, and Geoff Mulgan, Prime Minister's Policy Unit.

¹² Gordon Brown's economic team in opposition was Ed Balls, Charlie Whelan, Sue Nye, Ed Miliband and Geoffrey Robinson MP. Other ministerial members of the team were Alistair Darling MP, Helen Liddell MP and Dawn Primarolo MP.

¹³ Weeks before the ERM crisis forced the UK to devalue the currency, Major stated in a speech that he would not pursue 'the soft option, the devaluer's option' (Seldon 1998).

Brown formulated New Labour's plans for the BoE when he was Shadow Chancellor, from 1992-1997. He first laid out his approach in the 1993 conference document *Labour's economic approach*, which pledged "It is now time to reform radically the Bank of England and the conduct of monetary policy. The bank must be made more accountable and its decision-making bodies be made both more open and more representative" (Labour 1993). This idea was more explicit in the 1995 conference document *A new economic future for Britain*. "The Bank of England will need to be restructured in order that it can carry out its functions in an open and accountable manner...We are attracted by the option of establishing a new monetary policy committee, overseen by a more representative court" (Labour 1995). Tony Blair echoed these sentiments in his 1995 Mais lecture stating:

Our objective is clear. This is to reform the Bank of England so that it can carry out its increasingly important functions in an open and more accountable manner. Gordon Brown spelt out a series of reforms last week. We will then watch the track record of the Bank before deciding what, if any, further steps should be taken towards greater operational responsibility for the Bank in interest rate policy (Blair 1995).

Prior to the 1997 election, New Labour set about winning the confidence of business by undertaking one of the "biggest consultation exercise with business ever undertaken by a political party" (Labour 1997). The Shadow Cabinet spoke with thousands of businessmen and women up and down the country in a consultation exercise that resulted in New Labour's 1997 *Business Manifesto*, the first of its kind by a Labour party. The manifesto lists as the top priority "Stable prices with a target set to achieve inflation of 2.5 percent or less" and speaks of reform of the relationship between the

Bank of England and the Treasury in order to deliver on this commitment (Labour 1997). These documents clearly signpost the major institutional changes in monetary and fiscal policy that were put in place following New Labour's victory in the 1997 election.

Balls and Euro-monetarism

The genesis of New Labour's plan for the BoE did not come from consulting with interest groups, but came from a pamphlet written in the aftermath of the ERM crisis by a Labour party supporter, Ed Balls. In December 1992, Balls – a lead economics writer at the Financial Times – wrote a discussion paper for the Fabian Society titled *Euro-Monetarism: Why Britain was ensnared and how it should escape*, which set out a 'non-monetarist' alternative for achieving macroeconomic stability and credibility in an open economy (Balls 1992). At the time, no one in the Labour Party was advocating handing over control of interest rate policy, as seen by John Smith's reaction to Lawson's resignation speech (Pym et al. 1998, p.6). Balls was introduced to Brown in mid-1992 and became his economic adviser in 1994.¹⁴ Together Brown and Balls reworked this Fabian pamphlet and submitted it to an election strategy meeting in 1995. *Euro-Monetarism* effectively became New Labour's economic policy manifesto for the 1997 election. It contained every major institutional change introduced by Brown: an independent Bank of England with a mandate to pursue price stability backed by a government escape clause; devolution of bank supervision to a new agency; a restructured and more representative Court of Directors; and a medium term industrial strategy emphasising fiscal responsibility and investment (Balls 1992, p.17). Foreshadowing Brown's subsequent speeches, Balls calls for "a credible and predictable

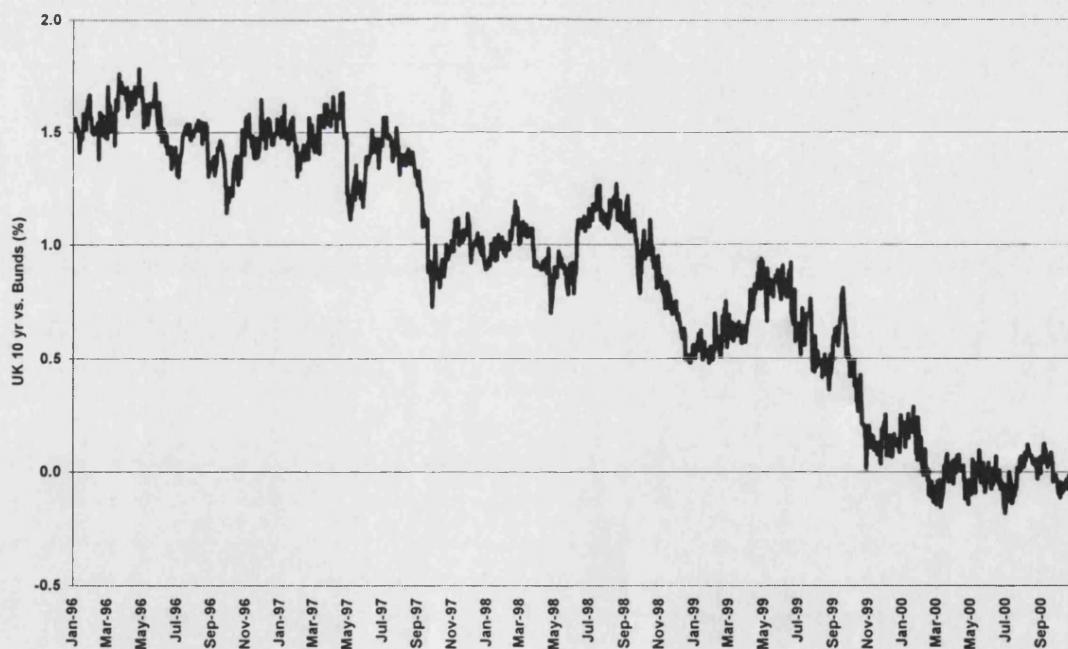
¹⁴ Balls was named Brown's Chief Economic Adviser following the 1997 election.

macroeconomic policy framework that can deliver economic stability combined with active government measures to promote growth and full employment" (Balls 1992, p.3).

Balls builds his case for independence in three steps. First, 'tying the hands' would buy New Labour anti-inflationary credibility with financial markets and allow it to break with Labour's image as the party of devaluation. Previous Conservative governments failed to put in place credible, institutional mechanisms to prevent political manipulation of interest rates for short-term gain: "monetarist targets could not conceal the gaping credibility gap between politicians' short-term desire to stimulate the economy and the public interest in medium-term stability" (Balls 1992, p.16). This importance of financial markets was not lost on Tony Blair, who noted "We must recognise that the UK is situated in the middle of an active global market for capital...[Capital] flows...can swiftly move against policies which fail to win investor confidence" (Blair 1995). Second, independence for the BoE would strengthen and not weaken the hand of a Labour government that had little to gain and a great deal to lose from trying to run monetary policy themselves (Balls 1992, p.16). The benefits of independence would be lower inflation and more time to focus on the fiscal and supply-side policies needed to build and sustain a recovery. Third, other left-of-centre governments had recognised the new reality of integrated capital markets and had pursued central bank independence, including the left of centre government in New Zealand. Failure to take this step, Balls argues, would result in "debilitating market doubts about the government's anti-inflationary resolve" leading to the same boom-bust cycles and financial crisis that were witnessed under the Conservatives (Balls 1992, p.18).

With Blair in agreement, Brown made up his mind shortly before the election to give the BoE full operational independence and asked Balls and Robinson to draft a letter detailing these arrangements for the Governor (Robinson 2000, p.37). The newly elected Prime Minister cleared this same document on the day following the election. A team from the Treasury worked on the details of the proposal over the weekend. Chancellor Brown presented the proposal to Governor Eddie George in an informal meeting on the Bank Holiday Monday 5 May. While the decision on the timing was the Chancellor's, the idea was pushed by Balls and was influenced by the successful example of the US Federal Reserve.

Figure 16: Spread between UK and German 10-Year Bonds



8.4 Explaining Timing and Design

International Financial Markets

New Labour gave control over interest rates to an independent but accountable Bank of England in order to gain credibility with the financial markets. This reform also

provided a platform of economic stability that would encourage investment by business. Of these two constituencies, the support of financial markets was most pressing in the short term, because New Labour could not govern if it continued to be seen as the party of devaluation and economic crisis. Operational independence for the BoE gave New Labour the breathing space to prove itself and to deliver on its policy promises that appealed to a broader centrist set of political interests in society while distancing itself from the hard-left supporters of Old Labour. It also provided a foundation for economic stability in the medium to long term, which it was hoped would lead businesses to undertake longer term investments and create jobs and growth.

With the approach of the 1997 election, New Labour's goal was clear. '[The] imperative for the Blair Government was to establish credibility with the markets' (Grant 2000a, p.16). Brown pledged to establish a stable macroeconomic framework and anti-inflationary policy in order to provide a stable platform for investment and 'retain the confidence of the financial markets' (Labour 1995, p.13). Brown signalled these policies to the financial markets through Gavyn Davies, chief economist at Goldman Sachs and New Labour adviser, who outlined the entire strategy for the BoE in an article published in the *Financial Times* in the month before the election (Timewell 1997). In this way, the announcement of the reform at the BoE was widely applauded by the financial press and markets alike. Long term interest rates declined, the pound strengthened and the FTSE equity index rose to new heights. According to *The Banker*, giving independence to the Bank of England established Gordon Brown's anti-inflation credentials and signalled that Labour could take the bold initiatives it had promised.¹⁵

¹⁵ "Blair's Britain", *The Banker*, June 1997, p.21-23.

An independent BoE with a mandate for price stability and a symmetrical inflation target reduces the threat from foreign exchange speculators who lack the target of a fixed exchange rate peg. While New Labour wished to signal their credibility to this set of interests, they were not concerned with signalling creditworthiness to foreign bondholders as Maxfield (1997) suggests. UK government debt is largely held by domestic institutional investors, insulating government from the need to fund its borrowing requirement abroad. The availability of inflation-linked instruments as an alternative to nominal gilt investments further discounted the importance of price stability to domestic bond investors.

Table 52: UK Government Foreign Borrowing

Year	Total debt held by private sector as % GDP ¹	Foreign debt as % GDP
1980	52.2	6.8
1985	54.2	6.1
1990	36.0	5.6
1992	35.8	6.2
1994	47.9	9.3
1996	52.5	8.4

1. The private sector held between 75 to 80 per cent of total debt during this period.
Source: HM Treasury

Interest Group Lobbying

What of the argument that politicians give independence to the central bank in response to lobbying from interest groups (Posen 1995b)? The evidence from the UK case suggests that interest groups did not lobby the Government, the Opposition or the Treasury on this issue. Given the fragmented representation of the City's interests and their preference for 'quiet lobbying', it is not surprising to learn that financial interests did not take part in debates about BoE independence. Financial sector associations only tend to lobby on those issues that are most relevant to their individual businesses, issues that have a direct economic impact on their membership such as issues of taxation and

regulation. They steer away from issues that are perceived as too political or not directly related to their interests. For example, the Director General of the British Bankers Association (“BBA”), Tim Sweeney, claimed in a letter to this author not to take a position on monetary policy issues, leaving macroeconomic lobbying to the CBI of which it is a member. The National Association of Pension Funds that speaks for the largest group of institutional investors in the UK also does not discuss monetary policy. The International Primary Markets Association was active in lobbying on the detail of the Financial Markets Act and the issue of the withholding tax on Eurobonds, but they did not lobby the Treasury on independence for the BoE.¹⁶

For financial associations, lobbying policymakers on political issues is seen as potentially damaging for their business and not worth the risk. When lobbying is undertaken, it is informal with a few senior representatives from member firms expressing their views directly to the Treasury, rather than to politicians. The financial associations do not issue reports on their views nor do they make their efforts public, only expressing an opinion if they are called to testify by a parliamentary committee. Otherwise they prefer the strategy of ‘quiet lobbying’ that is hard to detect and to support empirically (Coleman 1988, p.64). Nevertheless, key lobbies were able to signal support for reform even if they did not push for this policy.

Nor did business and trade associations lobby politicians on the issue of BoE independence. Both the Confederation of British Industry (“CBI”) and the Institute of Directors had internal policies in favour of BoE independence following the ERM

¹⁶ Interview with Robert Gray, Vice-Chairman of HSBC and Chairman of International Primary Markets Association, 16 June 2000.

crisis, but neither association lobbied the government on this issue (CBI 1993; Morgan 1993). Adair Turner, former Director General of the CBI, recalls:

When I took over in 1995 the CBI already had a formal policy in favor of Bank of England independence, but it was not a topic on which we were strongly lobbying. That reflected the fact that although there was a majority in favor of it [within the Economic Affairs Committee of the CBI], it was a somewhat technical issue that did not interest the ordinary membership... It wasn't something where in our meetings with the Prime Minister we would ask 'Why haven't you introduced central bank independence?'¹⁷

Leading business associations did not play an active part in this debate nor did their membership have a common preference. These conclusions suggest that the preferences of business were not a factor in the outcome.

Despite the lack of lobbying on BoE independence, it is still possible to argue that the preferences of business influenced New Labour as they prepared their package of economic policies prior to the 1997 election. Chancellor Brown knew his party needed to win the support of business in order to delivering on their election promise of achieving a higher rate of investment (Labour 1995, p.22). Blair and Brown have made a concerted effort to consult with business, speaking with over 10,000 business people through speeches to the CBI, the Annual Conference of the British Chamber of Commerce, the Federation of Small Businesses (Labour 1996). Given the wide ranging nature of this consultation, New Labour clearly had the preferences of business in mind when they argued that BoE independence would deliver economic stability, lead to lower interest rates and avoid the cycle of boom-bust experienced under the

Conservatives. However, not all New Labour's economic policies were made with solely business in mind as seen in the windfall tax on the privatised utilities, the moves to strengthen the Monopolies and Mergers Commission and the decision to sign the EU's Social Chapter and pass legislation facilitating the ability of unions to organise. These policies clearly conflicted with the wishes of big business, suggesting that New Labour imposed policies that would also benefit its traditional voters, not satisfy the preferences of one interest group.

The approach taken by business associations on BoE independence was mirrored by the Trades Unions Congress ("TUC"), which also supported greater independence for the BoE internally. However, during the public debate in the 1990s, the TUC resolutely sat on the fence and refused to take a firm view on the issue either way for fear of alienating parts of their membership. In the words of one TUC official:

We did not take a very firm view on it either way. We resolutely sat on the fence... We had other things on our agenda than worrying about Bank of England independence. It was a quite difficult period for us, on the industrial relations and labour market fronts. So we were not being pushed to take a position.¹⁸

The TUC had other things on its agenda than worrying about Bank of England independence. Externally the late 1980s and early 1990s were a difficult period on both the industrial relations and labour market fronts. Internally, the TUC was preoccupied with an internal reorganisation that sought to restore its role in influencing policy. And in the run-up to the 1997 election, the TUC was focused on the issue of labour standards such as the minimum wage, changes in the recognition laws of trade unions, the

¹⁷ Interview with Adair Turner, Former Director-General of the Confederation of British Industry, 30 November 2000.

¹⁸ Interview with Ian Brinkley, Economist, Trades Union Congress, 24 November 2000.

working time directive and the adoption of the Social Chapter of the EU. Independence for the BoE was therefore not something that featured in trade union debates. The trade unions were not influential in shaping New Labour's policies, as their traditional ties with the Labour party have been eroded. Given their diminished influence on UK party politics, it is not surprising to learn that the trade unions did not lobby on the issue of central bank independence.

It is doubtful if the trade unions could have affected this outcome regardless of their preference towards the central bank. By 1997, New Labour had clearly abandoned many traditional union concerns in order to move the party to the political centre. Marsh notes: "The decline in the number of a party's core voters, due to social changes, presents it with a dilemma. It has to choose whether to stick to the interests of its traditional voters and face declining electoral support or to transform and attract voters from new social groups in order to maintain, or even increase, electoral support" (Marsh 1998, p.64). New Labour needed to transform itself in order to win the election. Part of this transformation involved freeing the party from the control of the unions.

For his part, Ed Balls dismisses the suggestion that New Labour's decision to give the BoE operational independence was the result of domestic interest group lobbying.¹⁹ Officials at the Treasury and the Bank of England cannot recall any private sector lobbying on this issue. For example, Lord Burns, former Permanent Secretary of the Treasury during this period, recalls a certain amount of lobbying by the financial press and through publication of the Roll report, but the Treasury received no serious

¹⁹ Interview with Ed Balls, Chief Senior Economic Adviser of HM Treasury, 8 January 2001.

representations from banks or their associations.²⁰ Both the Treasury Select Committee and the independent Roll committee considered input from banks and industry, but neither of these efforts was seen as impacting the political debate. Given the lack of evidence to support the lobbying hypothesis – either in print or in discussions with officials involved in this debate – it is possible to conclude that interest group lobbying did not influence the Conservatives or New Labour on this. However it is certainly true that *indirect* pressure through the financial markets, through the investment decision of businesses, and through the voting patterns of homeowners did factor in the political judgements of the likely benefits and costs of such a reform.

Impact of the Transnational Epistemic Community

The second hypothesis suggests that politicians give independence to their central banks in response to academic ideas concerning monetary policy that are promoted by an epistemic community of monetary experts. The influence of this epistemic community is increased by uncertainty or an economic crisis. These experts must form a consensus on this paradigm and they must have a politician that can champion the legislation through parliament on their behalf. The UK case clearly supports this hypothesis. New Labour's decision to adopt independence for the BoE was heavily influenced by the ideas of economists, propagated by policy advisors and think tanks while the party was in opposition. Ball's pamphlet on *Euro-Monetarism* provided a coherent, worked-out strategy that Brown could adopt as his own. Brown was convinced of these ideas directly by his economic adviser, Ed Balls, with the assistance of monetary experts in academia and practitioners at other central banks, notably the Fed, the Bundesbank and the Banque de France. Each of these steps in the channel will be addressed in turn.

²⁰ Interview with Lord Burns, former Permanent Secretary of HM Treasury, 24 January 2001.

BoE independence emerged on the Labour Party's agenda as a response to a history of finance crises. Balls wrote Euro-Monetarism in the aftermath of the ERM crisis to suggest a domestic alternative to an external anchor, or as he phrased it a 'non-monetarist' alternative for achieving macroeconomic credibility in an open economy. British monetary policy was characterised by a high level of uncertainty in the early 1990s, with politicians searching for alternatives. Brown (and Prime Minister Blair) wished to learn from the failure of income policies under previous Labour governments, as well as the failure of monetary targeting and exchange rate targeting under the Conservatives. These events were critical in guiding the debate during the 1990s towards the solution of operational independence for the BoE.

As Chancellor Brown's economic adviser from 1994, Balls played a catalytic role in introducing Brown to the academic debate taking place among a transnational epistemic community of economists and central bankers. Balls recalls the main influences:

There was a CEPR paper on central bank independence [the Roll report] which in part we disagreed with but was quite important in terms of our arguments. I had been at Harvard where Summers had written a paper with Alesina on central bank independence and that gave the academic view of the debate. There was quite an intensive academic debate about the European Central Bank and its statutes. I certainly thought that [the architects of the ECB] were doing it the wrong way – they were making the wrong choices for a newly independent central bank which would have to establish its credibility. So we were quite negatively influenced by the way that was done. There was a paper by Stan Fischer [and Guy Debelle]

which looked at goal independence and instrument independence which was around at the time... Those would be the influences that we considered.²¹

Balls and Brown studied the institutional arrangements of other central banks - the Fed, the Bundesbank, the Banque de France, the European Central Bank and the Reserve Banks of New Zealand and Australia – in order to learn how to proceed from studying other countries' experiences. They wished to emulate the institutional designs of the most successful central banks, while avoiding the pitfalls of individual models. The BoE Act 1998 therefore represented a collage of best practices in central banking, combining the Fed's decision making structure with the RBNZ's inflation target and accountability.

Balls and Brown met with a number of central bankers: Trichet at the Banque de France, Tietmayer at the Bundesbank, Brash from the Reserve Bank of New Zealand. Perhaps the most influential meeting took place in February 1997 when Brown met with Alan Greenspan of the Federal Reserve. Brown was struck by how American interest-rate changes were not politicised, and agreed with Greenspan's sentiment that raising interest rates was an unpopular decision that was best handled by the central bank (Robinson 2000, p.36). Brown's original plan was to have a new MPC to advise the Chancellor on interest rate decisions. However, Brown and Balls decided that it was better to move decisively at the very beginning of the Parliament rather than become engaged in the old and unstable 'personality' relationship between the Chancellor and the Governor. Balls convinced Brown that external pressures would inevitably push Brown to give the BoE independence so it was better to make a virtue out of a necessity and take the political credit for the inevitable.

²¹ Interview with Ed Balls, Chief Senior Economic Adviser, HM Treasury, 8 January 2001.

While the importance of ideas for influencing policy is compelling in this analysis, causation cannot be supported by this case study. There are major problems with an 'ideas only' explanation. Why did ideas favouring central bank independence influenced New Labour, but not the Conservatives, as witnessed by the failure of the Treasury Select Committee's Private Member Bill and the Roll Report? In both cases, the Conservative Chancellor had championed this reform – first Lawson then Lamont – yet the Prime Minister had opposed it. While the lack of empirical evidence supporting central bank independence may explain Thatcher's decision in 1988, it is an unsatisfactory explanation for Major's refusal over 1992-1993 as the literature on this topic was quite extensive at this point. Clearly ideas alone are important but insufficient to convince the Conservative Party to adopt this reform. The answer is that ideas were secondary to the political imperative to get re-elected.

Tying the hands

Discussions with colleagues of Brown agree that the 'Iron Chancellor' did not blindly follow the suggestions of his advisers on this – or any- issue. Brown is described as someone who must be convinced of the arguments before making up his own mind and then he takes the decision. For a politician with Brown's experience, discussions of economic gains are not enough – there also need to be clear electoral gains in order to consider such a policy change.

BoE independence provided clear electoral gains for New Labour, but only electoral costs for the Conservatives. New Labour would gain anti-inflationary credibility with financial markets, as well as providing more breathing room to concentrate on fiscal and supply-side policies that were important for winning a second term. While critics argue

that an independent BoE provides a useful scapegoat for a Labour Chancellor, Balls argues that Chancellor Brown always believed he would be held responsible for poor economic performance regardless of the institutional framework. Nor did the marginal gains from lower long term interest rates on the government's debt factor highly, as these savings are not easily identifiable by the electorate. For New Labour, the key was to signal a new approach, to gain policy credibility and to open up room to manoeuvre.

New Labour needed to win credibility with business in order to be successful. 'Delivering a higher rate of investment will be a key objective for a Labour government' (Labour 1995, p.22). Blair and Brown have made a concerted effort to consult with business, speaking with over 10,000 business people through speeches to the CBI, the Annual Conference of the British Chamber of Commerce, the Federation of Small Businesses (Labour 1996). But not all of New Labour's economic policies were made with solely business in mind. Many of the policies clearly conflict with the wishes of big business, such as reform of the regulation of the privatised industries, the windfall tax on utilities, the strengthened Monopolies and Mergers Commission, the decision to sign the EU's Social Chapter, and new legislation facilitating the ability of unions to organise. The concerns of business were important, but they were not paramount to New Labour.

By contrast, the Conservatives only saw electoral costs from BoE independence that justified their opposition to this reform despite the economic gains and stability it would bring.²² For Thatcher, such a move would be a politically damaging admission of failure and it would remove the ability to set interest rates for electoral reasons. It would also

remove the government's ability to interfere with interest rates for political business cycle reasons. British politicians are uniquely tempted among their industrial peers to manipulate interest rates for political reasons, due to the structure of the home-ownership in the UK (Hansard 1993a). Over two-thirds of the population own their homes, which are financed mainly by variable rate mortgages linked to short-term rates (Committee 1993a, p.17). The extent of variable-rate debt in the UK means that interest rate changes affect personal disposable incomes quickly and significantly (Miles 1994, p.41). Homeowners are an important part of the electorate in the UK and British politicians recognise the tendency of the electorate to vote with their pocketbook.

Table 53: International Comparisons of Home-Ownership

	UK	Australia	Canada	NZ	Germany	USA
Owner Occupiers	68	70	63	74	38	65
Social Rented	23	6	6	n.a.	15	2
Private Rented & Other	<u>10</u>	<u>24</u>	<u>32</u>	<u>26</u>	<u>47</u>	<u>33</u>
Total	100	100	100	100	100	100
Owner Occupiers with a Mortgage	63	38	52	53	n.a.	61
Mortgage Debt as % GDP	61	26	45	38	48	52
Variable Interest Rate Mortgages as % Total	79	90	30	n.a.	5	26

Source: Evans et al (1998), Holmans (2000)

The Conservatives viewed homeowners as a key constituency of loyal supporters, which Thatcher called 'our people'. Thatcher resisted interest rate increases whenever it was politically expedient, arguing that the needs of homeowners must never be

²² Ironically, within the first parliament the Conservative opposition came out in support of the new arrangements.

forgotten.²³ “Other things being equal, on every ground a low interest rate economy is far healthier than a high interest rate economy” (Thatcher 1993, p.698). Despite telling the 1980 Conservative Party conference that “The Lady’s not for turning”, Thatcher swiftly abandoned her monetarist principles in response to the sinking popularity of her party. In the run-up to the 1983 election, the monetary targets were watered down in favour of an expansionary discretionary policy designed to appeal to consumers and mortgage holders. This switch reflected the imperative of the political business cycle, not the defeat of inflation. Thatcher engineered a second fiscal expansion prior to the 1987 election, resisting interest-rate increases in 1986 due to their impact on the homebuyers’ vote (Lawson 1992, p.85). Her resistance to interest rate increases in the run-up to the 1987 election ironically led to the real estate crash of 1989 and produced negative equity in many homes (Lawson 1992, p.85). Reflecting on this episode, Lawson concludes: “The picture [Thatcher] liked to present of herself as a uniquely doughty fighter against inflation was, in this sense, largely mythical” (Lawson 1992, ch. 53). As testament to this claim, the Thatcher government failed to meet a single one of its monetary targets between 1979 and 1990.

Major was equally sensitive to the politics of interest rates and saw nothing wrong in altering them for electoral purposes, such as the timing of a by-election. Chancellor Lamont chided Major, claiming: ‘I do not believe that even the timing of interest rate changes should ever be affected by political considerations. Interest rate changes should never be used to offset some unfavourable political event. To do so undermines the credibility of policy and the credibility of the Chancellor’ (Hansard 1993b). The phenomenon of negative equity following the real estate crash of the late 1980s created

²³ Thatcher had set out to create a home-owning democracy, passing legislation in 1980 allowing

a core constituency who would resist interest rate increases at all costs (Whiteley 1990, p.191). As the minutes of his meetings confirmed, Chancellor Clarke resisted interest rate increases in order to retain the support of the 1.7 million homeowners, or roughly 3 million voters, who were suffering from negative equity (Budgen 1996).²⁴ Apart from his interest rate concerns, Major saw a real threat to his electoral chances from Eurosceptics should he move towards monetary union.

Despite their party's history of boom and bust economics, and the debacle of the ERM crisis, the Conservatives believed that financial investors and business would continue to back their party due to the perceived radical threat from Labour and the trade unions. This belief was behind their advertising campaign during the 1997 election "New Labour, New Threat". The Conservatives wished to continue using their control of monetary and fiscal policy tools to win the support of consumers and mortgage holders, promising lower interest rates in their election manifesto. Without any perceived need to reform monetary policy from the electorate, and no credible threat from backbenchers to their durability as a government, the Conservatives did not have to respond to any demands for operational independence for the BoE. Instead they introduced small, token changes that had large, unexpected consequences such as adoption of an inflation target in 1992 and agreeing to publish the minutes of the interest rate decisions in 1994.

Bernhard (1996) has argued that New Labour gave independence to the BoE in order to increase the stability of their government. In this view, increased economic openness created more potential for intra-party conflicts over UK monetary policy, as seen in the

residents in state-owned council housing to purchase their flats (Dale 2000a, p.397).

²⁴ With the Conservatives suppressing interest rates in the run-up to the 1997 election, Labour Chancellor Brown was forced to raise rates as his first action in office in order to meet the existing inflation target.

aftermath of exit from the ERM. This institutional change was not made in response to fears that Labour party backbenchers might oppose Chancellor Brown's economic policies, threatening the durability of the New Labour government. The fundamental problem with this hypothesis, as applied to the UK, is that it assumes that backbenchers have the ability to credibly threaten to bring down the government. However, this threat was clearly not credible due to the concentration of power under the Westminster system and the lack of checks and balances on the government. For this reason, Major was able to face down numerous threats to his leadership from Eurosceptic backbenchers. Likewise, Labour backbenchers were relatively powerless to threaten the Blair government. The new intake of Labour ministers who took office in 1997 supported the modernising drive by Blair and Brown, as witnessed by their support for changes in the Labour party's constitution and institutional structure prior to the election.

8.5 Electoral Gains Plus Signalling

In summary, the BoE was given independence in response to a set of academic ideas that provided clear electoral gains to Chancellor Brown. The incentives for this reform came from the Labour Parties history of financial crises that had blown previous Labour governments off course in 1947, 1967 and 1976. BoE independence was designed to signal the new governments 'conservativeness' to financial markets in the short term while creating a platform of stability that would appeal to business in the medium term. Only business investment could deliver long-term growth and employment that New Labour would need in order to be electable in years to come. This plan was suggested by a paper written by the Shadow Chancellor's economic adviser, Ed Balls, that provided a road map to a politically salient solution. BoE independence matched Brown's desire to shed Labour's reputation as the 'party of devaluation' while acting as

a symbol of a new approach. Reform of the BoE was only part of Brown's larger plan of adopting tough fiscal rules, reforming the tax system and promoting a longer term focus of government spending designed to signal New Labour's prudence and trustworthiness as managers of the economy. Independence for the BoE was not in response to direct or indirect lobbying by trade associations, civil servants or BoE employees, nor was it designed to avert a potential threat from Labour backbenchers over economic policy.

Ch. 9 International and Domestic Sources of Economic Policy Reform

During the 1990s central banks have become the focus of public interest and a source of controversy in democracies. Over this period they have gone from operating in relative obscurity to centre stage, with figures such as Federal Reserve Chairman Alan Greenspan becoming as well known internationally as any head of state. This rise in visibility has reflected their growing importance given the rise in international capital flows and the increased interdependence of states. Central bankers are the navigators of the world economy (Economist 1999b). This rise has resulted in greater public criticism, not unlike the treatment given to international institutions like the IMF (Pauly 1997). Greater power comes at the cost of greater accountability, a point that central banks were perhaps slow to recognise during the 1980s. In recognition of this fact central banks during the 1990s focussed on increasing the transparency of monetary policy decisions and educating the public on the benefits of price stability. This process has been slow, as monetary policy remains an esoteric and complex area that few outsiders understand (Moran 1984b). Even monetary experts cannot agree on the pathway by which interest rate changes affect the economy. To be fair, it is only since the decline of the Bretton Woods system in the 1970s and the general move to floating exchange rates during the subsequent decades that monetary policy has become such a powerful instrument for managing the economy. And structural changes in the world financial system, such as the rise of international capital flows, the deregulation of financial markets and the rise of stagflation have made the task of navigating more difficult.

Given the increasing importance of monetary policy it is not surprising that the decision by politicians to delegate control over interest rates to central banks should be controversial. This formerly academic issue moved to the centre of political debates in

Europe that followed the signing of the 1992 Maastricht Treaty, which required all member countries who wished to join the single currency to legislate greater political independence for their central banks. The changes in Europe took place at the same time as the newly independent Soviet republics were setting up their own independent central banks, most of them modelled on the most successful central bank of the past half century – the Bundesbank. The Bundesbank itself became the source of heated controversy both within and outside Germany at the time of reunification, when Bundesbank President Pöhl objected to the rate at which Chancellor Kohl agreed to exchange East German marks for Deutschemarks. The Bundesbank then pursued a restrictive monetary policy that threw much of Europe into recession, culminating in the spectacular collapse of the Exchange Rate Mechanism in late 1992.¹ Such episodes, combined with increased media coverage of central bankers and their decisions, have exposed central bankers to public criticism – a position that many no doubt find uncomfortable. It was only a matter of time, therefore, before critics began to question the lack of democratic accountability of these bureaucrats who appeared to hold so much power.

This study has examined these debates in four industrial countries, and offers an explanation for the growth in the trend central bank independence that has been missing from the economics literature. The case studies indicate that politicians were only willing to delegate to central banks when a number of conditions were met. First, an epistemic community of monetary experts had formed a consensus behind this new paradigm. Increased uncertainty arising from present or past financial crises made the ideas of this ‘policy elite’ more influential and weakened domestic opposition to this reform. Second, this epistemic community succeeded in convincing a key politician to

champion this reform through the legislative process. This political champion was motivated by the incentives provided by this reform. Either the reformer held an ideological conviction that politicians should not be involved in setting interest rates, as in New Zealand, or he was motivated by the electoral gains arising from this reform, which improved the party's chances of re-election. Third, the political institutions were permissive by offering few checks and balances on an executive that wished to push through this reform. The hypotheses based on domestic interest group lobbying and the need to signal creditworthiness to international financial markets were rejected. However, one motivation of central bank independence was found to be the desire to signal the government's anti-inflationary credibility to a domestic audience of non-financial actors, such as unions and businesses. The findings from the case studies are summarised in the first section of this chapter.

The second section summarises the contributions made by this study to the literature on international political economy, focussing on the power of international financial markets to constrain national economic policies, the ability of interest groups to influence the design of monetary institutions, and the international and domestic sources of economic policy. The third section concludes by discussing alternatives to central bank independence for establishing policy credibility and pointing to areas for future research.

9.1 Summary of Findings

This thesis has studied the debates surrounding central bank independence during the 1990s in four countries, New Zealand, Canada, Australia and the UK. All four countries began the 1980s in a similar position, with central banks that were widely seen as

¹ Bundesbank President Karl Otto Pöhl was forced to resign as in 1992 after resisting the popular policies of Chancellor Helmut Kohl (Lohmann 1998, p.417).

politically influenced and with monetary policy frameworks that were in transition.

Due to their common history, these Anglo-Saxon countries shared economic and political institutions, and had similar historical, cultural and ideological influences during the period being studied, making a controlled comparison of their experiences a worthwhile endeavour. Two countries in this sample legislated greater independence for their central banks and two countries rejected this paradigm in favour of the status quo.

The Reserve Bank of New Zealand (“RBNZ”) and the Bank of England (“BoE”) were both given greater legal independence in 1989 and 1997, respectively, with politicians delegating operational control over the setting of monetary policy to the central bank guided by a single objective of price stability set by the government. A decade separated these changes, during which time the ruling parties in office in both countries switched from the right end of the political spectrum to the left. By contrast, Canada and Australia debated this institutional reform but both countries rejected it in favour of the status quo – namely a sharing of monetary policy responsibility between politicians and central bankers with broad mandates to pursue price stability, employment and output goals. Canada and Australia also witnessed changes of government, although only Australia had a swing from the left to the right end of the political spectrum.² Interestingly, all four central banks adopted inflation targeting at some point over the 1990s as the principle framework guiding monetary policy – New Zealand in 1989, Canada in 1991, the UK in 1992 and Australia in 1993. This operational trend was not discussed in the case studies, which focussed primarily on the reform of the statute governing the central bank as suggested by the economics literature on central bank independence. However, the discussion below will offer an explanation based on the view that an inflation target is an alternative to legal independence for central banks perceived to have a high degree of *de facto* independence.

What explains the different outcomes in these four cases, and why did the reforms in the UK follow so long after similar reforms in New Zealand? This study has approached this question from the point of view of both international and comparative political economy, looking at the international and domestic sources of institutional reform. Four explanations have been examined to explain the timing of this reform, namely due to: pressure from international financial markets, the ideas of a transnational epistemic community, lobbying by domestic interest groups, and the electoral calculations of politicians.

The results from the case studies are summarised in table 1. The first two rows of the table show the 9 periods of political debates that took place concerning central bank independence in the four case studies. For example, Canada debated the issue of central bank independence on two occasions, in 1991-1992 and again in 1993-1994. Likewise, politicians in the UK considered this policy reform on three occasions, under Chancellor Lawson in 1988-89, in the aftermath of the ERM crisis in 1992-1994 and following the election of New Labour in 1997-98. The hypotheses for explaining the outcome of these debates, and their accompanying corollaries, are shown in the first two columns of the table. The outcome of each 'observation' is shown in the final row.

² While some observers view the Liberal Party of Canada as a left wing party, it is near the political centre, with the left represented by the New Democratic Party.

Table 54: Assessing the hypotheses in the four case studies

Row	Period of Political Debate	NZ 1988-90	CANADA			AUSTRALIA			UK		
			1991-92	1993-94	1989	1991-93	1996	1988-89	1992-94	1997-98	
1	H.I Need to signal creditworthiness	M	Y	Y	N	Y	Y	N	Y	Y	
2	H.II Advocacy of epistemic community	Y	Y	N	N	Y	N	N	Y	Y	
3	A Financial uncertainty or crisis	Y	N			M			Y	Y	
4	B Consensus on policy preferences	Y	N			N			Y	Y	
5	C Political champion	Y	Y			Y			M	Y	
6	H.III Lobbying by interest groups	Y	Y	Y	N	Y	N	N	Y	N	
7	A Effective financial sector lobbying	Y	M	M		N			Y		
8	B Effective support of coalition	Y	Y	Y		M			Y		
9	C Effective opposition of coalition	M	Y	Y		Y			N		
10	H.IV Electoral Incentives to tie the hands	N	N	N	N	N	N	N	N	Y	
11	A Right-wing with short time horizon									N	
12	B Left-wing with long time horizon									Y	
13	C Increase cabinet stability									M	
14	C.I Few checks and balances	Y	N	N	N	N	N	Y	Y	Y	
	Outcome of debate	Y	N	N	N	N	N	N	N	Y	

Note: y = yes, n = no, m = mixed

Signalling Creditworthiness to International Financial Markets

Hypothesis I argued that politicians with a long time horizon and a need for balance of payment financing will give independence to the central bank as a mechanism for signalling their creditworthiness to international financial markets. While pressure from international financial markets was a significant factor in the decision of governments to introduce economic reforms in all the cases (row 1), only in the UK can this pressure be clearly linked to Bank of England independence. New Labour was aware that each post-war Labour government had been put off-course by a financial crisis shortly after taking office – in 1947, 1967 and 1976. In their efforts to make the Labour Party electable, Blair and Brown reinvented (New) Labour, changing the party's constitution and adopting a policy platform based on economic stability and prudence. To complete their repositioning and to avoid being blown off course by a financial crisis, New Labour needed to signal its anti-inflationary commitment to international and domestic financial actors as quickly as possible, in order to gain some breathing space to implement their economic policies. Operational independence for the Bank of England gained them this reprieve, although the design in the UK allowed politicians to retain ultimate political control of policy through their control of the inflation target, their right to issue a directive and their control of key appointments.

In Australia and New Zealand, incoming left-wing governments were met with a currency crisis in 1983 and 1984, respectively, leading both countries to float their currencies and deregulate their financial sectors. However, once inflation had been brought down and the government's finances were under control, international financial markets were satisfied and any electoral gains from changing the central bank legislation were seen as marginal. Australia did not see the need to reform the RBA at all despite the 1983 currency crisis and Australia's deteriorating credit ratings. Instead

the ALP government brought its finances under control and paid down its foreign debt. Having removed this potential area of weakness, the government pursued a distinctive set of macroeconomic policies designed to protect the social wage of the trade unions while controlling inflation through voluntary wage restraint. The informal targeting of inflation by the RBA from 1993, formally endorsed by the in-coming Liberal government in 1996, further mitigated any need to change the central bank's statute in the eyes of the international financial markets.

The incoming government in New Zealand was faced with a high and unsustainable debt and rising deficits that were largely financed overseas. The cost of servicing this debt was punitive and created a strong incentive for the Labour government to take action. Finance Minister Douglas therefore introduced a wide-ranging and rapid set of economic reforms that liberalised the economy. He then sold state assets to reduce overseas debt and supported a restrictive monetary policy implemented by the RBNZ. By the time Douglas announced the government's intention to reform the *RBNZ Act* in 1988, toward the end of the Labour government's second term, the external debt had been reduced, New Zealand's credit ratings were improving and financial market conditions were benign. Central bank reform, at this point, was not introduced to attract balance of payments financing. Instead, this reform was designed to signal to a domestic audience that politicians would no longer set interest rates for political reasons, as had occurred under the National government of Muldoon. The policy reform was introduced for domestic, not international, reasons.

The case of Canada further demonstrates how international financial market pressure is often more directed at fiscal policy than at monetary policy. The unsustainable path of Canada's public debts and deficits during the early 1990s put pressure on the Canadian

dollar and led to a downgrade of Canada's credit ratings, but it did not spark a financial crisis due to Canada's floating exchange rate regime. This international financial market pressure did lead the incoming Liberal government to focus on deficit reduction and to pay down Canada's foreign currency debt, but it did not lead to changes in the *Bank of Canada Act*. The Conservative government's decision to abandon Bank of Canada reform in 1992 and the Liberal's failure to reappoint Governor Crow in 1993 did not spark a financial crisis, as predicted by the government's critics, largely because monetary policy was already directed to price stability as embodied in the 1991 inflation targets. These findings provide only limited support for the international financial market hypothesis.

The conclusion drawn from this study is that hypothesis I is rejected. The need to signal creditworthiness did not explain the outcomes in these four case studies. Generally, claims about the ability of international financial markets to influence domestic policy must be carefully qualified. Any statements about the power of international financial markets must take into account the type of exchange rate regime, the existence of exchange controls, the state of the governments finances, and the structure of the domestic financial system. Maxfield's (1997) argument that the need for balance of payments financing determines the degree of leverage by financial markets may apply to developing countries or countries with a fixed exchange rate regime, but it has limited usefulness for industrial countries or countries with a floating exchange rate. Apart from the cases examined here, one need only look at the history of the US balance of payments to realise that large states are in a different position from small states in their relationship with international financial markets. And even relatively small states like Canada or New Zealand that had comparatively large current account deficits have room to manoeuvre based on their credit rating, their level of foreign borrowings and

their willingness to pay a premium on these borrowings. This is consistent with other findings that international investors in the bonds of developed countries focus on only a few economic variables when making the decision to invest (inflation, deficit to GDP, debt to GDP) and do not necessarily consider the status of the central bank (Maxfield 1998; Mosley 2000; Oatley 1999).

Ideas of a Transnational Epistemic Community

Hypothesis II argued that politicians give independence to their central banks in response to the academic ideas concerning monetary policy that have been promoted by a transnational epistemic community of monetary experts. This epistemic community consisted of central bankers, Treasury officials, economic advisers and academics. Such an epistemic community was active in the debates on five occasions (row 2). However, only three cases fulfilled all the criteria specified for explaining when the epistemic community would be effective at influencing policy reform: in the New Zealand debates during 1988-90 and in the UK debates from 1992-94 and again in 1997-98.

In both cases where central bank reform took place, there is evidence that the ideas of a transnational community of monetary experts influenced the design but not the timing of the reform. In New Zealand, the epistemic community consisted of officials at the Treasury and the RBNZ, as well as advisers to Finance Minister Douglas. These individuals shaped the overall direction of Rogernomics, as witnessed by Douglas' Economic Policy Package and the Treasury briefings in 1984 and 1987. These documents provided politicians with a road-map of reform based on theories from academia (notably the Chicago school), the work of international institutions such as the OECD, the IMF and the BIS, and the reform experiences in Latin America and other industrialised countries. The detail of the *RBNZ Act 1989* reflects the state of the economic paradigm circa 1988, particularly its monetarist focus on a single objective of

price stability, the time inconsistency literature on delegation, and the public-choice contracting approach developed for the RBNZ Governor. These ideas were translated directly into the legislation by an RBNZ team that was intimate with the state of the academic literature. In addition to academic work, New Zealand policymakers emulated the policies of low inflation countries with independent central banks, such as the implicit inflation targeting approach taken by the Bundesbank and the Swiss National Bank (Bernanke et al. 1999).

New Labour's 1997 decision to give the Bank of England independence was heavily influenced by the ideas of economists, propagated by policy advisors and think tanks while the party was in opposition. The work of economic advisors like Ed Balls and Gavyn Davies were important for convincing Chancellor Brown of the economic benefits to be gained from this reform. Ball's 1992 pamphlet, *Euro-Monetarism*, provided a coherent, worked-out road map that New Labour then adopted in 1994 as its economic policy platform. This pamphlet advocated an independent Bank of England with a mandate to pursue price stability backed by a government escape clause, devolution of bank supervision to a new agency, a restructured governance structure and a medium term fiscal strategy emphasising responsibility and investment (Balls 1992).

The only difficulty is explaining why ideas were influential in guiding New Labour's policies, but did not influence the Conservatives during 1992-94. An epistemic community of City bankers, practitioners and academics presented a coherent framework in the Roll report. Likewise, the financial sector representatives and foreign central banks contacted by the Select Committee recommended the same solution. The motivation for these efforts was the 1992 ERM crisis, which heightened the uncertainty facing policymakers. These ideas were supported in the ruling government initially by

Chancellor Lamont. The difference between these two debates is that the proposal to give the BoE independence was supported by Labour Prime Minister Blair, but opposed by Conservative Prime Minister Major (and not strongly advocated by his second Chancellor Clarke). For Major, this policy reform did not offer electoral incentives but only suggested electoral costs, due to the loss of the ability to set interest rates for electoral reasons and the opposition from Eurosceptics. More will be said about these factors below. The conclusion is that the ideas promoted by an epistemic community by themselves are insufficient for explaining the timing of this change, although they do explain the content of the reform when it was finally agreed.

In the cases of Canada and Australia, academics and central bankers were central to the debates but their involvement did not result in any changes to the central bank's legislation. This failure to influence policy can be explained by two factors: a lack of consensus among the epistemic community on the need for reform, and the lukewarm support that these proposals received from central bankers themselves. In Canada, the ideas of economists like Laidler (1991) succeeded in creating a focal point around the need to reform the BoC's legislation during the 1991-92 period. The influence of Laidler's pamphlet is seen in the government's agenda as reflected in the Conservative government's 1991 proposals. However, during testimony before a parliamentary committee, the epistemic community in Canada failed to show any consensus. While the majority of academic and business economists agreed on the desirability of price stability as the goal of monetary policy, they did not agree on the need to change the Bank of Canada's legislation. Some vocal critics such as Fortin voiced strong opposition to the proposal, while even a monetarist economist like Howitt had his doubts. Likewise in Australia, many academics were opposed to the reform proposals championed by Hewson and the opposition Liberals between 1991-1993. And those

Australian economists who did favour reform could not agree on an alternative framework, proposing instead a confusing array of alternatives that did not provide policymakers with a convincing road map of reform. The failure of the Liberals to get elected and the lack of consensus among the epistemic community led the ALP to stick with the status quo.

The second factor that mitigated the need to change the central bank's legislation was opposition from central bankers themselves, who viewed themselves as operating with a high level of independence already. In Australia, senior RBA officials led by Governor Fraser and Deputy Governor Phillips were opposed to a change in the central bank's mandate. Narrow targets were seen as constraining monetary policy discretion in an unfavourable way, particularly given the RBA's multiple objectives and Australia's historical and institutional context. Instead, RBA officials felt an inflation target would be appropriate, which they adopted internally from 1993. Treasurer Keating highlighted this opposition in debates with Hewson, demonstrating how a politician will often seize on a lack of consensus among the experts to support or reject a proposal. In Canada, Governor Crow did make a convincing case for giving the Bank of Canada a narrow mandate of price stability, but he rejected the other elements of the legislative package that were being considered at the time. Crow and other Bank of Canada officials felt the discussion of independence was misplaced, as monetary policy should always be answerable to the democratic process. Finally, the Bank of Canada was already pursuing price stability under an inflation-targeting framework adopted in 1991, which delivered low inflation very quickly. Like Australia, the Bank of Canada was comfortable with the dual responsibility for monetary policy put in place in the 1960s, and preferred the status quo to some unknown framework that might arise once the legislation was opened up to scrutiny. Given the lukewarm support from the BoC and the clear division

among Canadian economists, the Select Committee advocated sticking to the status quo rather than trusting to some ‘ephemeral wisdom’ about monetary frameworks.

In summary, ideas were a central part of the debates in many of the cases over monetary reform, and were a crucial factor in the two cases where the central bank legislation was changed. An epistemic community was successful at influencing central bank independence when two conditions were met. First, all the corollaries explaining when the ideas of this epistemic community are effective must be met, namely heightened uncertainty, a clear consensus on policy preferences and a political champion. If economists or central bankers do not reach a consensus on the need to change the central bank’s legislation, politicians have no incentive to change it nor do they have a clear road map for reform. Under these circumstances, politicians will stick with the status quo. In Canada and Australia, inflation targeting pursued with greater transparency was seen as a viable alternative to delegation for achieving anti-inflationary credibility of monetary policy. The second condition relates to the role of politicians as champions of central bank reform. While ideas may be able to explain the content of reform, the timing remains in the hands of politicians. Politicians must therefore have adequate incentives to champion this reform. Such an incentive may be provided by the need for balance of payments financing, the desire to be re-elected or an ideological belief in the reform itself. In each case, the reform must agree with the worldview of a powerful politician who adopts this reform as his own. Without political salience, ideas are barren. Hypothesis II must therefore be carefully qualified.

Lobbying by Domestic Interest Groups

The evidence of the four cases rejects hypothesis III that a central bank is given independence in response to lobbying by the financial sector or other domestic interest groups opposed to inflation. There was evidence of interest group lobbying on five

occasions (row 6), of which the financial sector was active in four (row 7). The financial sector presented evidence to parliamentary committees in New Zealand, Canada and the UK. They also waded into the debate through the financial press and the publications for clients. Finally, they may have engaged in quiet lobbying although financial associations and policymakers interviewed for this study (both current and retired) denied this activity. Financial sector lobbying, however, was not a good predictor of the outcome. While the financial sector supported RBNZ reform, it also supported this reform in Canada during both debates and in the UK during the 1992-94 debate. In Canada, the financial sector's efforts were undermined due to the opposition of the chief economist of Toronto-Dominion. This failure to speak with a common voice allowed opposition politicians to discount these views. In the UK, representations on behalf of the financial sector to the Treasury Select Committee had no impact on the outcome, as the ruling government paid little attention to the final report (or similar efforts in the Roll report).

The lack of effectiveness of financial sector lobbying is not surprising given the structural changes taking place in the four countries during this period, a point raised in a similar study by Moran (1991). Financial sector reform was a common phenomenon across the cases studied, with the liberalisation of exchange regimes, the deregulation of financial markets and the greater competition from foreign banks and the other 'pillars' of the financial sector over this period. In general, all these countries were moving towards a universal banking model dominated by a few, large firms. This type of change meant that financial sector firms were preoccupied with more pressing issues, such as the detail of reforms affecting their industry, the changing competitive landscape and their declining profitability. This finding is consistent with the argument that the lobbying capacities of banks varies over time (Moran 1991, p.189). For this

reason, representatives from financial sector associations did not get involved in all these debates, as more pressing issues required their focus that had a clear impact on their businesses, such as legislation or regulation affecting the financial sector.

This study has also argued that the financial sector did not necessarily hold unitary preferences towards central bank independence. First, in all the cases studied except Canada the central bank was also responsible for banking supervision, creating a potential conflict of interest as discussed in chapter 3. Second, financial firms may have had difficulty in determining how monetary policy affects their asset portfolios, leading to unclear preferences. Inflation has offsetting effects on a portfolio of diversified assets that does not lead to a uniform preference against inflation (King 2000). While inflation clearly reduces the value of fixed income assets in the long run, in the short run this is not the case due to immunisation of portfolios whereby assets and liabilities are offset. In the long run, real estate and possibly equity may be correlated with inflation, leading to mixed preferences towards inflation among financial sector participants exposed to these asset classes (King 2000; Maxfield 1998). Without clear preferences towards central bank reform, it becomes impossible to lobby effectively on this issue.

Business and trade union associations were also active in the debates about the central bank (row 8 and 9), but they suffered from two problems. In all the cases studied, business and labour interests were fragmented and were unable to speak with a single voice on any given policy issue leading them to take opposing positions in these debate. In New Zealand, the elitist NZBR and Federated Farmers supported greater RBNZ independence with a single mandate, but the Manufacturers' Association opposed it. In Canada, the elitist BCNI supported BoC independence but the Canadian Exporters Association and the Canadian Manufacturers Association opposed it. Only in the UK

did the Confederation of British Industry (“CBI”) act as a peak association for business (and finance), but then it did not get involved in this debate and did not give testimony to parliament. The CBI’s declining political influence was not spent on issues like Bank of England independence, which was viewed as an esoteric topic with little practical influence for the CBI’s membership, but was directed instead at more practical business issues such as labour market legislation.

This statement about the lobbying effectiveness of business may underestimate the extent to which politicians take implicit business preferences into account when designing economic policy. According to Lindblom (1977), business sits in a privileged position due to their control of investment and employment, both valuable resources that impact the popularity and success of politicians. A clever politician, it is argued, takes into account the wishes of business even when they are unstated. This argument may be seen in both the New Zealand and the UK cases, where Douglas and Brown needed to signal their credibility domestically to this key audience. The extent to which Brown and Blair listened to business concerns is shown by their extensive canvassing of business opinion prior to the 1997 election, and their decision to issue a separate business manifesto – the first such manifesto issued by the Labour Party in the UK. As Moran (1991) states, “[The] power of business can never be accurately gauged by examining the activities of business as a political lobby alone” (p.188). This view of the ‘structural’ power of business applies equally to the financial sector in both New Zealand and the UK, as the financial sector was seen as a key opinion maker that signals to the public the credibility of politician’s and their policies.

Organised labour was vocal in opposition to central bank independence in Canada and New Zealand, but they had little political influence. Organisations like the CLC in

Canada and the NZCTU in New Zealand were not encompassing associations, and so lacked legitimacy as insiders. In both countries, multiple unions representing different sectors of the economy claimed to speak for organised labour, but worked at cross-purposes, diminishing any potential political influence. As a result, organised labour was 'relatively disorganised', cut off from any strong institutional ties with the left-wing political parties, and faced with declining union membership. In the UK, the trade unions had lost their privileged position with New Labour, and their peak association – the Trades Union Congress – was retrenching. The TUC did not get involved in the debate over the Bank of England, being more concerned with issues such as the minimum wage and adoption of the EU social chapter. The TUC preferred to stay out of the spotlight on political issues like monetary policy, and it is doubtful if they would have been listened to if they tried. Only in Australia were trade unions a politically influential interest group, due to their representation by a single peak association – the Australian Council of Trade Unions – and their close institutional and personal ties with the ruling Australian Labour Party. This influence was reflected in the Accord negotiated with the Labour government that underpinned economic policy from 1983 to 1996. Organised labour's voice in opposition to a narrow mandate for the Reserve Bank was a factor in the Labor government's decision to stick with the status quo.

Politicians 'Tying the Hands'

The fourth hypothesis offered to explain the trend in central bank independence highlighted the importance of incentives for leading politicians to adopt this reform. Politicians must see clear electoral gains from this institutional reform that exceed the electoral costs of giving up control of interest rates before they are willing to delegate to the central bank. This hypothesis received only partial support in only one of the two cases where central bank reform took place, namely with the election of New Labour in

the UK in 1997 (row 10). The New Zealand case appears to falsify this hypothesis, as the reform was introduced by politicians who did not stand for re-election after central bank independence had been legislated. The other 7 observations where politicians chose to stay with the status quo appear to provide some support to the ‘tying the hands’ hypothesis. However, the partisan versions of this hypothesis are rejected, while the non-partisan corollary concerning cabinet stability was not adequately tested by these cases. These conclusions are discussed in greater depth below.

This rationale of electoral gains was most clear in the reform of the Bank of England. For New Labour, the reform improved the party’s electoral prospects and the future political ambitions of Chancellor Brown. It provided New Labour with credibility with financial markets and businesses, and more breathing room to pursue fiscal policies that would provide the basis for a second term (which they won in June 2001). BoE independence also suited New Labour’s desire to shed the party’s historical reputation as the ‘party of devaluation’, while symbolising a new approach. For the Conservatives the political benefits of BoE independence did not exceed the costs. For Thatcher, it implied the loss of the ability to alter interest rates for electoral purposes to gain the support of home-owners and other key Conservative Party supporters. Major shared this view. Major faced an additional electoral cost, namely the threat that central bank reform would lead to further damaging confrontations with the Eurosceptics in his party. In both cases, Thatcher and Major hid their political motivations for opposition to this move under the rhetoric of the need to ensure ministerial accountability of monetary policy in a democracy. Given that many democracies have independent central banks, including the Fed and the Bundesbank, this objective rang hollow.

The case of New Zealand appears to falsify this hypothesis based on electoral gains.

Independence for the RBNZ was introduced and championed by Finance Minister Douglas, and his supporters in cabinet, Caygill and Prebble. However, Douglas and other members of his faction resigned from the government after the RBNZ Act 1989 was safely through Parliament, and did not contest their seats in the 1990 election (McLeay 1991, p.6). They did not wish to be re-elected, removing the main incentive for this hypothesis. Apparently, Douglas introduced this reform because he ideologically believed that it was the best policy for the country, not necessarily because it would benefit him personally. In fact, many of the reforms introduced by Douglas had the opposite effect, as they increased the instability of the government by leading to damaging divisions between the left and the right-wing of the NZLP. Prime Minister Lange was forced to resign after his effort to oust Douglas over the proposed tax reform had backfired. Similarly, Anderton left the party to form the New Labour Party that competed for the votes of traditional Labour Party supporters in the 1990 election. Thus, introducing a reform that was opposed by the trade unions and other traditional NZLP supporters was not designed to improve the NZLP's chances of re-election.

Both the cases of Canada and Australia, as well as the debates under the Conservatives in the UK, support the hypothesis that politicians will not introduce a policy that is believed to harm their electoral chances. The *Bank of Canada Act* was not changed as this reform was considered risky or politically unpopular by both the Liberals and the Progressive Conservatives. During the 1991-92 debates, the Progressive Conservatives recognised that the timing for pursuing such a reform was wrong due to the constitutional debates that were dividing the country at the time. Central bank reform was divisive, and the Progressive Conservatives were already lagging in the polls due to their implicit support of the BoC's high interest rate policy. Embedding a narrow

mandate of price stability that was not fully endorsed by other central banks or academic economists was a political risk that was not worth taking. By contrast, the Liberals increased their electoral popularity by attacking Governor Crow during the 1993 election campaign. They then replaced Governor Crow with Governor Thiessen in order to symbolically assert their control over the central bank in the eyes of the public.

Finally, Australian politicians did not tie their hands because they did not have to. The decision to stick with the status quo reflected political calculations of the electoral advantages to be gained from such a policy. No politically influential interest group was lobbying in support of greater independence, while the most important lobby – organised labour – was opposed. Central bank reform was against the interests of organised labour, and it reduced unnecessarily the government's policy flexibility. Given that the Liberal opposition publicly advocated this reform, any move in this direction would be a politically damaging admission of their guilt in interfering in monetary policy. Nor did the Liberal-National opposition see the need to change the RBA's legislation when it was elected in 1996, despite their earlier contrary policy stance. By 1996, inflation was low and the economy was growing so the government did not need to do more than issue a public statement in support of RBA independence and its inflation target.

The partisan versions of the 'tying the hands' explanations contained in corollary A and B were rejected in all cases except the UK in 1997. First, partisanship in itself was not a good predictor of central bank reform as seen in table 3. While so-called 'Labour' parties introduced the reforms in New Zealand and the UK, the Labour government in Australia rejected this reform. The only consistent finding from this case study is that right-wing politicians did not 'tie their hands' in any of the cases studied. Second, the

incentives to delegate based on time horizon were not supported. Right-wing politicians with a short time horizon were expected to delegate in order to reduce the room to manoeuvre of an incoming left-wing government. This was not the case in New Zealand, the UK and Canada. The National government under Muldoon did not consider this reform, but then the case study has argued that Muldoon's government was so confused in its policies that it was right-wing in name only. And by the time the National government of Bolger was elected in 1990, the RBNZ was already independent. The UK Conservatives failed to pass this reform despite their likely defeat in the 1997 election, perhaps because they did not believe that they could lose. In Canada, while the Progressive Conservatives were willing to discuss this reform prior to the 1993 election, the incoming Liberals never seriously considered it. However, Canada does not have a left-wing party that is politically viable, so this incentive was not truly present.

Table 55: Partisanship and Central Bank Reform

Country	Date	Nature of Change	Party in Power
New Zealand	1989	Central bank given legal independence with a narrow mandate of price stability based on an inflation target agreed between the Governor and government.	Labour Party (left)
Canada	1991	Joint announcement of inflation targets, jointly agreed by government and central bank, but no change to legislation.	Progressive Conservatives (centre-right)
Australia	1996	Joint announcement of independence and government endorsement of inflation target set by central bank, but no change to legislation.	Liberal Party (centre-right)
United Kingdom	1997	Central bank awarded legal independence in setting of interest rates, under management of a Monetary Policy Committee, based on narrow mandate of price stability with inflation target set by government.	New Labour (centre-left)

Left-wing politicians with a longer time horizon were expected to delegate in order to reduce the cost of financing government debt. This prediction was not supported by any of the case studies. The Labour government in New Zealand passed the RBNZ Act 1989 towards the end of its second term, when it had already paid down much of the

country's foreign debt and it seemed likely they would lose the 1990 election. In this case, the main reason given for RBNZ independence was as a mechanism to eliminate political interference by the National Party whose past political interference in interest rates was seen as one of the principal causes of New Zealand's economic underperformance. Finance Minister Douglas may have also seen a need to 'tie the hands' of his own party in order to prevent Labour opponents of Rogernomics from subsequently undoing his reforms. This case is somewhat of a conundrum as it does not fit any simple explanation based on 'tying the hands' arguments in the literature. This thesis argues that ideology, not electoral incentives, explains the New Zealand outcome. Likewise, the Australian Labor Party never seriously considered this reform, despite their strong mandate that lasted from 1983 to 1996 and the punitive costs charged on Australia's overseas borrowing. Rather than reform their central bank, ALP politicians preferred to pay down their debts and remove this source of weakness. Only the election of New Labour in the UK satisfied this hypothesis, and then the rationale for adopting was to signal their anti-inflationary credibility, not to reduce the cost on their relatively low levels of debt outstanding.

Finally, these cases have not provided a direct test of the hypothesis in corollary C that politicians will 'tie their hands' in order to increase the stability of the ruling coalition. Bernhard's arguments are based on the assumption that backbenchers or coalition partners can credibly threaten to bring down the government. This is not the case in the Westminster-style parliamentary systems considered here where power is concentrated in the hands of the executive and backbenchers have little power. In addition, the plurality electoral rules in these four countries led to consistent majority governments, which did not have to rely on coalition partners to stay in office. However, these cases provide an indirect test of Bernhard's hypothesis, as two majority governments did give

independence to the central bank in the absence of a threat to the stability of the government. And in the case of the UK, the Conservative government under Major did face a credible threat from Eurosceptics within the ruling coalition, who threatened to bring down the government over the Maastricht Treaty, but Major faced them down without making any concessions on the government's policies.

Impact of Institutional Variables

One of the constraints highlighted by the political economy literature concerned the number of checks and balances imposed by the political institutions. Political systems with federal systems, bicameral legislatures or higher party fractionalisation were expected to find it more costly and difficult to pass the legislation required to give the central bank independence, leading them to stick with the status quo. The four case studies provided support for this institutional constraint. New Zealand and the UK had unitary structures that did not require compromises with either provincial or state governments. New Zealand has a unicameral legislature, while the upper house in the UK plays a largely supportive function to the lower house, making it easy for the executive to push through its preferred legislation. Many studies of New Zealand's economic reforms note that they were more radical and far-reaching than similar reforms in Australia. Castles et al (1996) argue that the slower pace of reform in Australia is explained by Australia's restrictive bicameral parliament and federal division of powers versus the lack of checks and balances inherent in New Zealand's unicameral system and first-past-the-post voting rules. Similar points were made by Bolland (1994), Goldfinch (2000) and Nagel (1997).

This lack of checks and balances in New Zealand and the UK made it easier for politicians in these countries to push through central bank reform. However, Australia and Canada are federal systems with bicameral legislatures, which creates a number of

hurdles that must be overcome to approve legislation. The Australian Senate has shown its ability to bring down a government, as it did in 1975, while constitutional battles between the federal government and the Provinces in Canada meant that the executive did not pursue an additional institutional reform that was seen as potentially divisive. Both Australia and Canada stuck with the status quo, as predicted. In fact neither country has introduced significant changes to their central banking legislation since the 1960s.

9.2 Questioning Legal Measures of Independence

This thesis has argued that an epistemic community promoted central bank independence as a solution for controlling inflation, by convincing private actors of the anti-inflationary intentions of monetary policy. Given this starting point, it is interesting to look at the inflationary record of different countries during the 1990s to see if this policy prescription was supported *ex post*. Table 2 shows the inflationary performance of a range of OECD countries, which have been loosely categorised by their predominant monetary framework over recent history. This classification is not definitive, as many of these countries changed their monetary framework as well as the degree of legal independence of their central banks over this period. As a result, table 2 is only meant to be suggestive.

The most striking conclusion to be drawn from this table is that inflation was brought down significantly between the 1980s and 1990s across all these countries, regardless of the monetary framework put in place. This outcome does not appear to be explained by the level of central bank independence. For example, Belgium, France and Norway achieved levels of inflation at the same level or below the record in Germany, Switzerland and the USA over the 1990s, despite being rated among the more

politically controlled central banks through the mid-1990s when their legislation was changed.

Table 56: Inflation Performance of OECD Countries, 1970-1997

Year	CBI Index ¹	1970-79	1980-89	1990-97
<i>OECD Average</i>		10.1	8.8	3.3
Exchange Rate Peg				
Austrian	67	6.1	3.8	2.6
Belgium	47	7.1	4.9	2.3
Denmark	79	9.3	6.9	2.1
France	45	8.9	7.3	2.1
Ireland	n.a.	12.7	9.2	2.4
Italy	41	12.2	11.1	4.4
Netherlands	67	7.0	2.8	2.5
Norway	37	8.4	8.3	2.5
<i>Average</i>		8.9	6.8	2.6
Monetary Target				
Germany	100	4.9	2.9	2.7
Switzerland	96	4.9	3.3	2.5
<i>Average</i>		4.9	3.1	2.6
Inflation Target				
New Zealand	29 ²	11.4	11.8	2.3
Canada	55	7.3	6.5	2.2
United Kingdom	44	12.5	7.4	3.9
Sweden	n.a.	8.6	7.9	3.6
Finland	61	10.3	7.3	2.2
Australia	42	9.8	8.4	2.6
Spain	29	14.3	10.2	4.4
<i>Average</i>		10.6	8.5	3.0
Floating Exchange Rate				
USA	74	7.1	5.5	3.1
Japan	52	9.0	2.5	1.4
<i>Average</i>		8.0	4.0	2.2

1. The CBI rank is taken from chapter 1, table 2, and is an average of four indices. 2. Pre-1989 reforms.
Source: IMF International Financial Statistics, Cottarelli and Giannini (1997), Grenville (1997).

One possible conclusion from this table is that these economies have experienced a cyclical downturn in inflation (following the recession of the early 1990s). Inflation has

declined for all these countries during the 1990s, regardless of the monetary framework they have in place. This cyclical downturn, combined with the widespread support for price stability, may be responsible for low inflation and not the institutional framework for monetary policy. Of course, practitioners have long been sceptical of the time inconsistency literature and the suggestion that policymakers will use discretion over interest rates to spring inflationary surprises on the public (Goodhart 1994b; McCallum 1995). But academics have not paid much attention to the views of central bankers, preferring to mine instead a rich vein of theoretical research without trying to relate it to actual practice. And political scientists, who are in a better position to judge political behaviour, have chosen to steer clear of monetary policy, as it is an intimidating and technical issue area without much general appeal to their field.

A second interpretation is that legal measures of central bank independence do a poor job of capturing the *de facto* independence of central banks (Banaian et al. 1998; Forder 1998b; Temple 1998). Central bankers in Canada and Australia and have argued that they operate with a high degree of *de facto* independence that is not reflected in the legal rankings assigned by academics. According to this view, the whole economics literature on coding statutes is doomed to failure as it fails to recognise that private actors view the BoC and the RBA as independent. While the case studies have provided ample evidence in support of the opposite position, the inflation records of these countries – as well as the long standing anomaly of the Bank of Japan – have demonstrated that there are alternatives to changing the legal statute of the central bank for gaining credibility. In Australia, the wage and incomes accord negotiated between the ALP and the unions played a key role in controlling wage inflation. It also created a constituency in favour of low inflation, as any inflation greater than the amount factored into the Accord meant that unionised workers experienced a decline in real wages.

Convergence in Policy Frameworks or Diffusion?

This thesis has been premised on the paradigmatic view that legal measures of central bank independence were a significant proxy for *de facto* independence, as assumed by a large body of empirical literature reviewed in chapter 2. Given the findings of the case studies, and the evidence of a secular decline of inflation across a range of central banks, it may be time to reject this null hypothesis in favour of the view that legal indices are a poor indicator of *de facto* independence. This 'heterodox' position is supported by a variety of academics and practitioners, particularly central bankers in those institutions seen as being open to political influence (Crow 1993b; Fraser 1994b; Macfarlane 1996).¹ If legal measures are a poor indicator, then it is possible to argue that the operational changes introduced in all the cases reflect a variety of alternatives to statutory independence for increasing the anti-inflationary credibility of policy. Two alternatives will be discussed briefly, although a more thorough examination will need to be carried out in the future. These two alternative strategies are increasing the transparency and accountability of the monetary policy framework, and developing a reputation for conservativeness through actions taken to control inflation.

Inflation Targeting with Greater Transparency

An alternative approach for achieving monetary policy credibility has been to increase the accountability of monetary policy by adopting an inflation target, supported by an increase in the transparency of the central bank's decision making. This strategy was pursued by Canada in 1991, by the UK in 1992 and by Australia in 1996 (although it was informally in place from 1993). In all cases, inflation targets were introduced after inflation had been brought largely under control, as a mechanism for embedding the gains of disinflation and as a domestic anchor for private sector expectations. And in all

¹ One academic, James Forder of Oxford University, has written a number of articles making this case, and even edited a special issue of Oxford Economic Papers on this topic (Forder 1998a, 1998b, 2000; Forder et al. 1998).

cases, this framework introduced under a conservative government that resisted the trend towards legislation greater central bank independence.

Canada announced the adoption on an inflation target in early 1991 after inflation had been brought down but prior to the political debates over the BoC's legislation. The credibility of this framework was demonstrated when medium-term expectations for inflation fell despite the jump in headline CPI to 12% resulting from the introduction of the GST (BoC 1991a, p.9). The credibility (and legitimacy) of this framework was boosted by Governor Thiessen who took a number of steps to increase the transparency of monetary policy as described in chapter 6. In the UK Chancellor Lamont introduced the inflation target after Prime Minister Major repeatedly rejected the Chancellor's requests for Bank of England independence following the ERM crisis (Lamont 1999). Australia was slow to adopt an inflation target due to the presence of the Accord put in place by the ALP in 1983 which lasted until 1996. While the RBA pursued an inflation target internally from 1993, it was only endorsed after the Liberal government was elected in 1996. The joint Statement with the RBA at this time was intended to signal the government's support of this framework. From this point, the RBA went to great lengths to increase the public understanding of monetary policy and the central bank's role, increasing the number of speeches and publications and agreeing to give testimony before a Parliamentary committee on a regular basis.

Ironically, New Zealand's inflation targeting framework undermined the credibility of the independent RBNZ over the 1990s.² On two occasions, the terms of the inflation

² Debelle's (1996) analysis of New Zealand's 1989 reforms presents a mixed picture. He found that the drop in inflation expectations did not occur until one year after the new legislation was passed in 1990, but then expectations fell rapidly suggesting there was a credibility gain from the new framework (Debelle 1996). New Zealand *ex post* real interest rates declined and the long term premium relative to

target were changed following an election – first in 1990 and again in 1993, when first the time horizon for achieving price stability was extended and next the target band was widened.³ Both these episodes demonstrate how politicians are still able to indirectly influence policy under an independent RBNZ. Then two breaches of the 1 to 3 % band occurred – the first in the second quarter of 1995 and the second in the fourth quarter of 1996. The first breach led to an exchange of letters between the Governor and the Minister of Finance, and some calls for the dismissal of the Governor which the government ignored. The second breach caused no such activity, despite being larger and lasting longer, suggesting that the threat contained in the *RBNZ Act 1989* to dismiss the Governor was not credible (Bernanke et al. 1999). These events led to criticisms as the Governor had considerable flexibility to exclude inflationary items from the operational CPI target based on a number of escape clauses, further reducing the accountability and credibility of the framework (Bernanke et al. 1999, p.95). The lesson from this episode is that the definition and operation of the inflation target are more important than the announcement of the target itself, which has led many observers to comment that ‘actions speak louder than words’. Ultimately credibility is derived from results (Nicholl and Archer 1992, p.319).

Reputation ✓

A second and related strategy for achieving monetary policy credibility involved developing a reputation for conservativeness. Delegation as an alternative ‘commitment technology’ was identified by Rogoff (1985) who recommended appointing a conservative central banker who has a reputation within the financial community for defending price stability. This conservative central banker would place a larger weight

US interest rates narrowed after the reforms were introduced in New Zealand. Both indicators reflect positively on the reform.

³ The time horizon for achieving the target was lengthened from year-end 1992 to year-end 1993 following the election of the National Party in 1990. Then the target range itself was widened from 0 to 2

on price stability relative to employment stabilization than is implied in the public's social loss function. A conservative central banker will then set out to 'reveal' this preference at the earliest occasion. This reputation for toughness is revealed when the central banker's commitment is tested at an early stage and then is re-tested often. The disadvantage of reputation as a strategy for credibility is that price stability is achieved at a higher social cost, as measured by a higher sacrifice ratio (Debelle et al. 1994; Posen 1993).

The Bank of Canada's pursuit of price stability under Governor Crow can be seen as a strategy to build a reputation for conservativeness. Crow revealed his preference for price stability over the other objectives in the Bank of Canada Act in his Hanson lecture in 1988. This commitment was tested through the years 1988-1991, when interest rates were pushed up to punishingly high levels in order to squeeze out inflation. The Bank's policy was aimed at achieving inflation that was 'clearly below 2 per cent' with Crow insisting that not even a low level of inflation was credible, which Crow's critics took to mean a target of zero inflation. The cost of Crow's toughness, critics argue, was the 1990-91 recession which was deeper and more painful than it needed to be. Fortin notes how the Canada-US short term interest rate differential averaged 0.9 percent from 1980-88, but increased to 3.6 percent from 1989-1996 under Crow and Thiessen as the Bank of Canada strove to establish its reputation as a tough central bank in capital markets with no concern for the disinflationary costs (Fortin 1996, p777).

The import of Crow's strategy was not lost on academic economists familiar with the literature. "[Since] assuming office, Governor Crow has taken a number of steps to bolster his reputation as an 'anti-inflationist', presumably in the belief that achieving

this reputation will reinforce any anti-inflationary policies that the Bank actually follows" (Lipsey 1990, p.40).⁴ Crow used rhetoric, in the form of public announcements and speeches, to signal his commitment to price stability to private actors (Laidler 1997, p.211). But this strategy was not initially successful. "[Rhetoric] was not enough to generate the increase in credibility in Canada that the major legislative reform achieved in New Zealand...[The] Bank of Canada had to support their rhetoric with the vigorous application of tight monetary policy. That is, to signal their true anti-inflation aversion and reduce the uncertainty, the Bank may have been overly conservative, thus increasing the disinflation cost" (Debelle 1996, p.75). The need to back-up rhetoric with toughness meant that Canada had the highest sacrifice ratio of the 19 industrialised countries studied by Ball (1993), as predicted by the academic literature.

The strategies adopted by conservative politicians in Canada and Australia are similar to the steps taken by the Conservatives in the UK. Rather than statutorily changing the legal independence of the central bank, politicians introduced a series of consecutive reforms – some might say ‘hesitant’ reforms – that had the ultimate impact of increasing the de facto independence of the central bank over time. This observation raises two points. First, do private actors give right-wing politicians the benefit of the doubt when judging their anti-inflationary credentials while forcing left-wing politicians to make more radical, institutional changes to achieve the same standing? This appears to have been the case in the four cases studied here. Inflation targeting alone was sufficient in Canada, Australia and the UK under the Conservatives, while New Labour in the UK

receiving the support of a key coalition partner (Bernanke et al. 1999).

⁴ Fortin and Osberg (1998) describe an allegorical tale to capture the costs paid by the Bank of Canada in the pursuit of reputation. "Let's think of Credibility Mountain as an enormous construction project, aimed a building a mountain of sand just outside Ottawa to symbolise our national willingness to tolerate high unemployment in the hope that inflation will disappear...[Since] the cumulative amount of output foregone due to excess unemployment over the period 1989 to 1997 was approximately \$475 billion, by now Credibility Mountain would be rather large and growing" (Fortin and Osberg 1998, p.163).

and the NZLP in New Zealand instituted central bank reform. In Australia, the ALP negotiated an alternative institutional mechanism – the Accord – to reinforce their credibility. This line of questioning deserves to be researched and tested in greater depth in subsequent work.

Second, have central banks been converging on preferred policy model, as suggested by the globalisation literature? Or have we witnessed instead a diffusion of best practices among central bankers that have emulated the features of other countries, such as the Bundesbank and the Fed, while adapting them for historically and culturally different settings? This diffusion, as opposed to convergence, was witnessed by Moran (1991) in his study of the financial services revolution. He found that the UK and Japan adopted the form of regulatory reforms from the US, which was the site of 'best practice' in the regulation of banks. Likewise, the adoption of inflation targets, with or without accompanying statutory independence, reflects a process of policy emulation that began with the Bundesbank and was passed to the RBNZ, the BoC and the RBA, among others. In this case, it appears that there has been a substantial move among central banks towards greater transparency, greater accountability and greater de facto independence. This view is tentative, and remains to be tested in future empirical work.

9.3 Contribution to International Political Economy

The main issues that have preoccupied IPE over the last thirty years have been the relationships "between wealth and power, states and markets, interests and institutions, the international political economy and domestic politics" (Katzstein et al. 1998, p.684). This study has made a contribution to two of these categories. First, it has looked at the impact of international financial markets on national policies in the key area of monetary policy. Second, it has considered the relevant importance attributed to

international and domestic factors when determining economic policy in this issue area. Each of these contributions will be addressed in turn.

International Financial Markets and National Policies

Globalisation describes the increased interdependence or integration of sovereign states. One way to measure globalisation is to look at flows across borders, whether they be trade in physical or financial assets, migration of people or the transfer of information. A more narrow focus on financial globalisation considers the process whereby states compete to attract the savings and investment of private actors, which take the form of equity, bonds, foreign exchange and foreign direct investment. A main debate in IPE concerns how financial globalisation affects the policy autonomy of states. Are governments able to pursue distinctive and partisan macroeconomic policies or are they hindered by financial globalisation? And do international capital flows force states to converge on a specific set of policy preferences, such as the neo-liberal institutional arrangements associated with the Washington consensus (Ikenberry 1992; Williamson et al. 1993)?

A structuralist (or globalist) school within IPE views the dramatic increase in cross-border capital flows as a new structure in the international system that limits the room to manoeuvre of states (Andrews 1994; Cerny 1993; Goodman 1993). “Capital mobility is fully consistent with Waltz’s underlying conception of a structural feature of international politics: a constraining condition that rewards certain behaviours and punishes others” (Andrews 1994, p.202).⁵ This school includes Gramscian and historical-materialist authors who view financial globalisation as part of a hegemonic bloc controlled by capitalists. For example, Gill and Law (1989) argue that the so-called

power of international capital mobility to constrain states has been encouraged or reinforced by shared ideas about state powerlessness. A more liberal school provides a less ideological and more qualified view, arguing that rising financial globalisation restricts the ability of states to pursue inflationary fiscal and monetary policies and has caused the roll-back of the Keynesian welfare state (Crotty 1989; Kapstein 1994; Kurzer 1993; Oatley 1999; Scharpf 1991; Schwartz 1994).

Opposed to this 'convergence view' are a wide spectrum of authors who contest the 'myth of the powerless state' and view the claims of financial globalisation as overstated.⁵ The state retains some measure of autonomy due to the existence of institutions such as encompassing trade unions, the state of the government's finances, or the size of state (Garrett 1998b, 2000; Garrett et al. 1999; Hay 2000b; Katzenstein 1985; Mosley 2000). Garrett's studies of partisan politics found no support for the convergence thesis: "My basic claim is that the globalisation of markets imposes far fewer constraints on the range of feasible economic policies than is commonly thought" (Garrett 1998c, p.72). Frieden (1997) argues that politicians are only constrained by interest groups and the electorate, not by international financial markets. The ability to manage the exchange rate, for example, depends on political will and electoral support, not on capital market constraints. "While politicians and observers often present international monetary events as though the markets were tossing and turning currencies at will, in fact governments are almost always capable of sufficiently affecting traders' incentives to drive currencies as they wish"(Frieden 1997, p.82). Large states such as the US retain the ability to act, such as running current account deficits over extended

⁵ Andrews is referring to the Waltz (1979). The view that international capital constrains states has been developed from the economics work of Mundell and Fleming, which was introduced most vividly into IPE by Cohen as 'Unholy Trinity' (Cohen 1995; Fleming 1962; Frenkel et al. 1987; Mundell 1962, 1963).

⁶ For the pluralist view, see Kapstein (1994), Strange (1996) and Weiss (1998). For the corporatist view, see Alesina et al (1997), Baker et al (1999), Garrett (1998), Katzenstein (1985) and Goldthorpe (1984).

periods with no negative side-effects (Gilpin 1987; Nye 1990). Financial globalisation was encouraged by hegemonic states like the USA that retain the ability to reverse it (Helleiner 1994; Walter 1991).

This study supports the authors who find that states retain policy autonomy – such as the ability to have politically-influenced monetary policy – when certain conditions are met. International financial markets have the ability to influence politicians through the exchange rate or through the government's overseas borrowings. These two pathways were examined in the cases studies. These case studies were consistent with Mosley's argument that international financial market pressure is strong but narrow. International financial markets have the ability to sanction states, but financial market actors only focus on a few economic indicators when evaluating economic performance, namely the levels of inflation, government debt and deficits (Mosley 2000). Financial markets punish states that follow unsustainable or inflationary policies, which were associated with Keynesian policies during the 1970s and 1980s.

This association explains why the partisanship literature argues that international financial markets are suspicious of left-wing governments. However, international financial markets also punish right-wing governments with poor economic performance, such as New Zealand under the Muldoon government or Canada under the Conservatives, as well as unsustainable policies such as the UK's commitment to the ERM under the Conservatives. A recent OECD study shows clearly that countries with big budget deficits, big current account deficits, and a history of high inflation 'now pay a penalty in the form of higher real interest rates', but this outcome is not dependent on the party in power (Brash 1996a). Market pressure, therefore, does not focus on partisanship, but on indicators of poor economic health.

During the 1990s, a number of left-wing governments have pursued fiscal consolidation, such as Australia and New Zealand, which led to budget surpluses and provided these governments with room to move (Alesina 1999).⁷ It provided the means to pursue more redistributive policies so long as these policies were not inflationary or fiscally unsustainable. Australia guaranteed its room to move by institutionalising wage restraint and funding deficits domestically with a floating exchange rate regime. Likewise, New Labour in the UK has retained room to move by sticking to Brown's 'Golden Rules' for fiscal spending. What this study concludes is that central bank independence is not a direct outcome of partisanship or financial market pressure on left-wing governments, although international financial markets may affect the incentives of politicians for pursuing such a change as seen in the case of the UK.

RBNZ Governor Brash argues that the power of financial markets is hugely exaggerated and that the unchanging reality is that debtor countries yield influence to their creditors, with higher borrowing ceding more influence (Brash 1996a). He points to the variation of economic policies across states to support this claim.

[There] are, even among OECD countries, countries which are running public sector deficits of 10 percent of GDP and New Zealand which is running a surplus; countries whose net public sector debt is in excess of 100 percent of GDP and others where the ratio is less than 30 percent; countries where the government spends more than 60 percent of GDP and others where government spends little more than 30 percent; countries with inflation running at more than 10 percent annually and others where inflation is less than 2 percent; countries

⁷ These economic reforms towards liberalism have come from both sides of the political spectrum. In the OECD, liberalisation measures have been implemented by left-wing governments in France, Sweden, Australia, Spain, Ireland, Greece, Portugal, Finland and the UK (Henderson 1998, p.69).

where unemployment is above 20 percent of the work-force and others where it is less than 6 percent; countries whose exchange rate is pegged to another currency and others where the exchange rate is freely floating. It would therefore be untrue to suggest that the international financial market had somehow forced a common set of economic policies on the world (Brash 1996a).

This study of central bank independence found that international (and domestic) financial markets are not concerned with the status of the central bank or the institutional arrangements governing monetary policy provided that inflation is low and stable. In this regard, fiscal discipline and the coordination of macroeconomic policies are more important for ensuring low inflation than the status of the central bank, a point made by Sargent and Wallace (1981). Without the coordination of monetary and fiscal policies, the central bank's pursuit of price stability is not credible, as seen in Canada during the late 1980s when the BoC's high interest rate policies contributed to large and growing deficits. In all the cases studied, politicians took steps during the 1980s and 1990s to reduce government debts and to institutionalise fiscal discipline. The Australian government committed to balance the budget over the course of the business cycle and to reduce net debt. Canada's government reduced the deficit and virtual eliminated foreign debt. New Zealand passed the Fiscal Responsibility Act. And New Labour in the UK adopted of the 'golden rule' of borrowing only for investment. It is noteworthy that both left wing and centrist governments undertook these fiscal consolidations, which has also been the case worldwide (Alesina et al. 1999; Henderson 1998).

Although this study was not primarily concerned with regulation, it is important to highlight that state agencies retain the ability to structure the 'rules of the game' within

which the financial markets act through their control of regulation (Helleiner 1994, Kapstein 1994, Moran 1984a, Moran and Wright 1991).⁸ By shaping the incentives and the profitability of the financial sector in the cases studies, politicians in these four cases controlled the pace and the direction of change. Note how Douglas in New Zealand made the float of the currency inevitable by removing exchange controls and deregulating the foreign exchange market. Similarly, the Canadian and Australian governments removed legal barriers that existed between the different pillars of the financial system, and encouraged the entry of foreign banks, increasing the level of competition and reducing banking profitability. Both countries also rejected mergers among their major banks, in the interests of the consumer. In the UK, New Labour radically changed the regulatory structure for banking supervision – stripping the BoE of this responsibility and creating a new ‘super-regulator’ under the FSA. These moves demonstrate how politicians play a role in shaping financial markets through structural power (Moran 1984a, Strange 1993).

International and Domestic Sources of Economic Policy

Many works of political economy have noted how institutional change follows from an economic crisis, generally originating in the international sphere. This view is found in much of the two-level games literature (Milner 1997; Putnam 1988). Labour governments in Australia and New Zealand were led to pursue radical, neo-liberal economic and financial reforms by currency crises in both countries. In Canada, foreign concern about the size of Canada’s deficits and debts led the Liberal government to abandon its election pledges and made deficit reduction its key priority. New Labour introduced a wide-ranging set of economic reforms, including giving independence to the Bank of England, partly out of fear of an international financial crisis. These

examples appear to demonstrate how pressure from the international system leads politicians to abandon their electoral pledges in order to adopt the economic policies preferred by international markets.

This view of international factors, however, is overstated. It fails to recognise two points. First, an international financial crisis may signal the need for economic reform but the crisis is often triggered by domestic factors such as an election. In the cases discussed above, economic reform always followed an election – in 1983 in Australia, 1984 in New Zealand, 1993 in Canada, and 1997 in the UK. In many cases the so-called ‘international’ financial crisis was led or involved a heavy component of domestic speculation, as suggested by Brash in New Zealand and by research on the ERM crisis in the UK (or past peso crises in Mexico). Elections sometimes play an important role in triggering a financial crisis, signalling the need to undertake economic reforms. As one observer put it, the international financial markets are the final check on domestic interest group demands for economic policy. This view suggests that politicians use the threat posed by international financial markets as a bargaining tool for resisting the demands of domestic interest groups, as suggested by the ‘two-level games’ literature.

Second, a financial crisis does not determine the *content* of economic reform, which is determined by domestic politics and constrained by existing institutions (Williamson 1994). Both the 1983 ALP and the 1984 NZLP election manifestos contained some degree of commitment to economic reform along neo-liberal lines, suggesting that they were influenced by these ideas while in opposition rather than being captured by the market once they were in office (Easton et al. 1996, p.30). These reforms had many

⁸ This view is rejected by the work of Goodman and Pauly (1993) and the contributors to Cutler et al (1999) who argue that increased financial interdependence and rising capital flows has forced the state to reduce its role in regulating financial markets, and to delegate this task to private actors.

significant similarities, such as the floating of the currencies and the deregulation of the financial sectors. However, the differences are starker. Hawke's consensual approach, contrasted with Douglas's 'blitzkrieg' approach, is explained by the different power of interest groups, particularly organised labour (Castles et al. 1996, p.10). Due to the strong institutional ties with organised labour, the ALP rejected contractionary fiscal policies and expanded the social wage in exchange for negotiated wage restraint generating a better economic performance than New Zealand during the early 1990s (Debelle 1996; Easton et al. 1996, p.45). The point to be made is that the contents of these economic reforms were dictated by domestic factors in these two countries, not by international actors. The conclusion is that domestic politics continue to matter, particularly when it comes to the content and timing of domestic political reforms. This finding reinforces the IPE body of literature examining the interaction of domestic and the international politics that was inspired by the early work of Gourevitch (Gourevitch 1986; Martin et al. 1998; Simmons 1994).

Appendix: Political Economy Studies of Central Bank Independence

Year	Author	Dependent Variable	Independent Variables	Methodology, Hypothesis and Findings
1983	Banaian, Laney & Willett	Inflation (price deflator, CPI, nominal national GNP)	Fiscal deficits / savings Unionisation Change real income per capita Income inequality (Gini coefficient) Imports / GDP CBI (dummy variable 1,0)	17 Industrial countries from 1960-80. Compared structural and economic explanations of pressure for monetary accommodation against CBI. In each case CBI was significant and negative, suggesting inflation could be about 4% less. None of the other variables were significant, except real income per capita which was sensitive to choice of proxy.
1984	Woolley			Adopts an institutional and interest group approach. Argues that despite de jure independence, Fed is involved in politics and is influenced by politicians (President, Congress), bankers and economists.
1985	Woolley			CBI cannot be reduced to numbers, and do not remove the need to study the politics between policymakers and interest groups. Changes in the relationship between the central bank and politicians have been precipitated by periods of crisis. Central bank independence is a 'façade' that primarily serves a political function. The central bank, which uses two valuable political resources to bargain with government: its expertise and the support of the financial community.
1987	Protopapadakis & Siegel			Central banks do not have to accommodate budget deficits. Found only a weak association between increases in debt growth and either money growth or permanent increases in inflation, suggesting that "central banks in industrialised countries with moderate deficits can pursue an independent monetary and inflation policy over long periods of time, notwithstanding the size of government deficits.

1988	Barnhart & Darrat			Movements in money growth do not influence fiscal policy, suggesting that monetary and fiscal policies are set independently in the OECD economies
1988	Masciandaro & Tabellini	Budget deficits Public expenditure Government debt Real interest rate Inflation	Fiscal dominance of central bank (CBI).	5 countries (Australia, Canada, Japan, New Zealand and USA) between 1970-85. If fiscal authorities dominate a dependent central bank, the bank will fund government deficits.
1989	Alesina	(1) Inflation (2) Misery Index	CBI Deficits Political instability	1968-86 for 12 countries Builds an index of political instability and borrows one on CBI to test rational-expectations augmented theories of partisan politics (RPT) against political business cycle theories (PBC). There is a positive correlation between political instability and Okun's misery index. Alesina also finds a correlation between CBI and inflation
1990	Burdekin & Wohar	(1) Inflation (CPI) (2) Monetary base (proxy for monetary policy) (3) Fiscal deficit (proxy for fiscal policy)	Lagged values of: Rate of growth of monetary base Budget deficit / GDP CPI growth rate Government spending / GDP 3 Month T-bill rate or equivalent Unemployment rate Exchange Rate Current account deficit (or trade deficit where not available) Floating exchange rate dummy variable (1971-74, 1974-85)	Eight OECD countries from 1960-1985, using quarterly data. Lagged variables specified using OLS and Final Prediction Error criterion. Three equations estimated simultaneously by generalised least squares using maximum likelihood procedure. Authors claim central bank policy appears to be directed more toward price stability and less toward accommodation of government budget deficits in countries with a central bank that is independent of government.
1990	Hetzel			A public choice analysis of the relationship between Congress, the Fed and the executive. His views on the redistributive effects of inflation and strategies adopted by the Fed to protect its independence foreshadow Posen.

				Unexpected inflation redistributes income among societal groups. Incentives to organise vary across interest groups, which suffer from collective action problems. The most active lobby against high interest rates during the 1960s and 1970s were the construction industry, purchasers of homes with fixed-rate mortgages, S&Ls, owners of small businesses and farmers. The commercial banking sector and small savers are two groups opposed to inflation.
1990	Willett & Keen			Found evidence of political pressure on interest rates using 90-day T-bill rate, which contradicts the findings of Beck (1987) who found no evidence of an election cycle in the fed funds rate
1991	Goodman	CBI	coalitions of societal actors expectations of political leaders regarding tenure in office	Theoretical case to explain CBI. He argues that the existence of a strong conservative societal coalition is necessary for the creation of an independent central bank. To be sufficient, however, political leaders must also expect that their party will be in office only a short period of time.
1991	Grilli, Masciandaro & Tabellini	Inflation Budget deficits Debt Employment GDP	CBI Political regime type Frequency and significance of political change Political fractionalisation	Study 18 OECD countries from 1950-89. CBI promotes low inflation with no apparent costs in terms of real economic performance. Rising debts are associated with representational democracies and fractionalised party systems which lead to short term coalition or minority governments with high turnover. CBI does not restrict the rise of unsustainable debts, nor is there any relationship with output growth or its variability, or unemployment, which leads the authors to compare it to a 'free lunch'.
1991	Heller			Uses simple comparison of 16 countries from 1980-87 to show how "central banks without supervisory responsibilities were more successful in attaining a low inflation rate than central banks with shared or full supervisory responsibility." (p.65) <i>MRK: comparisons of</i>

				<i>Heller classification with others show many discrepancies.</i>
1991	Swinburne & Castello-Branco	CBI	Public Opposition to Inflation Federalism	
1992	Goodman			Politicians give independence in context of domestic and international environment. Banks keep independence by allying with private financial community. CBI is a two way exchange – promote interest of financial community against inflation in exchange for support against politicians who may wish to revoke independence. (p.8) Monetary policy is explained by institutions, esp. central bank, and politics. The degree of CBI is the key explanatory factor. PBC and partisan politics existed and labour militancy (interest group) was effective in influencing policy when central bank was dependent in UK and Italy, but not in Germany where it was independent.
1993	Cukierman			Political influence over the central bank may be subtle or overt. Signalling from the executive or proposals to limit independence are subtle pressures. Overt pressure is seen when governor of the central bank is routinely replaced following a change of government despite legal restrictions against this possibility. There is empirical evidence supporting political turnover of the central bank governor following a change of regime in both industrial and developing countries
1993	Havrilesky			Found evidence that the Fed responds to signalling by the Treasury, to congressional threats to Fed's independence, to the signals from Senators at biannual Hearings, and to signals from the banking sector delivered through the Federal Advisory Council to the Fed. Suggests but cannot support that financial sector actively lobbies the Fed.

1993	Havrilesky & Granato	Inflation	CBI (BP) Corporatism (% unionisation, centralisation, labour index, cabinet portfolios held by left, left % of vote in election) Size of Public Sector (Public expenditures / GDP, public expenditures per capita) Dependence on Oil imports (Oil imports/GDP)	Test 18 industrial countries for 1955-87. Used Chow tests to identify two distinct groups of countries based on inflation then used canonical discriminant analysis to test which variables explain the breakdown. Checked their results using stepwise analysis to identify the dominant variable. Found that only CBI explained inflation. Corporatism, size of public sector and dependence on oil imports were not significant.
1993	Posen	(1) Inflation (CPI) (2) CBI (CWN)	(1) Effective FOI (universal banking, regulatory power, political regime, party fractionalisation) CBI (CWN measure) Significant government change Frequency of government change Fixed exchange rate dummy (2) Effective FOI Significant government change Frequency of government change	Tested two hypotheses for 17 industrial countries from 1950-89 using OLS regression. In first regression, Posen found that effective FOI was significant and negative while CBI was insignificant. A fixed exchange rate regime was also significant. Significant government change showed mixed results while frequency of government change was not significant. In second regression, effective FOI was significant predictor of CBI with adjusted R^2 of 0.47-0.52. Government change variables were not significant.
1994	Alesina & Perotti			Budget deficits are best explained by political conflicts between social groups and the set of budgetary institutions. Need to reform the institutions governing the budget, such as introducing a balanced budget rule, reducing the number of veto players or giving independence to the central bank
1994	Cukierman			CBI is higher when the size of government debt is greater and when the government relies more on borrowing in the capital markets. CBI lower the interest cost on the debt (via the inflation premium). Second, the larger the value of unexpected inflation to politicians, the greater the inflationary bias and the larger the benefits to delegating to the central bank. Third, when party polarisation is greater, or

				the political regime is unstable, outgoing parties delegate more to the central bank to tie the hands of incoming governments.
1994	Cukierman			Why CBI trend now? (1) success of Bundesbank and Swiss National Bank, (2) inflationary experiences of 1970s, (3) Latin American countries want to secure gains from stabilisation, (4) EMU and Maastricht, (5) breakdown of Soviet Union, (6) removal of capital controls and desire to attract potential investors and creditors.
1994	Henning	Maintain peg or devalue	CBI Domestic financial structure (universal / commercial banking, credit / capital market-based, concentration) Financial interests	Henning provides theoretical argument that foreign constituencies ally with domestic interests in countries with capital market-based financial systems, principally banks, to create a transnational coalition against devaluation or depreciation. Connections between banks and industry in countries with credit-based systems, on the other hand, prevent a transnational coalition forming and favour an exchange rate level that is competitive.
1994	Simmons	Adherence to interwar gold standard “rules of the game”	Political stability CBI Partisanship (left) Labour unrest Regime type (federal / unitary)	Simmons found that degree of political stability, central bank independence and the influence of the Left were the most statistically significant. Labour unrest and regime type were not significant
1995	Alesina & Gatti			Develops a theoretical model to support Alesina's empirical work showing that an CBI reduces output volatility by reducing 'political' variability caused by partisan politics in a two-party system, coalition governments or interparty struggles between factions.
1995	Al-Marhubi and Willett	Inflation (mean GDP deflator 1973-89)	CBI (BP, GMT, CWN, Willett) Union centralisation (hump-shaped index) Openness (imports/GDP)	20 industrial countries for 1973-89. Find that CBI, openness and union centralisation are significant, while FX regime and size of budget deficits are not.

			Budget deficit (as % GDP) FX regime (years of peg as % of total years 1973-89)	
1995	Cukierman & Webb			In developing countries, 35% of CB governor changes occur within six months of change of government, compared to 10% for industrial countries. (p.406) Found no significant relationship between central bank vulnerability and political regime change. (p.408) Low and medium political change do not affect the central bank.
1995	De Haan & Van't Hag	CBI	(1) inflationary bias (2) stock of government debt (3) political instability (4) rate of inflation (5) experience with high inflation (6) universal banking system (7) regulatory role of central bank	(1) Not significant. (2) Not significant (3) Lower political instability is associated with higher CBI. (4) Not significant (5) Using average inflation over the period 1900-40 as a proxy, found that experience with high inflation is associated with CBI. (6) Universal banking was associated with CBI when using CWN index, but not other measures (7) When central bank does not regulates banks, CBI is higher when using CWN index, but not other measures
1995	De Haan & Van'T Hag	CBI (various)	Inflationary bias Government debt Level of political instability Inflation Experience with high levels of inflation 1900-1940 Universal banking Regulation of financial system	Found that high political stability, measured as the frequency of government changes in the 1980s, leads to lower central bank independence, not higher as suggested by Cukierman. Countries that experienced high inflation between 1900-1940 established independent central banks. Posen's arguments were only supported when Cukierman's 16-variable (CWN), weighted legal index was used, not the others.
1995	Mas			The institutional design of a central bank is not sufficient for ensuring credibility and low inflation in developing

				countries. Government policy should focus on financial sector reforms which bolster effective FOI, such as financial liberalisation, privatisation, development of financial markets and limits on lending to government
1995	Posen	(1) CBI (various) (2) Inflation (CPI)	Effective FOI (universal banking, regulatory power, political regime, party fractionalisation) Decade dummies Exchange rate regime dummy Effective FOI (universal banking, regulatory power, political regime, party fractionalisation) CBI (CWN measure only)	Analysed 32 low-to-moderate inflation countries from 1960-89, of which 17 were OECD. Using OLS regression Posen found that effective FOI is positively related to CBI and negatively related to inflation in both OECD and developing countries. Regressions using only the components of effective FOI showed mixed results between the OECD and larger samples. CBI is not significantly related to inflation using time weighted least squares regression when effective FOI (or its components) are included. The adjusted R^2 is the same as found by other studies of inflation.
1996	Bernhard	(1) Cabinet durability (2) CBI	(1) Time to election Party system attributes (majority / minority / coalition) Fractionalisation Polarisation Economic openness (capital account openness, trade/GDP) CBI (CWN measure) Unionisation (2) Economic openness (capital account openness, trade/GDP) Left partisanship (Alford index) Strong bicameralism Punishment (polarisation, coalition / minority govt, committee strength) Financial sector strength (Posen FOI)	Found that only fractionalisation, polarisation, CBI, unionisation and time to election were statistically significant. Party system attributes and partisanship were not. Economic openness measures were marginal or insignificant. Politicians will choose an independent bank: (1) if government ministers, party legislators, and coalition partners possess different monetary policy incentives and (2) if government ministers fear that party legislators and coalition partners will withdraw their support over a policy dispute.

1996	Bleaney	(1) Inflation (CPI) (2) Unemployment	CBI (CWN) Corporatism Centralisation of wage bargaining	Tests 17 OECD countries for 1973-82, and 1983-89. CBI is negatively associated with inflation and has no significant effect on unemployment. Wage bargaining is significant for unemployment, and associated with higher inflation in first period only. Results are robust when using other proxies, controlling for outliers or controlling for fixed exchange rate. Pegged rate is alternative to CBI for controlling inflation.
1996	Burdekin & Burkett			<p>View inflation as the outcome of conflict between groups competing for income, first proposed by Tobin. Different domestic actors will compete for a greater portion of the income available in an economy (presumably through rents, wages and interest) creating excess aggregate demand for income. The excess demand may then be accommodated by monetary authorities through increased money supply, or the government through increased budget deficits. The strategies adopted by policymakers to fight inflation depend on how different interest groups within society are affected.</p> <p>“...controlling inflation is not just a matter of technical manipulation of fiscal and monetary instruments, but also hinges upon the degree of (implicit or explicit) distributional consensus among the major income claimants” (p.225). The success of any strategy hinges on accommodating or protecting these key interest groups.</p>
1996	Garrett & Lange			The predictions from interest group models only hold in a limited number of cases as they do not consider the effects of institutions. Private sector institutions (“socio-economic”) such as labour unions or public sector institutions (“formal”) such as central bank independence will effect the impact of internationalisation on political policy. These effects have been ignored in IPE. Other formal institutions are political regime type (democratic, totalitarian, authoritarian); number of veto players; and the election formulae (proportional

				representation, single member districts, geographic representation).
1997	Maxfield	CBI (???)	Effectiveness of signalling creditworthiness Financial regulation (capital controls) Capital mobility Competition among states Politicians tenure BoP conditions (debt, export capacity and foreign exchange reserves)	Politicians use central bank independence as a signalling mechanism to increase their creditworthiness with international investors and creditors.
1998	Banaian, Burdekin & Willett			The authors suggest that a public choice approach should be employed to answer the critical question of what institutional aspect of central bank independence is the most important.
1998	Bernhard			Politicians will choose an independent bank: (1) if government ministers, party legislators, and coalition partners possess different monetary policy incentives and (2) if government ministers fear that party legislators and coalition partners will withdraw their support over a policy dispute.
1998	Broz	Origins of central banks, 1688-1850	Wartime finance Monopoly rents Political regime (unitary / federal)	Broz argues for the joint-products model of collective action where creation of the central bank provided both a public good (protection of property rights) and an excludable private good (monopoly rents through control of currency) which was used to motivate a sub-group of financial interests to petition for the creation of the central bank. Suggests that unitary systems founded banks first because they did not face the political conflicts within parliamentary systems.
1998	Clark et al	Political business cycles	CBI National policy autonomy (floating exchange rate regime)	Authors argue that as national policy autonomy decreases or central bank independence increases PBCs become less likely. They test 18 OECD countries. They found that none

				of the eight countries in which the central bank is highly independent demonstrated any evidence of a PBC.
1998	Hall & Franzese	(1) Inflation (2) Unemployment	(1) CBI (average of CBI, GTM, BP) Index of co-ordination of wage bargaining (CWB) Interaction term CBI * CWB Openness (exports + imports as % of GDP) Real GDP per capita Left cabinet representation Union density (% of labour force unionised) (2) same variables as (1) plus Terms of trade (export prices / import prices) Interaction term (terms of trade x openness)	Examined 18 OECD countries from 1955-90. Left out Greece, Spain and Portugal due to authoritarian regimes, claiming that CBI will not be credible under these circumstances. In all models, CBI and CWB have a negative and statistically significant relationship to the rate of inflation. Unemployment is also higher with increased CBI in the absence of co-ordination.
1998	Hayo	Societal preference for low inflation	(1) Inflation (2) CBI (BP, GMT, Alesina) OLS estimators from (1) Autoregressive error terms from (1) SUR-estimators (not explained) Average inflation	Hayo uses data from 1976-93 collected in Eurobarometer surveys of nine European countries which ask respondents to rank their goals for the government among four choices: maintain order, more democracy, fight rising prices and protect freedom of speech. In (1) Hayo runs OLS regressions of the average first or second priority assigned to price stability against average inflation over the same period, with and without autoregressive error terms due to autocorrelation. The results were inconclusive. In (2), he calculates correlations of the terms from (1) with measures of CBI, but again can neither confirm or reject his hypothesis due to the data.
1998	Keefer and	Inflation (rate of depreciation)	CBI (CWN measure)	Test 3 hypotheses using a regression of 72 countries from

	Stasavage of money)	Effectiveness of checks & balances (executive constraints, party fractionalisation) Polarisation (income inequality, ethno- linguistic fractionalisation) Political instability (rate of executive turnover, freq. of regime transition) Real income / capita (control variable) Decade dummies	1950-90: (1) delegation has more credibility the greater the number of veto players; (2) credibility from delegation is enhanced by moderate political instability and polarisation, and (3) CBI is more likely to endure in countries exhibiting conditions 1 and 2. Individual terms were not significant but interaction term between CBI with checks & balances was. Mixed results when controlling for real income / capita.	
1998	Lohmann		Lohmann disagrees with Posen (1993) that institutions do not matter due to the influence of interest groups. Interest groups are only influential when the central bank is designed, but thereafter “elected politicians deliberately set up veto points in order to insulate monetary policy from counterproductive political pressures”. German monetary policy is subject to electoral pressures. There is no evidence that partisan preferences are influential via the power of appointment. The Bundesbank council is staffed with partially independent technocrats whose independence decreases with the partisan support for the federal government in the Bundesrat” (p.440) Central bank appointees are de-politicised by the internal peer group pressure within the Bundesbank. The Bundesrat’s veto points protects the Bundesbank’s independence.	
1998	Miller		CBI is a mechanism used by politicians to protect the subsidies awarded to interest groups so as to maximise the 'rents' that the politicians receives, in the form of campaign contributions. Miller treats banks as a special case of interest groups, linking his argument to Posen's FOI. Banks have an asset-liability mismatch which leads to exposure to inflation	
1999	Bernhard and	Choice of exchange rate	Domestic political institutions	Studied 20 OECD countries 1974-95. Conclude that in

	Leblang	regime	(majoritarian / proportional, committee system, exogenous electoral timing) Economic openness (trade dependence) Vulnerability to shocks (real effective exchange rate, variability of domestic credit, economic size) Capital mobility (capital controls, international borrowing) Domestic political factors (partisanship, electoral cycle, EC membership) CBI (CWN measure)	systems where the electoral system decisively determines the composition of government and the cost of electoral defeat is high, politicians will be unwilling to relinquish policy control with a fixed exchange rate. In systems where coalition governments are common and the policy process is open, politicians adopt a fixed exchange rate.
1999	Broz	Choice of exchange rate regime	Autocracy Wealth Trade openness Inflation differential Financial openness Policy inertia (lagged dependent variable) Political stability	Ran regression of 100 states from 1973-95. Broz argues that states where political decision making is opaque (autocracies) will adopt the transparent exchange rate peg as a commitment technology, while transparent political systems (democracies) will opt for CBI. Found that autocracies are 18% more likely to adopt fixed exchange rate, richer countries opt for fixed exchange rates, and larger countries opt for floating exchange rates.
1999	Broz	Inflation	Domestic political regime (democratic / autocratic) CBI (CWN measure) Exchange rate regime Wealth (GDP per capita) Financial openness Political stability	Ran regression of 69 states from 1973-89. Broz found that CBI is only effective against inflation in democracies, while an exchange rate peg constrains inflation regardless of regime type.
1999	Franzese	(1) Inflation (GDP deflator) – linear-additive model (2) Inflation – weighted average model	CBI (average of CWN, GMT, BP) Government partisanship Trade openness (exports + imports as % GDP) Financial sector employment (as % of	He looks at 18 OECD countries from 1972-90, using annual data. Acknowledging the “severe multicollinearity” of his variables which led other researchers to abandon similar efforts, Franzese argues that the weighted-average model of inflation dominates the other two models. He interprets his

		(3) Inflation – interactive model	total) Inflation abroad Union density Co-ordination of wage bargaining	results to support his hypothesis while disproving the linear-additive theory and Posen's effective FOI. "Specifically, central bank independence has most anti-inflationary bite when (a) the government is most left, (b) union density is highest, (c) the economy is least open, (d) inflation abroad is highest, (e) the financial sector is smallest, and (f) wage-bargaining co-ordination is lowest, and visa versa" (p.19).
1999	Moser	(1) CBI (various) (2) Inflation (average 1973-89)	(1) Dummy variables for political system (strong checks & balances, weak, none) Experience with inflation (average inflation 1900-40) Control variable for external shocks (standard deviation of growth) (2) Dummy variables for political system (as above) Interaction term between dummy variables and CBI (various measures) Openness (following not shown) Inequality Government debt / GDP Dummy variable for membership in EMS	Examines 21 OECD countries, which he splits into the three groups based on the existence and strength of checks and balances. (1) Countries with strong checks and balances have more legally independent central bank than countries with weak or no checks and balances. A variable proxying for experience with inflation is not significant. (2) Evidence supports the thesis that the negative relation between legal central bank independence (degree of behavioural independence) and inflation is stronger in countries with strong checks and balances than in countries with no checks and balances. However, there is no difference between those countries with strong and weak forms of checks and balances. There was no systematic evidence of other causes of inflation for the other variables.

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