Accounting for Economic Institutions:
How Independent Central Banks Affect Democratic Accountability

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Abstract

The economic voting literature emphasizes that complex government structures lead voters to weigh the economy less in their voting calculus. While a number of institutional factors have been considered by the literature, these have largely been institutions that voters can directly punish through electoral mechanisms. However, there are numerous institutions that affect political and economic outcomes that voters have no means of punishing for bad results but that are directly dependent upon the choices of elected officials. In this paper I explore how changes in the international political economy, in conjunction with electoral considerations, affect politician incentives to increase central bank independence. Preliminary evidence from the reform of the Bank of Japan in 1997 supports the underlying political motives posited in the theory.

Introduction

Why do governments choose to give up control of monetary policy at a specific point in time when the incentives to do so are always present? The economics literature claims that when politicians remove the ability to use monetary policy at their discretion to increase short-term economic growth (which does not increase long-run growth but does increase inflation) that better economic outcomes are likely to obtain. However, these incentives are always present and can do little to explain why politicians decide to delegate authority over monetary policy to an independent central
bank in one country while those in others do not. Further, it can do little to explain the timing of such decisions within countries. I argue that by considering how alternative economic institutional arrangements affect politicians’ campaign strategies, in particular creating a new actor to blame when bad economic outcomes obtain, we can better understand both the cross-national and cross-temporal variation in political control of monetary policy. My theory presents an explanation for why politicians would want to give up control of important macroeconomic policy tools even when the economic benefits from doing so are minimal.

When politicians control monetary policy, they are able to increase the money supply to increase economic growth and employment when it is politically expedient to do so. This may occur when the economy has dipped below the natural rate of growth or when a politician wants to push economic growth above the natural rate for their own purposes. This latter temptation is thought to be particularly acute prior to elections because poor economic performance tends to reduce the government’s vote share (Schultz 1995). By increasing growth and employment prior to elections, incumbent politicians can improve their reelection prospects. When markets perfectly anticipate this type of behavior the result is increased inflation without increased growth or employment. Even if markets are not able to perfectly anticipate political manipulations of the economy (and so these monetary expansions are still able to increase growth temporarily), inflationary expectations will be higher when politicians cannot credibly commit to maintaining low inflation.

By handing monetary policymaking authority over to an independent and conservative central bank ¹ politicians can reduce inflation by lowering market expectations of future inflation. Lower inflation is associated with increased investment and, in the long-run, increased economic growth. If voters prefer low inflation to high inflation and care about long-run economic growth then, *ceteris paribus*, this ought to be the preferred policy outcome. Further, incumbent politicians ought to

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¹ A country’s central bank is charged with overseeing the nation’s money supply. How the money supply is handled has implications for short-run growth and employment as well as inflation in both the short- and long-run. An independent central bank is one in which the goals that the bank is to pursue are clearly defined/not easily changed, the bank may choose among the various monetary policy instruments to achieve that goal, and which has minimal political interference in the execution of monetary policy. For a more detailed explanation see Cukierman et al. 1992. A conservative central bank is one that is more inflation averse than politicians.
be punished less at the polls because one aspect of the economy, inflation, is less likely to be performing poorly. This particular incentive to increase central bank independence exists across countries. However, a monetary policy focused on price stability may lead to policies that result in lower growth at any particular moment in time. Poor economic performance on other economic dimensions (such as growth) may lead to electoral losses for politicians that could have been avoided had they been able to offset these aspects of economic decline through the use of monetary policy which is, after increasing the central bank’s independence, out of their control by design. Which of these countervailing prerogatives will prevail is not explained in the extant literature. Below I explain how the strength of the incentive to increase the independence of a central bank will vary with the extent to which credit claiming or blame shifting is electorally profitable in different political contexts - an incentive on which the accountability literature can shed light.

Most theoretical and empirical research on electoral accountability, and economic voting in particular, has focused on the confusion of voters over whom to assign credit/blame between democratically elected entities for economic outcomes. Very little has dealt with the impact of other types of institutions that might also be responsible for the outcomes that voters are interested in. If voters are confused by the presence of multiple democratically elected players in the policymaking process, the extension of that logic implies that the relationships between voters, politicians, and ‘autonomous’ economic institutions like independent central banks would further complicate this attribution process. However, there is currently no research that investigates these relationships. Thus, we don’t know if voters are taking these other institutions into consideration when making vote choices and, if they are not, we do not know why they are not.

In particular, central banks hold an important place in national economic outcomes since the collapse of Bretton Woods. The movement from fixed to floating exchange rates in many countries and the increased ease of moving capital across borders has resulted in monetary policy having a greater effect on domestic economies than in previous eras (Clark 2003). This increased effectiveness of monetary policy on economic outcomes thus affords those who control the money supply with a greater impact on economic outcomes while subsequently reducing the impact of other actors on those outcomes. If voters are punishing or rewarding politicians based upon macroeconomic

\footnote{For exceptions, see Naurin 2006 and Duch and Stevenson 2008.}
performance then the amount of political control over central banks ought to affect how much of the credit or blame is placed upon politicians. The more independent a central bank is from political interference, the less politicians should be held to account for economic outcomes, *ceteris paribus*, thus making it a particularly appropriate institution to study.

For politicians to be punished less for bad economic outcomes in this situation, however, voters would have to know that their elected officials a) had more limited control over the outcome and b) are reasonably constrained in their ability to reassert control over monetary policy. When independence is increased voters may not always be cognizant of the difference between the central bank and the government in terms of responsibility for economic outcomes. As such, it may be that, regardless of the level of central bank independence voters continue to blame politicians for economic outcomes which they no longer control. Below I explain the circumstances under which voters are most likely to assign blame to the bank and when they are unlikely to do so. I argue that when blaming the bank is relatively easy, politicians will point the finger at the central bank for bad economic outcomes and some voters will hold the government less responsible for the bad economic outcome. The next section lays out extant theories of accountability and economic voting. The impact of central bank independence on economic outcomes and why central banks ought to be studied in conjunction with electoral competition is then discussed in the third section. This section also lays out a number of empirical implications that arise from the theory. The fourth section presents evidence from a preliminary study of the Japanese decision to increase central bank independence. The final section concludes with next steps.

**Accountability and the Economic Vote**

There is significant cross-national evidence that both perceptions and objective measures of poor economic outcomes reduce the prospects for reelection of incumbent governing parties. Norpoth (1984) finds that higher inflation erodes presidential popularity in the US and Jordahl (2006) arrives at a similar conclusion regarding the impact of macroeconomic variables for Swedish voters. Recent evidence from a series of cross-national surveys indicates that, in fact, the phenomenon of economic voting is present in most western democracies (Duch & Stevenson 2008). Economic voting is the
idea that people “vote the economy”. That is, economic outcomes, or perceptions of economic outcomes, are strong predictors of vote choice. Specifically, poor economic performance is expected to reduce the likelihood of voting for the incumbent government while good economic performance is expected to either increase or, at worst, have no effect upon vote choice and electoral outcomes. Prospect theory implies that people are more aware of bad consequences than of good ones - taking the good to be natural and not the result of the actions of others but seek to determine responsibility for bad outcomes (Kahneman and Tverski 1979; Lewis-Beck and Paldam 2000). That is to say, voters are less likely to reward someone for a good outcome but will try to punish someone for a bad outcome. Much of this literature has focused on how different institutional configurations help or hinder voters’ ability to assign credit or blame for economic outcomes to the appropriate decision maker (e.g., Duch and Stevenson 2008, Lowry et al. 1998, Powell and Whitten 1993, Whitten and Palmer 1999). This attribution, occurring on an individual-level, aggregates to relationships between the economy and electoral outcomes that differ significantly across countries due to the institutional context in which voters find themselves cross-nationally.

Public opinion scholars interested in how individuals come to their voting decisions have found that the economy is a significant determinant of individual vote choice. Further, in most countries, it is the state of the national economy, not personal financial situations, that most strongly affects vote choice (e.g., Kiewiet and Kinder 1979; Lewis-Beck 1988; Borre 1997). Voters do not hold the government responsible for personal economic misfortunes but do hold them accountable for maintaining a strong national economy. Most scholars find that past economic performance largely determines voter expectations for the future and so focus on indicators of retrospective voting in their analyses of survey data (MacKuen et al. 1992). Voters are found to actually be quite well informed about the macroeconomy near elections, though their knowledge seems to dwindle after the election (Paldam & Nannestad 2000). This implies that campaigns may serve as a means

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3Nannestad and Paldam (1995) find little evidence of sociotropic voting in Denmark but significant evidence egotropic voting. However, this could be a result of cultural expectations of government responsibility for providing for the economic well-being of the individual in Denmark given the long-term commitment of the state to providing employment and generous unemployment compensation in that particular country.

4The literature tends to focus on retrospective, sociotropic voting. That is, the focus is on vote choices arising from past national economic outcomes as opposed to future or personal economic outcomes.
through which individuals learn about the current economy. It also implies that the connections that voters make between politics and economics may not be static but triggered by how politicians frame these connections. Because of the focus on the economy in their voting decisions and the apparent connection that voters make between policy and the state of the economy, the ability of voters to make accurate assessments of responsibility for economic policy is important for the mechanisms of economic voting to function.

If these individual attribution processes are to aggregate to significant differences in economic voting between different countries that persist over time, then it must be that people in some countries are more likely to attribute responsibility for economic outcomes to politicians than in others. The most common explanation for these cross-national differences is that domestic institutional contexts make attribution easier in some locales and more difficult in others. It is argued that institutional context complicates this process for voters because voters are either unsure of who to hold responsible (the punishment model) or they are unable to use the economy as a strong signal of how well the government has done its job (the competence model). In the punishment model, institutional configurations affect the ability of voters to focus their attributions of economic responsibility effectively. As a result, voters simply do not use the economy as much in making their vote choice as the lines of responsibility become increasingly blurred between different political actors. Clarity of responsibility created by institutional settings affects the abilities of individual voters to attribute credit or blame for economic outcomes (Powell 2000; Gerring and Thacker 2004). Hence, a high clarity of responsibility institutional context is one in which responsibility for policy is obvious and citizens have the ability to remove politicians or parties that fail to represent their interests in a manner that can meaningfully change policies (Powell 2000). Institutions thought to reduce clarity of responsibility include coalition and minority government (Powell & Whitten 1993), bicameralism (Richard Nadeau & Yoshinaka 2002), and federalism (Robert C Lowry & Ferree 1998). The ability of voters to assign credit and place blame on the political actors responsible for particular outcomes is imperative if accountability is the normative objective that a polity is interested in pursuing. The existence of multiple actors with overlapping responsibility for a particular policy or outcome thus reduces the ability of voters to observe who actually produced the outcome (Bednar 2007; Powell 2000; Powell and Whitten 1993). When there are multiple agents whose behaviors
have an (probabilistic) effect on an outcome, the ability to infer the impact of contributions by any individual agent through the knowledge of the final outcome is difficult for principals. This inability to fully observe the actions of agents and their effects produces incentives for either shirking in cases where all agents have an explicit mandate to contribute to the production of a good (Güth et al. 2001) or for an agent to take actions outside of their immediate mandate in order to be associated with a likely positive outcome (Bednar 2007).

The inability of voters to assign responsibility for outcomes, however, is not simply a result of the actions of their multiple agents but also of the voters limited knowledge about the agents actions in the punishment model. In this way, it is the publicity of actions that allows voters to hold agents accountable (Naurin 2006). People have to know that their elected representatives have taken some actions and be able to link those actions to the outcomes that they observe. This likely occurs through campaigns. The factors that reduce or enhance clarity of responsibility are a combination of both static (e.g., federalism, bicameralism) and dynamic (e.g., divided government, coalition government, increasing trade dependence) properties of political life (Nadeau et al. 2002, Duch and Stevenson 2008). The types of agents that have been most thoroughly examined by the literature (e.g. bicameral opposition, coalition government, independently elected executive, etc.) are typically ones whose presence and actions would be publicized repeatedly over time; their actions would also be publicized more heavily in the lead up to elections (Stevenson & Vavreck 2000). In particular, when there exist multiple actors who impact outcomes (and politicians are among those actors) politicians seeking reelection have an incentive to try to claim credit for good outcomes and to shift blame to someone else for bad outcomes, regardless of how much influence they actually had over the outcome (Cain et al. 1987; Powell and Whitten 1993).

While the punishment model builds from incomplete information models of the relationship between voters and politicians, the competence model begins with the premise of highly informed voters who know precisely the division of power over economic outcomes within the government and between the government and other actors. These voters are trying to assess the extent to which the economy informs them about the competence of the government to manage the economy (Duch & Stevenson 2008). Voters in this model are aware that the government’s policies will affect the economy but that there are things outside of the government’s purview that affect economic outcomes.
as well (Alesina and Rosenthal 1995, Duch and Stevenson 2008). It is the combination of both the concentration of economic policymaking that electorally dependent policymakers have (relative to other, nonelectorally dependent actors such as markets or independent central banks) and the effects of these policies on economic outcomes that lead to the voters’ problem of signal extraction and the resulting cross-national differences in economic voting according to Duch and Stevenson. They argue that diminished economic voting in low clarity of responsibility contexts results from a greater diffusion of economic voting across parties and, in cases where national economies are subject to larger external shocks, the known inability of governments to affect economic outcomes. The explicit input of actors that are not parts of the government is a main difference between the punishment and competence models. The competence model implies that as elected officials have relatively fewer tools with which to affect the economy, they ought to be held less accountable by voters for economic outcomes. This implies that increasing the autonomy of central banks, under particular circumstances enumerated below, ought to reduce economic voting.

An Explanation of Central Bank Independence

The functions and effects of central bank independence, however, have been explored in a manner that is largely disconnected from research on voting and the electoral process. This omission, while reasonable during early periods of research on economic voting, needs to be filled given trends in the international political economy. For much of the past century most central banks have been directly under the control of governments (Goodman 1991). As such, monetary policy was a macroeconomic policy tool that was available to politicians for political manipulation. By increasing the money supply (equivalent to reducing interest rates), money is effectively cheaper and, as such, consumption increases in the short-run before inflationary pressures are realized. In this way, politicians can use monetary policy to bolster chances of reelection. The past twenty years, however, have witnessed an increase in the level of independence of a number of central banks.

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5 Do you guys think that I should discuss the differences between the competence and punishment models so much? For my purposes they lead to largely similar conclusions. This was pertinent when I was focusing this paper on an extension of the Duch and Stevenson model, but I’m not sure if it’s necessary anymore. Is it a distraction?
banks, particularly in Western Europe. This occurred in the midst of drastic reductions in barriers to trade and capital mobility and major changes in exchange rate regimes following the end of Bretton Woods. Thus, numerous politicians in multiple countries have given up a tool of protecting their seats just as that tool was becoming more powerful.

These systemic changes have important implications for the effectiveness of monetary policy and the desirability of controlling the money supply. Robert Mundell and Marcus Fleming model the effects of fiscal and monetary policy in an open economy on economic output. The show that, at any point in time, a state cannot maintain fixed exchange rates, allow the free movement of capital, and use monetary policy to affect output: states can only have two of these three at a time. Thus, if states want to maintain an exchange rate peg and allow for capital mobility, then monetary policy will not be an effective policy tool for increasing short-run economic growth because monetary policy will have to be used to maintain the exchange rate. Instead, the government can increase spending to boost the national economy which increases demand for the national currency. This increased demand raises domestic interest rates, which increases capital flows into the country and, subsequently, put upward pressure on the fixed exchange rate. Those in charge of monetary policy will therefore have to purchase foreign currencies with domestic currency in order to maintain the exchange rate. The net result is no change in the exchange rate but increased national income.

If a government allow its exchange rate to float (i.e., the value of the national currency is determined by international supply and demand for the currency) while allowing capital to move freely, then monetary policy can once again effectively adjust the national economy. This is because monetary policy authorities can decrease (increase) the interest rate when the economy is below (above) its natural trajectory and simply allow the reduction in domestic interest rates to result in a depreciation of the exchange rate.

Clark (2003) shows that when exchange rates are flexible and capital is mobile (as has increasingly been the case in the international financial system over the last 30 years), greater independence of the central bank significantly reduces the ability of the government to indulge in macroeconomic manipulations prior to elections (political business cycles). He argues that an independent central bank will counter manipulative attempts at fiscal expansion through tightening the money supply, thus rendering such manipulations much less effective. But if the central bank is politically
dependent then the government has the opportunity to use monetary policy to engage in political business cycles. At the very least, the central bank will accommodate fiscal expansions if the bank is politically dependent. Given that economic growth prior to elections appears to increase the electoral prospects of incumbents and monetary policy has become an increasingly powerful tool for achieving such ends as governments have moved toward more flexible exchange rates and increased capital mobility, why would politicians want to give this tool away?

I argue that politicians would want to give up this tool for two reasons that relate directly to their focus on reelection. The first is related to traditional time inconsistent preference arguments about central bank independence (CBI). As monetary policy becomes a more powerful tool for politicians to use for manipulating growth and employment prior to elections, markets ought to expect increased use of this tool by politicians. The inability to surprise markets leads to no additional growth or employment, only increased inflation (Bernhard et al. 2002). Since increased inflation has a negative effect on electoral prospects for incumbents (Anderson 1995, Jordahl 2002), they may prefer to take this option away by handing monetary policy over to an independent central bank. Thus, delegating policy authority to an autonomous central bank, through inflation reduction, ought to decrease the frequency and/or magnitude of bad economic outcomes, which would lead to better electoral prospects for incumbents. This is an incentive that will increase as the economy becomes more open and states intervene in currency markets to maintain exchange rates less.

Even though inflation may fall with greater central bank autonomy, the economy will still experience downturns. The second electoral reason that politicians may have to increase central bank independence is that doing so should result in these periodic downturns having a diminished impact on the electoral prospects of incumbents. This is because, as Duch and Stevenson argue, as politicians are less responsible for the economy voters will use the economy less in their vote calculus. The mechanism through which voters change their economic voting habits, discussed below, is driven by a politician strategy of blame shifting to the independent central bank when the economy goes awry. If politicians expect to be able to shift blame to the central bank when things are going poorly, then this may provide them with sufficient incentive to increase the independence of the central bank. Thus, when governments remove the ability to manipulate the economy from
their own hands by both increasing the effectiveness of monetary policy (by allowing the national currency to float and removing barriers to capital movements) and handing monetary policy making over to an independent central bank then evidence of economic voting ought to become weaker.

This change in economic voting ought to be commensurate to the relative change in control over monetary policy. That is, the electoral benefit from increasing central bank independence ought to be greatest in those cases in which the government hold the greatest control over monetary policy in the status quo. When political control over monetary policy is greatest, an increase in CBI of one unit will have a much larger marginal impact on the ability of the government to shift blame than would the same absolute magnitude increase in CBI for a government in a country with a relatively high status quo level of CBI. This is because when the government already has minimal control over monetary policy, an increase in central bank independence is unlikely to dramatically alter the relationship between the bank and politicians and hence, there will be little to be gained electorally from such an action. When the government has significant control over monetary policy, on the other hand, even relatively small increases in legal independence are likely to result in a much larger change in the relationship between the central bank and the government, thereby producing potentially large electoral benefits. However, as noted above, when the government has significant control over an effective monetary policy, retaining control over this tool allows politicians to engage in minor political business cycles prior to close elections. As such, it is a priori indeterminate which of these influences will be stronger at any given point in time. What would lead a government to want to move from an institutional setting in which it could effectively manipulate the economy to another in which it largely cannot? I believe that there are two, largely exogenous but interconnected, factors which might help explain changes in preferences for control over monetary policy among politicians.

The first reason that politicians might prefer giving up the ability to indulge in political business cycles relates to changes in the costs and benefits of such indulgences that arise from increased

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6 These implications are derived formally in a model not presented in this paper.

7 In the remainder of this paper the discussion will center around the specific roles of central bank independence in the decision calculus of policymakers, however, this should always be evaluated in terms of the decision to hand over monetary policy to the central bank in the context of effective monetary policy.
economic interdependence. As economies become more interconnected, domestic governments have less control over their own economic fates. When international trade and capital become a larger part of the domestic economy the actions of foreign governments and international markets will increasingly affect domestic growth. While one macroeconomic policy tool (such as monetary policy) may become relatively more effective for managing the economy, the absolute ability of national policy makers to affect economic outcomes may be falling. Duch and Stevenson (2008) argue that as trade becomes a larger share of a national economy, economic voting decreases precisely because the government has less control over economic outcomes. Further, the costs of engaging in political manipulation of the economy are likely to increase (through less predictable exchange rates, increased premiums on capital entering the country, etc.) as interdependence increases.

While the changing nature of the costs and benefits of engaging in political business cycles provides a reasoning for governments to not engage in these activities, it does not provide an explanation as to why they would want to provide their central banks with the ability to conduct monetary policy without political direction. These changes in the international political economy, though likely noted by politicians, may not necessarily be noticed by voters. Increasing interdependence is likely to occur gradually. While the trend of interdependence may be bolstered by specific legislative or executive actions, voters are unlikely to notice incremental changes. Voters are likely to increasingly overestimate the amount of control the government has over the economy as interdependence increases. This may arise from ignorance or simply from a desire to “blame” someone for economic woes. In the case of ignorance, it seems likely that this overestimation would arise from a failure to note gradual changes in the ratio over time. This is similar to the psychological phenomenon of selective attention which causes people to pay attention to only a small part of the stimuli available to them. People notice things that they see changing in apparently

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8 Note that these arguments are about engaging in monetary or fiscal expansions for political purposes by expanding the economy when such measures are not attempting to correct for a dip in the economy to get it back toward the natural rate of growth. They are concerned with trying to expand the economy above its natural rate of growth for a short period of time prior to elections. As such, any fiscal or monetary expansion is not necessarily evidence of political manipulation.
random ways while ignoring the underlying trends. As such, the government is likely to garner the same amount of blame for economic outcomes even though they have less control over these very outcomes. By making a very public change in the institutional setting, politicians may be able to essentially “wake voters up” to the true amount of control that the government has over the economy. While politicians can inform voters about these structural changes in the economy, this is likely to be a difficult case to make. It would require explaining how complex international forces are causing economic problems, explanations which would typically not be obvious to voters. If these explanations are complex they are less likely to be effective in persuading voters (Zaller 1992). Similarly, if people simply want someone to blame, having someone else to point to would be useful for a politician. By changing the domestic political institutional arrangement politicians can make a more simple argument: it’s the central bank’s fault and we can’t control them.

While changing institutions is a particularly strong signal that politicians could send to indicate a change in the true level of government influence on the economy, less drastic signals could be the attempts to “pass the blame” during subsequent campaigns. However, by delegating responsibility in a public manner politicians can send a signal to at least moderately attentive voters about the underlying state of the world (Zaller 1992). One product of election campaigns is that less informed voters form more solid beliefs about the state of the economy through the agency of politicians (Arceneaux 2005). When combined with a costly institutional change, this would likely lead to politicians handing decisions over to third parties when they have lost a significant amount of control over economic outcomes already. If a large gap between public perceptions and actual responsibility has developed then it is likely in the politicians interests to pay a cost to inform voters of this.

Further, due to the electoral incentives of politicians voters do not need to understand the specific policy instruments that central banks use to manipulate the macroeconomy in order to sometimes place credit or blame on central banks for economic outcomes. Instead, I argue that politicians have an incentive to inform voters of the importance of the policies pursued by the central bank. A means by which voters learn about the actions of politicians is through media coverage of economic policies and political competition (Chong and Druckman 2008; Salmond n.d.). Politicians from opposing parties have an incentive to expose the actions of one another for
electoral gain (Schultz 2001). When the economy is performing poorly in a country with mobile capital, flexible exchange rates, and high levels of CBI, the government can credibly claim that they are not responsible for that outcome. They can shift blame to the independent central bank. Opposition parties will not be able to easily rebut this fact as doing so would likely require a detailed explanation of why it was government policy and not central bank policy that is to blame. These types of detailed policy explanations are not particularly effective means of attracting voters (Zaller 1992). Further, voters may more readily project their emotions onto a tangible institution—one that can be named and personified in the central bank’s chair—than they could toward something less tangible such as ‘the international economy.’

Further, this strategy of blame shifting is likely to be one which always favors those in government. This is because politicians have the central bank to deflect some blame onto whenever the economy is performing poorly but are unlikely to have the central bank attempting to garner credit from voters when the economy is doing well. Ostensibly, statements by the central bank are not aimed at the electorate but at market actors who are likely to extract particular information about future policy moves due to profit maximizing incentives. Thus, the availability of this information does not mean that all voters will fully understand the consequences of these policies or their relationship to the politicians over whom voters have more direct control. However, it does indicate that some voters may be able to understand a) that economic outcomes are the result of both monetary and fiscal policies and b) the government’s level of control over monetary policy. Incumbent governments competing for reelection during good economic times will attempt to claim credit (again, regardless of their actual responsibility for the outcome). Opposition parties are unlikely to gain electoral leverage by reinforcing the economic accomplishments that have been achieved under the sitting government, even if they are only doing so by trying to credit the bank for these improvements. Their campaign efforts are better spent on increasing the salience of issues that differentiate them from the government—pursuing good economic outcomes is unlikely to be an issue that they want to differentiate themselves on. This leads to the first set of clear empirical implication of this theory:

**Hypothesis 1.** Higher levels of central bank independence ought to decrease the magnitude of the
economic vote under bad economic conditions but have no effect on economic voting under good economic conditions.

**Hypothesis 2.** Incumbent politicians ought to attempt to shift blame for bad economic outcomes to the central bank but no such efforts should be made during good economic times.

**Corollary 1.** Following a change in the level of central bank independence, politician strategies of blame shifting should change as well: an increase in CBI ought to result in increased blame shifting following the change, and vice versa.

An important conduit of this blame shifting activity is the media which acts as both a platform for politicians to disseminate their messages and an additional monitor of politicians’ behavior. The media reports extensively on the actions of central banks. The statements and reports of central bankers are combed for meaning by financial analysts and make headlines on a regular basis. Changes in interest rates are regularly mentioned on the evening news. This opens the possibility that voters may have at least some basic knowledge that the central bank’s actions have some impact on their lives, even if they do not fully understand this impact. Additionally, the media is able to monitor the truth of politician statements on the economy. Attempts to blame the central bank when it is politically dependent are more likely to be flagged by both members of the opposition and the media as false. For instance, recent attacks on the governor of the Bank of Spain, Miguel Fernández Ordóñez, by Spain’s Socialist government have been addressed by newspapers such as the Financial Times stating that, "[w]hat makes the disagreements surprising is that the central bank is not a wholly independent institution. [Central Bank Governor] Mr. Fernadez Ordonez is a Socialist and was formerly a senior government official" (Mallet 2009).

There is also evidence of an increase in rhetoric coming from central banks (including those with a high degree of independence) in the period prior to an election, perhaps indicating that central bankers are trying to reassure markets and voters of their competence and reduce inflationary fears (Maier 2002). In particular, the actions of the central bank ought to be most prominent in the minds of politicians and voters during economic downturns. Because voters are more likely to punish politicians for bad economic outcomes than they are to reward them for good outcomes and making the assumptions that politicians prefer holding office over being turned out of office and are
minimally risk averse over reelection, politicians are likely to try to implement both institutional and campaign strategies that bolster their electoral chances. When bad outcomes obtain, politicians would be expected to attempt to pass the buck to another actor in order to avoid punishment. The existence of a politically independent central bank thus provides a potential scapegoat for politicians to skewer. Further, while placing blame on another institution may be feasible, it is unlikely that the independence of the central bank will diminish any positive economic voting during good economic times because of a) the absence of cues from politicians crediting the bank with the good outcome and b) the limited benefit that high growth brings to politicians anyways.

Central bankers, always aware of the possibility of politicians reigning in their independence, are also likely to defend their actions. However, due to the relationships that politicians have with society, it is likely that politicians will be both more likely to have their message(s) exonerating themselves from responsibility heard by the average voter and to be more persuasive in this message than will the central banker. This is because the likely target of central bank messages (markets) is better able to process information efficiently than are individual voters. As such, central banks use more technical jargon in their communication than do politicians, who target the electorate. While the media may be able to help voters parse out responsibility for economic outcomes, the likelihood that a voter will receive and process a piece of information that excuses politicians from blame increases if politicians have an alternative institution to blame. Because of these relationships, voters ought to be less likely to engage in economic voting during downturns in institutional contexts with higher levels of central bank independence, though not necessarily in boom years.

This line of reasoning provides a motivation for politicians to increase central bank independence. As such, the first step in this project is to look for evidence that politicians have taken these issues into consideration when altering the independence of the central bank. Whether these electoral strategies work, however, is a question to be explored later in the project.

**The Reform of the Bank of Japan, 1997**

For most of the post-war era the Bank of Japan has been among the most politically dependent central banks in the world (Cukierman et al. 1992). The Bank of Japan was officially subordinate
to the government, with its goals being “solely for achievement of national aims” as defined by the government (Dwyer 2004). Specifically, the Bank of Japan was placed under the supervision of the Ministry of Finance (MOF) which could force the Bank to undertake specific policies, appoint and dismiss the governor, and whose officials had non-voting rights on the Bank’s Policy Board. Yet for much of the 25 years prior to the 1997 reform of the Bank’s charter it had also presided over some of the best economic performance among the developed countries - consistent high growth paired with low inflation. Beginning in 1990 the Japanese economy slowed dramatically with the collapse of the asset bubble that had developed during the late 1980s; increased inflation, however, was not a problem. In fact, a lack of inflation proved problematic as the Bank of Japan increased the liquidity in the economy by lowering interest rates to effectively zero but was unable to achieve the needed negative real interest rates to boost consumption and get Japan out of the deflationary cycle in which it was stuck. Given that the Bank of Japan was able to convince markets to its commitment to maintaining low inflation in the long-run in spite of its high degree of political dependence, why would politicians want to grant the central bank independence? Traditional explanations for increasing central bank independence have little to say about the Bank of Japan reforms. In this section, I give a brief overview of the Japanese economy since WWII until the Bank of Japan was given political independence in 1998, with a focus on the period from from 1980 until 1998. The political environment in which policymakers made the decision to increase central bank independence is explored in detail. I find that the government was motivated by a need to deflect blame for poor economic performance prior to parliamentary elections.

Overcoming a time inconsistency problem did not seem to be the motivation for the change in the Bank of Japan’s charter in 1997. In the first decades following the Second World War, Japanese politicians were focused on the goal of reconstruction. Japan was a member of the Bretton Woods System, with a fixed exchange rate of 360 yen per dollar and tight capital controls (Cargill et al. 1997). This arrangement allowed the Bank of Japan to use monetary policy to stimulate domestic demand. The Bank’s first priority, however, was to maintain the currency peg and, secondarily, increased growth. As such, inflation performance during this time (because it was not a political priority) was somewhat poor in comparative perspective, with inflation averaging about 4.5% between 1950 and 1972 (Cargil et al. 1997).
While the late 1960s saw a tightening of the money supply, due to a combination of current-account surpluses and political pressures, the Bank of Japan loosened monetary policy between 1970 and 1973. The monetary loosening\(^9\) was a result of political pressure by the Tanaka government, with the hope that easy money would aid in the Prime Minister’s plan to increase social insurance coverage through his Reconstruct the Japanese Archipelago plan as well as increase domestic demand (Cargill et al. 1997, Ito 1992). This policy of lowering interest rates was taken despite recommendations by the Bank of Japan to do precisely the opposite (Ito 1992). When the monetary loosening began the yen was still pegged to the dollar and world inflation was rising, resulting in nearly 20% yearly inflation rates between 1970 and 1973 (Duus & Hall 1988). Following the oil shocks of 1973, Japan was forced to float the yen\(^{10}\). This led to the period of “wild inflation” that lasted until 1975.

Following this bout of severe inflation the “national aim” became reducing the growth of money supply. The Bank of Japan announcement in 1975 tied the growth of money to inflation; it did not, however, state an inflation target (Cargill 1998). While Krugman (1998) and Bernanke (2000) both cite the focus on money growth (an instrument of monetary policy not necessarily an end in and of itself) as an important factor in the financial crisis of the 1990s, from the mid-1970s through the late 1980s this strategy produced impressive results. The Bank of Japan began announcing its expectation of money supply growth at the beginning of every quarter and was largely accurate in these growth rate projections (Cargill et al. 1998). This gradual reduction of the money supply and the Bank of Japan’s successful defense against inflation during the 1979 oil crisis brought inflationary expectations down, leading to incredibly low levels of inflation from 1975-1985. Furthermore, the real economy grew at rate unmatched by any other industrialized country.

This period of low inflation coincided with the easing of capital restrictions. While financial

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\(^9\)“Monetary loosening”, “easy money” and “monetary expansion” are used interchangeably in this section. Engaging in monetary loosening means that the money supply was increased and, equivalently, that interest rates were reduced. ‘Tightening’ and ‘contraction’ of the money supply connote the opposite.

\(^{10}\)The yen, though officially floating, was more of a managed float. That is, when it appreciated too much, the Bank of Japan would intervene in international capital markets, purchasing Japanese yen with foreign reserves and sterilizing the increase in the domestic money supply by purchasing domestic debt instruments (Cargill et al. 1998, Lincoln et al. 1998)
and capital liberalization had begun in 1966 when Japan joined the OECD, restrictions on the movement of capital were largely removed with the 1980 implementation of the Foreign Exchange and Foreign Trade Control Law (Japan 1980, Lincoln et al. 1998). This move in 1980 to increased capital mobility (completed by 1985 (Lincoln et al. 1998)), in combination with MOF deregulation of various domestic debt instruments, resulted in increased effectiveness of monetary policy for stimulating domestic demand in by the mid-1980s (Cargill et al. 1998).

During this period of low inflation in the mid-1980s the yen became overvalued in response to an international effort to depreciate the US dollar. The Bank of Japan’s attempt to move market prices for the dollar into line with economic fundamentals worked too well, leading to an overvaluation of the yen. In response to this the Bank of Japan lowered domestic interest rates (which would reduce foreign demand for yen). While monetary-base\(^{11}\) growth increased from 5% to 15% (Cargill et al. 1998), consumer prices did not rise because the inflationary pressures of the expansion in the money supply were offset by the reduction in the costs of imports because of the overvalued yen. This led to an asset bubble in which land and stock prices rose much faster than would their true value because of the ease with which investment funds could be obtained on the domestic market. As the yen’s value fell, monetary expansion was reined in, leading to a burst of the asset bubble, and the revelation of problems with the banking system more generally, in 1990 and the beginning of Japan’s lost decade.

Following the crash the Bank of Japan reduced interest rates slowly between 1991 and 1994 because of a continued eye toward exchange rates (Bernanke 2000, Cargill 2001). This hesitancy on the part of the Bank of Japan is credited with deepening the economic crisis during its early stages. By 1994, the Bank of Japan had lowered nominal interest rates to practically zero, flooding the market with yen in an attempt to increase spending. However, Bernanke (2000), Cargill (2001), and Krugman (1998) all argue that this increase in the money supply failed because markets believed that the Bank of Japan would tighten monetary policy once the economy rebounded to return to a path of long-run low inflation. That is, the markets did not believe that the Bank of Japan’s commitment to increase inflation were credible. Given the credibility that the Bank of Japan had

\(^{11}\)The monetary base is a measure of the money supply. It is composed of M2 + CDs. M2 is composed of all currency in circulation, plus demand deposits in banks, savings accounts, travelers checks, and time deposits.
achieved for a commitment to low inflation, traditional economic explanations for increasing CBI fall flat.

Considering the political environment that politicians found themselves in, however, provides insights into why the Japanese government decided to increase the independence of the central bank in the late 1990s. Following the change in electoral laws in the 1994 election, the dominant Liberal Democratic Party (LDP) had returned to power as the dominant member of a coalition government. The government had come to power promising economic, and specifically bureaucratic, reform (Dwyer 2004). Prior to the economic downturn of the 1990s, there was “little shifting of responsibility for the control of economic policy and its consequences among the government, the ministries, and the central bank. The Bank of Japan is legally subordinate to the Ministry of Finance, and no claims of formal independence are suggested. The Ministry of Finance and the LDP (until 1993, at least) had generally assumed responsibility for monetary policy and its inflationary consequences” (Cargill et al. 1998, pg. 190). This is not surprising considering the tight ties between the MOF and the Bank of Japan. In addition to the formal hierarchy between the Ministry of Finance and the the Bank of Japan informal relationships between the two bureaucracies were manifest in the alternation of the professional backgrounds of Bank of Japan governors: governors were chosen alternately from within the Bank of Japan and from the Ministry of Finance (Cargill et al. 1998).

Beginning in late 1995, however, the government began discussing central bank reform. The decision to increase central bank independence seemed odd considering that discussions surrounding the reforms in which it was claimed that an excess of bureaucratic independence had led to Japan’s economic problems (Dwyer 2004). Were the reform efforts an attempt to remedy a problem of too much independence, making the Bank of Japan legally independent of the government was not an appropriate response. However, members of the ruling coalition, in particular the junior members (the Japan Socialist Party (JSP) and the Harbinger Party) were particularly keen to increase the Bank of Japan’s independence. Dwyer (2004) argues that the junior coalition members were

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12This makes me think about Bernhard and Leblang’s (2002) IO article in which increasing the number of veto players increases the need for CBI as a credible commitment to particular distributional problems associated with monetary policy, but it doesn’t seem quite like what is going on in Japan. Thoughts??
worried about the electoral consequences of failing to engage in bureaucratic reform (pg. 254). She argues that, “central bank reform was not most politicians’ primary aim, but rather emerged from their efforts to gain electoral leverage by pointing fingers at, and removing from MOF’s hands, responsibilities that politicians could claim bureaucrats had mismanaged” (Dwyer 2004, pg. 252). Cargill (2001) echoes this sentiment, stating that the “revision of the Bank of Japan Law was the outcome of complex political maneuvering by the Ministry of Finance that had nothing to do with correcting past Bank of Japan policy. The Ministry found central bank independence a convenient way to divert attention from its failure to deal with the nonperforming-loan problem” (pg. 131).

The Bank of Japan Act, passed in May 1996 and enacted in April 1997, significantly increased the autonomy of the central bank. Article 3 states that “the Bank of Japan’s autonomy regarding currency and monetary control shall be respected.” It also increased the transparency of the internal decisionmaking processes of the Policy Board, requiring it to publish votes on monetary policy and to report to the Diet twice a year. The combination of these two policies were in line with contemporary academic arguments about monetary institutions. However, it did little to alleviate the problems of the Japanese economy. In fact, it has been argued that increasing the Bank of Japan’s independence actually hindered recovery. The Bank, desirous to prove its independence, failed to implement monetary policies advocated by the government that were economically sound (Cargill 2001).

The Japanese General Election was held on October 20, 1996, approximately five months after the Bank of Japan Act was passed. The coalition between the LDP, SDP and the Harbinger Party was narrowly reelected. It is, obviously, not possible to state that the decision to increase the independence of the Bank of Japan resulted in the government’s reelection. However, it does appear that members of the cabinet believed that the decision to remove monetary policy from their control would bolster their chances of reelection.

The Japanese decision to increase central bank independence provides preliminary support for the reasonableness of the arguments presented in this paper. Based upon standard economic motivations for increasing central bank independence, there was little reason for the Japanese government to increase the Bank of Japan’s autonomy. There does seem to be evidence that the government was interested in pinning the blame for Japan’s economic misfortunes on another actor.
Given the status quo institutional environment there were no such actors that the government could point to that were distinct from itself. It was the desire to both appear proactive and create scapegoat that led Japanese politicians to increase central bank independence.

**Conclusions and Next Steps**

This paper provides a good base for considering the electoral reasoning underlying institutional change. I argue that governments facing poor economic and, as a result, electoral outcomes have an incentive to pass blame for the economy to another actor. Central banks provide a particularly attractive target because politicians can craft an understandable argument that blames the central bank and the central bank is unlikely to want or be able to convince voters that the bank’s actions have been appropriate. By handing control of monetary policy to a politically independent central bank a government can improve its chances of being reelected by both reducing the expected magnitude/frequency of downturns and scapegoating the bank when downturns do occur.

These incentives have been increasing as the ability of governments to manipulate the national economy for electoral gain has diminished due to increased interdependence. While politicians would be expected to observe this change in their actual ability to affect economic outcomes voters may not. As such, voters may be attributing more responsibility to the government than is deserved. If voters are assigning too much responsibility to the government then politicians may want to change voters’ perceptions of their level of responsibility. This would be particularly true when voters are looking for someone to blame. When the gap between voter perceptions of government responsibility for economic outcomes and the reality of government control increases enough, the need to reduce this gap through a public institutional change will become paramount.

The next step in this research agenda is to develop empirical tests of these various implications. One avenue is to test for systematic differences in economic voting across countries with different levels of central bank independence. Similar survey data from a number of countries that asks about both vote choice and economic perceptions is needed along with yearly data on central bank independence, exchange rate regime and ease of capital mobility in order to create a hierarchical model of economic voting to consider the implications for cross-national variation. Further, the
recent changes in central bank independence that have resulted in the Eurozone countries due to provisions in the Maastricht Treaty and European Monetary Union (EMU) accession provide a sort of natural experiment. In the lead up to the full implementation of EMU in 2002, the European Union conducted an educational campaign to inform EU citizens about the nature of the changes and, in particular, the European Central Bank. As such, if we were to see changes in the levels of economic voting within countries due to changes in the independence of monetary policy it would be following the introduction of the Euro. In particular, countries such as France and Italy ought to have seen relatively large changes in economic voting over the course of the 1990s due to their large central banking reforms and the fact that, relative to many of the smaller members of the Eurozone, their monetary policy had been (relatively) less tied to the Deutsche Mark.

The mechanisms that ought to lead to these diminished levels of economic voting need to be tested as well. If voters are learning about the bank’s role in bad economic outcomes (but not necessarily in good ones) through the actions of politicians, then these should be found in politicians’ statements. Conducting content analysis of the largest national newspaper for countries that saw a change in CBI for discussion of the central bank’s responsibility for economic outcomes prior to elections needs to be conducted. Significantly more mentions of the bank’s role during economic downturns when the bank actually has more of an effect (i.e., after an increase in CBI) would be supporting evidence. This should become particularly acute prior to elections.

Finally, the individual-level mechanisms can be tested. In particular, do statements like Pelosi’s about the innocence of politicians for bad economic outcomes actually affect voters? A relatively simple experiment could give some leverage to this question. It would involve asking a random sample of survey participants to read a brief newspaper article about their central bank’s role in the current economy. Later in the survey all participants would be asked to state who they think is most responsible for the current state of the economy and their vote choice if an election were to be held tomorrow (along with the normal battery of questions about party identification, economic perceptions, etc. as well as both economic and political knowledge questions). If those who are moderately informed about politics and/or the economy and who received the treatment were found to attribute less responsibility to the government for bad economic outcomes this theory would be supported. Unfortunately, this method is unlikely to allow for variation in economic context (i.e.,
whether the economy is doing well or not), but would be a step in the right direction.
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