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0521823331 - Appointing Central Bankers: The Politics of Monetary Policy in the United States and the European Monetary Union

Kelly H. Chang

Excerpt

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I

Introduction

Central banks are often independent, but the degree of independence varies among the banks and over time. Until recently, the British government dictated the Bank of England's monetary policy (Schaling 1995: 91–2). In contrast, the Deutsche Bundesbank controlled policy without government interference (Schaling 1995: 95–6).¹ De Nederlandsche Bank straddled the two extremes; in the event of disagreement, the Dutch finance minister and the central bank had to compromise (Schaling 1995: 93–4). Both the Bundesbank and De Nederlandsche Bank are now parts of the European System of Central Banks, and both should be more similar in their independence; the statute for the new system explicitly prohibits any central bank from taking government instructions (Grilli, Masciandro, and Tabellini 1991; see Cukierman 1992 and Schaling 1995 for excellent reviews of the existing indices of central bank independence).

Although central banks vary in independence, most share a common characteristic: political appointments. Despite the safeguards of central bank independence – for example, no government instructions or closed policy meetings – politicians appoint monetary policy makers. Thus, appointments remain a potential avenue of political influence on monetary policy. The idea behind appointments is simple: if a politician appoints someone like herself, then the appointee should act like the politician when setting monetary policy.

However, influence rarely works so directly or easily. The extent to which politicians influence monetary policy through appointments depends on the appointment process itself, particularly two features of the process. First, different branches of government often share the power to

¹ Prior to the start of EMU. In January of 1999, the ECB took over the monetary policy setting authority of the Deutsche Bundesbank and De Nederlandsche Bank.

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appoint. For some central banks, the cabinet appoints candidates subject to legislative approval (e.g., Japan; Bank of Japan Law, Art 23, ¶1–2). For others, the process is reversed: the legislature or cabinet nominates, and the president appoints (e.g., Germany; European Commission 1998: 40, fn. 3). In either set of cases, those who nominate have first-mover advantage and can have relatively more power in the process.

Second, central banks usually have decision-making boards with multiple members. As a result, politicians can rarely influence policy dramatically with one appointment; they usually have the existing members to contend with. In Sweden, until 1999, this problem did not exist as virtually all terms expired every four years right after each parliamentary election (Schaling 1995: 90–1). In Germany, however, each term lasted eight years, and the terms were staggered over several years.² Thus in Sweden, one round of appointments was sufficient to significantly influence policy, while in Germany it was probably not enough.

In short, politicians have to work within the constraints of the process in order to influence monetary policy through appointments. Furthermore, in every country, the appointment process reflects the degree to which the powers are separated or shared in the governmental system. In Sweden, the legislature dominates the process, but legislative dominance does not mean much in the context of unified government; in such a system, both legislative and cabinet approval of nominees would be redundant. In Germany, the legislature nominates, and the executive appoints, and the separation of these powers does make sense because the government is not necessarily unified; the majority party of both the lower house, the Bundestag, and the upper house, the Bundesrat, can differ from that of the president.

In the United States, as in Germany, the appointment power is also shared between the executive and legislative branches. In accordance with Article II, Section 2 of the U.S. Constitution,³ the president appoints Federal Reserve (Fed) members with the advice and consent of the Senate. The president has first-mover advantage in his powers to nominate, but his choice must be conditioned by the Senate's preferences, because of the

² These features still exist although the Bundesbank no longer sets monetary policy.

³ “[The President] shall nominate and by and with the advice and consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other officers of the United States, whose appointments are not herein otherwise provided for, and which shall be established by law: but the Congress may by law vest the appointment of such inferior officers, as they think proper, in the President alone, in the courts of law, or in the heads of departments.”

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[More information](#)*1.1 The Book's Main Questions*

Senate's power to veto the president's choice. This simple bargaining process, the same process for thousands of federal appointments, produces the policy makers to one of the most powerful institutions in the world – the Federal Reserve. But this particular process, the process for the Fed, has seldom been studied.

This book examines the Fed appointment process and its impact on monetary policy. Because the appointment process repeats in a stable context, it provides an excellent opportunity to examine interbranch bargaining in an area rarely studied by economists – appointment politics – and in a policy subject rarely studied by political scientists – monetary policy. What is the appointment process? How does it really work? Which politicians influence appointments? Who designed the process and for what purpose? This book attempts to tackle these questions with a detailed theoretical and empirical study of Fed appointments that is extended to the new European Central Bank (ECB) – often called the world's most independent central bank.

1.1 THE BOOK'S MAIN QUESTIONS

In mid-January of 1996, Alan Blinder, the Vice Chairman of the Federal Reserve, announced his imminent resignation. Two days later, the Clinton administration expressed interest in the possible nomination of Felix Rohatyn (Wessel 1996: A2), a well-known easy monetary policy advocate. In a vociferous and public attack, Senate Republicans subsequently opposed Rohatyn's candidacy and specifically his potential easy influence on monetary policy (Wilke and Frisby 1996: A3, A16). Rohatyn withdrew within days from consideration although the administration had yet to announce a formal nomination (Wilke 1996b).

About ten days later, the Clinton administration nominated Alice Rivlin, the White House Budget Director, and an academic economist, Laurence Meyer, for an additional vacancy. Both Rivlin and Meyer were widely seen as much more conservative candidates compared to Rohatyn. This time the Senate Republicans were far more receptive. Senator Mack of the Banking Committee remarked that the new members "... are likely to give us a board committed to price stability, and that's what we want to see" (quoted in Wilke 1996a).

This story highlights several important insights into the political appointment process of the American system. First, politicians care about appointments because they believe appointments affect policy. Senator Mack objected to Rohatyn's possible easy influence on monetary policy

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and supported Rivlin and Meyer's likely contributions to price stability. Second, the Senate as well as the president may influence the appointment process. Rohatyn's withdrawal from candidacy followed heavy Senate criticism. Third, prior to the formal nomination, the president and Senate engage in bargaining regarding the possible nominees. The back and forth between the president and Senate and Rohatyn's withdrawal preceded a formal administration nomination.

But these insights follow from one anecdote. Do they generalize to other appointments – in other American agencies, in other central banks, or in the Fed? This study addresses the question theoretically and empirically with respect to the Fed with an extension to the ECB. More precisely, the study addresses three specific questions. First, do politicians influence monetary policy through appointments? Second, who influences appointments – the president and Senate jointly or just the president? Third, what explains the structure of Fed appointments?

1.2 QUESTION 1: DO POLITICIANS INFLUENCE MONETARY POLICY THROUGH APPOINTMENTS?

It seems reasonable to assume politicians want their monetary policy preferences to be reflected in monetary policy. Monetary policy profoundly influences the economy, and the economy is often the key to electoral success. A strong empirical relationship exists between the economy's performance and voting for the incumbent party (Kramer 1971; Stigler 1973; Tufte 1975; Fair 1978, 1980; Alesina and Rosenthal 1989, 1995; Erikson 1990; Alesina, Londregan, and Rosenthal 1993). For example, Reagan took advantage of this relationship in 1980 with the campaign slogan, "Are you better off than you were four years ago?"

Because politicians know the appointment process and the Fed's structure, they should be able to strategically appoint Fed members in order to obtain their preferred policy. I use this logic to construct a model of how politicians' monetary policy preferences translate to policy, and then empirically test the model's predictions to see if political influence occurs in the manner specified by the model.

In answer to this first question, this book's results indicate that politicians do influence monetary policy with Fed appointments. Despite the Fed's highly regarded independence, appointments remain an important avenue of political influence on monetary policy. In other words, independence does not imply total freedom from political authority. The Fed may have more autonomy compared to other American agencies, and the Fed

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is more autonomous compared to most central banks, but it hardly runs amok. By appointing the appropriate members, the president and Senate basically keep the Fed in line with their preferences while still allowing for the Fed's freedom on a day-to-day basis.

The question of political influence and monetary policy has received much attention in economics, but the perspective is different from the one adopted in this book. From the economic perspective (see particularly Kydland and Prescott 1977), political influence is a *problem* that needs to be solved. The problem starts with the policy makers' incentive to deviate from the socially optimal inflation rate of zero. If policy makers unexpectedly inflate, unemployment decreases, but because economic agents know that policy makers have these incentives, they expect the policy makers to deviate. Because expectations determine inflation, the outcome is positive inflation, which is suboptimal. In their landmark study, Kydland and Prescott (1977) called this the problem of "time inconsistency."

Subsequent economic studies concentrated on two sets of solutions to the problem of time inconsistency. The first was reputation. Barro and Gordon (1983) found that through repeated interactions, policy makers can convince economic agents of their dedication to zero inflation. The second set focused on institutions. Rogoff (1985) and others examined how delegation of monetary authority to a conservative central banker renders society better off by lowering inflation and increasing output. Subsequent works in central bank independence found that appointment features such as longer terms, timing around elections, and conservative biases of the central bankers are pareto efficient (Frey and Schneider 1981; Grilli, Masciandro, and Tabellini 1991; Lohmann 1992; Waller 1992; Alesina and Summers 1993; Waller and Walsh 1996; see Cukierman 1992; Persson and Tabellini 1994, 1999 for excellent summaries).

The problem of political influence is further complicated by the existence of political parties. The "political business cycles" literature showed how policy can fluctuate suboptimally according to partisan interests (Nordhaus 1975; Hibbs 1977; Rogoff and Sibert 1988; Persson and Tabellini 1990; and Rogoff 1990). In a vein similar to Barro and Gordon, Alesina (1987) demonstrated that if the parties cooperate on setting a credible policy in a repeated, two-party game, the cycles attenuated. Building on Rogoff's institutional solution, Waller (1992) and Waller and Walsh (1996) found that the partisanship of central bankers can be reduced by working with the timing of central bank appointments around elections.

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The modeling choices in this literature reflect the interest in solving the problem of political influence. The models are dynamic, general equilibrium representations of the entire economy with few institutional details. The actors are represented by homogenous types or representative agents. For example, one central banker represents all central bankers. In the political business cycle models, the policy makers are divided into two parties, but for each party, one party member represents the entire party. Furthermore, the work is more theoretically than empirically developed.⁴ But these choices are understandable because the purpose of these models is to show whether a variation in the setup, the proposed solution, leads to optimal outcomes in economic aggregates such as inflation or output. In such models, details may add unnecessary complications.

A group of economists and political scientists have taken an approach different from the preceding general equilibrium models. The quantitative work is empirical and focuses on the Fed's reaction function: regression models with monetary policy as a dependent variable and political influence measures as independent variables (e.g., Beck 1982a; Chappell, Havrilesky and McGregor 1993, 1995; Havrilesky 1993, 1995; Morris 1994, 2000). In particular, Havrilesky (1993, 1995) used reaction functions extensively to find the influence of the president, Congress, and interest groups. On appointment specifically, the results of Morris (1991, 1994, 2000) and Keech and Morris (1996) support presidential and congressional influence through appointments. Morris' thesis (1994) provided the first efforts to formalize a theory of Fed appointments. There are also some very careful qualitative studies by Woolley (1984), who delved into the political meaning of independence, and Kettl (1986), who focused on the evolution of the Chair's role.

In contrast to the studies in time inconsistency, central bank independence, and political business cycles, the Fed literature is characterized by an almost opposite set of features. First, few models of strategic interaction exist (exceptions are Morris 1994; Morris and Munger 1997), and

⁴ The empirical work has lagged behind the theoretical breakthroughs. Some evidence suggests a negative relationship between inflation and central bank independence (higher central bank independence implies lower inflation; Grilli, Masciandro, and Tabellini 1991; see Cukierman 1992 for an extensive review). Considerably more empirical work has been done with respect to political business cycles. Starting with Hibbs (1977), the evidence tends to support post-election cycles based on certain conditions predicted by the models (Alesina and Roubini 1990; Persson and Tabellini 1994, 1999). The evidence is not so clear on preelection cycles (Nordhaus 1975; Alesina and Roubini 1990; Persson and Tabellini 1994, 1999).

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if they do, the models are static, one-shot games rather than dynamic, repeated games. Second, Fed studies often do make distinctions between different individual actors rather than typologizing them. For example, Chappell, Havrilesky, and McGregor (1993, 1995) examine the differing influences of Reagan and Carter. Third, Fed scholars talk more about the institutions and processes of monetary policy, but there is little formalization of these characteristics. Fourth, in direct contrast to the time inconsistency and central bank independence literature, studies of the Fed are characterized by more empirical than theoretical work.

While both sets of studies provide important findings about central banks, the Fed, and monetary policy, none are quite right for answering the first main question. As this book will show, the appointment process determines how and when influence occurs. The central bank independence literature abstracts from process, as it rightly should, since its concerns are not how the process *actually* works, but rather how central bank relations with politicians *should* work – an essentially normative enterprise, albeit with positive tools. As for the reaction function approach, it is also unsuited to answering the first main question because it seeks to show whether influence exists after any appointment. But not all appointments are alike; influence occurs in certain circumstances but not in others. In this book, those circumstances are clarified through a model of the appointment process that shows that whether influence occurs depends on the direction of policy change desired by the politicians and if the current makeup of the central decision-making board is favorable for moving policy in that direction. Rather than as a *problem* to solve, I treat political influence as a phenomenon about which we want to find out the mechanisms and effects.

1.3 QUESTION 2: WHO INFLUENCES APPOINTMENTS?

Both the president and Senate have distinct powers in the appointment process: the president chooses nominees, but the Senate can veto those nominees. Can the president afford to ignore the Senate, or does the Senate's veto power really mean something?

In fact, the Senate's veto power has substantial bite in the process, as this book will show. The Senate does not have to actually exercise its veto power, and it rarely does; in the case of Fed appointments, the Senate has never rejected a nominee (Morris 2000: 78). The mere threat of the veto is enough to make the president pay attention to the Senate's preferences. If the president does not anticipate the Senate, he faces the consequences – a

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long, drawn-out confirmation battle that means tolerating whatever policy the current Fed dishes out compared to a possibly better policy if the president compromises with the Senate. For example, rather than fight a war for Rohatyn, the president compromised with his choices of Rivlin and Meyer.

This second question underscores a debate in the political science appointments literature between those who believe the president always anticipates the Senate versus others who believe the president dominates all the time. Proponents of presidential anticipation claim that Senate acquiescence is not Senate powerlessness because the president takes into account the Senate's preferences before formally nominating the candidates (Calvert, McCubbins, and Weingast 1989; Lemieux and Stewart 1990; Hammond and Hill 1993; Morris 1994; Nokken and Sala 2000; Snyder and Weingast 2000). In contrast, presidential dominance scholars claim that the president chooses whomever he pleases, and the Senate will agree because of a norm of deference to the president (Moe 1985, 1987b). Both have used the rarity of Senate rejections as support for their respective theories, but Senate acceptance cannot be used to refute or support either theory: both predict acceptance.⁵

As with many debates, the truth lies somewhere in the middle, as other parts of the bureaucratic delegation literature have concluded. Over the last twenty years, political scientists have gradually modified the principal-agent theory to the realities of the American political setting. Older studies tended to focus on one principal or another, but more recent studies incorporate multiple principals. In the early 80s, the congressional dominance literature examined how Congress influences the bureaucracy through oversight (Weingast and Moran 1983; McCubbins and Schwartz 1984; Weingast 1984). Presidential scholars responded by pointing out the importance of the president through mechanisms such as appointments (Mackenzie 1981; Moe 1985, 1987b). Recent studies take a more holistic approach by considering the president, Congress, the courts, and the bureaucracy together. They show how these institutional actors bargain with one another given their different constitutional powers (Moe 1985, 1987b; McCubbins, Noll, and Weingast 1987; Calvert, McCubbins,

⁵ The two theories are also observationally equivalent with respect to Senate roll-call votes when: (1) the president's ideal point lies outside the range of the Senate ideal points, and (2) if dominance scholars define Senate deference as median deference rather than unanimous deference. In (1), all senators vote in the same manner regardless of dominance or anticipation. In (2), a majority of the senators vote in the same manner regardless of dominance or anticipation.

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and Weingast 1989; Ferejohn and Shipan 1989, 1990; Matthews 1989; Eskridge and Ferejohn 1992; Hammond and Knott 1996; McCarty 1997; Epstein and O'Halloran 1999; Cameron 2000). These studies have identified the conditions under which Congress, the president, or the courts dominate policy and when they truly share powers (see particularly McCarty and Poole 1995; Hammond and Knott 1996).

Those conditions are also apparent in the Fed appointment process. If we start with a model in which the president always anticipates the Senate, there are still cases in which the president clearly dominates, and others in which neither the president nor the Senate dominates. It depends on whether the president and Senate agree on the direction of policy change and on their preferences relative to current monetary policy.

First, if the president and Senate disagree on the direction of policy change, there is deadlock, and they agree to maintain current policy. Any policy change makes one or the other worse off. Clinton faced this situation with his first few appointments to the Fed. Clinton wanted to move policy in an easier direction, but the Republican Senate Banking Committee did not. When he tried to move policy with Rohatyn, the committee objected, and Clinton had to pull Rohatyn's nomination as well as an earlier nomination of Alicia Munnell.

Second, if they agree on the direction of change, but the president likes the current policy more than the Senate, then the president dominates. From the beginning of his first administration, Reagan wanted to move monetary policy in an easier direction. Martha Seger was Reagan's second Fed appointee in 1984. She faced Democratic opposition in the Senate Banking Committee, but the Republican majority in the committee sided with Reagan and wanted policy to ease up even more than Reagan did. With his choice of Seger, Reagan moved policy as far as he could with this one appointment, and the Democratic senators could not stop him.⁶

Third, if they agree on the direction, and the Senate likes the president's preferred policy more than the current policy, then the president again dominates. When Carter appointed Nancy Teeters in 1978, both he and the Senate clearly favored easier policy; the Senate favored less easier policy, but only slightly less. Under these circumstances, Carter was able to choose Teeters who, even today, is pointed out as the quintessential monetary policy liberal.

⁶ Reagan appointed Seger during a congressional recess and angered the Democrats in the process. The Democrats tried to pass an amendment to withdraw the nomination, but the amendment failed to pass on party lines (Morris 2000: 78).

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Finally, if they agree on the direction, but the Senate likes the current policy more than the president does, then the president has to accommodate the Senate. For example, when Reagan appointed Alan Greenspan in 1987, he sought a candidate less hawkish than Paul Volcker. The Senate also wanted someone less hawkish but somewhat more hawkish than Greenspan (Greider 1987: 713–14; Martin 2000: 155–7). But because they agreed that policy should move toward somewhat less vigilance on inflation, and because the President had first-mover advantage in choosing the nominee, Reagan could choose a less hawkish candidate, Greenspan, than the Senate would have preferred. However, he could not have gone further to choose a candidate who was still more liberal without incurring Senate threats of rejection.

These second and third cases therefore show presidential dominance within an anticipation framework. But is there dominance all the time? This book's empirical results indicate that it is unlikely. In a direct comparison of the anticipation and dominance models, anticipation does better most of the time for the Federal Open Market Committee (FOMC) – the Fed's main decision-making body.

In identifying dominance within an anticipation framework, this book fits in with more recent studies of appointments. In their study of Supreme Court appointments, Moraski and Shipan (1999) demonstrate that depending on the policy preferences of the president and Senate relative to the current policy, the president or the Senate or both may influence appointments. Bailey and Chang (1999, 2003) show that in addition to the policy preferences, the costs to each side of further nominations determine whether one, the other, or both the president and Senate influence appointments. McCarty and Razaghian (1999) bring similar concerns to an examination of Senate confirmation times for executive branch appointments.

1.4 QUESTION 3: WHAT EXPLAINS THE STRUCTURE OF FEDERAL RESERVE APPOINTMENTS?

The Federal Reserve Act of 1913 created the Federal Reserve System, which consists of twelve district reserve banks,⁷ and two main decision-making institutions in Washington, DC: the Board of Governors (BOG)

⁷ The twelve district reserve banks are located in New York, Boston, Philadelphia, Richmond, Cleveland, Chicago, Atlanta, Dallas, St. Louis, Minneapolis, Kansas City, and San Francisco.