

9. POPULISM, INSTITUTIONAL QUALITY, AND CENTRAL BANK INDEPENDENCE

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This chapter looks at the impact of populism on central bank independence through two different lenses. First, using a wide cross-country dataset, it provides empirical evidence that one aspect commonly attributed to populism, namely national identity politics, has negatively impacted on central bank independence. Second, considering the potential impact on institutional quality, the chapter investigates the relationship between institutions and central bank independence. The largest empirical study to date on the determinants of central bank independence found a negative relationship to institutional quality variables. This is shown to be due to sample length. Using a different dataset for central bank independence with a considerably longer sample, institutional variables are found to be positive and highly significant determinants of central bank independence.

9.1. POPULISM AND CENTRAL BANK INDEPENDENCE²

Central bank independence (CBI) is often regarded as a pillar of effective monetary reform, particularly in developing countries. However, granting independence of policy determination to a central bank is not merely an economic policy decision. It is a choice that is deeply intertwined with political preferences, and therefore granting (or rescinding) independence can relate to political cycles. Goodhart and Lastra (2018) argue that the electoral success of populist political movements in various countries may result in pressures on the independence of central banks. They observe a tension between the expanded mandates of central banks, and the electoral discontent with the prevailing status quo since the Global Financial Crisis.

The relationship between political populism and CBI that Goodhart and Lastra (2018) lay out, contains elements that are testable. The challenge is to define what constitutes a populist movement, and to find an empirical representation for such a definition. While there is no consensus on the meaning of populism, national identity politics is one aspect that is commonly associated with it. For example,

¹ International Monetary Fund.

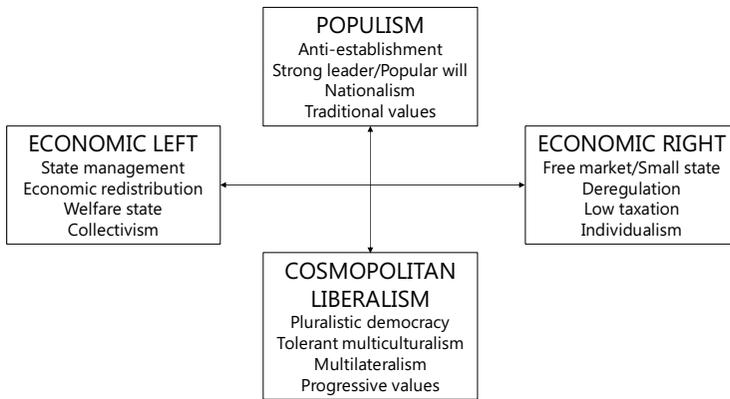
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² This part of the chapter is based on Agur (2018).

Figure 1 depicts the categorization of contemporary politics by Inglehart and Norris (2016), where nationalism is identified as one facet of populism.

Political nationalism is a variable on which data is available from the World Bank's Database of Political Institutions (DPI). DPI counts a party as nationalist if "a primary component of its platform is the creation or defense of a national or ethnic identity." DPI records several 0-1 dummy variables relating to nationalism, namely "nationalist chief executive", "nationalist largest government party" and "nationalist largest opposition party". DPI covers 178 countries between 1975-2012.

Figure 1: Inglehart and Norris' (2016) Categorization of Contemporary Politics

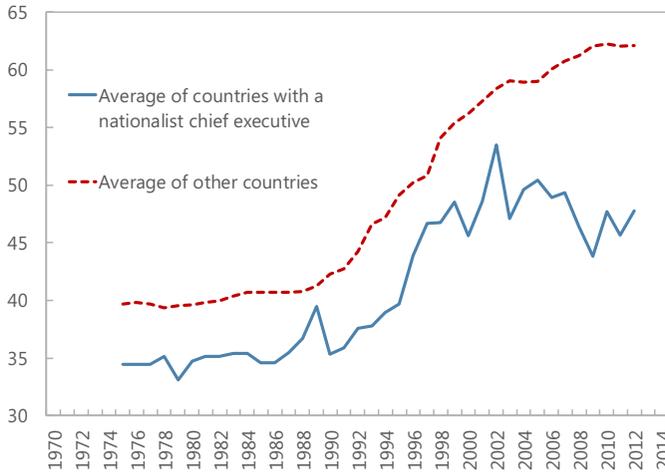


Political variables tend to change infrequently, and we require a CBI dataset of maximum scope (time and countries) to fully exploit the variation in the political data. This guides our choice for *de jure* measures of CBI, which offer much wider scope than *de facto* measures. We consider *de jure* CBI as a measure of policy intent. Legal independence of the central bank does not guarantee *de facto* independence, and the relationship between *de jure* CBI and inflation outcomes is not always clear-cut (Cukierman, 2008). However, statutory reforms towards increased CBI are a policy statement, a desire to untie the central bank and the government. In the practice of monetary reform, *de jure* CBI is often a prerequisite for *de facto* CBI and successful monetary reform more broadly (Freedman and Ötoker-Robe, 2010).

The best known *de jure* CBI index was developed by Cukierman, Webb, and Neyapati (1992). Garriga (2016) applies this method to 182 countries between 1970-2012. Her dataset includes 382 identified instances of monetary reforms, of which 276, 50 and 56 instances, respectively, resulted in higher, unchanged, and lower CBI. We combine the Garriga's CBI data with DPI data to gauge the link between nationalism and CBI. Figure 2 provides a first glance at this link. It

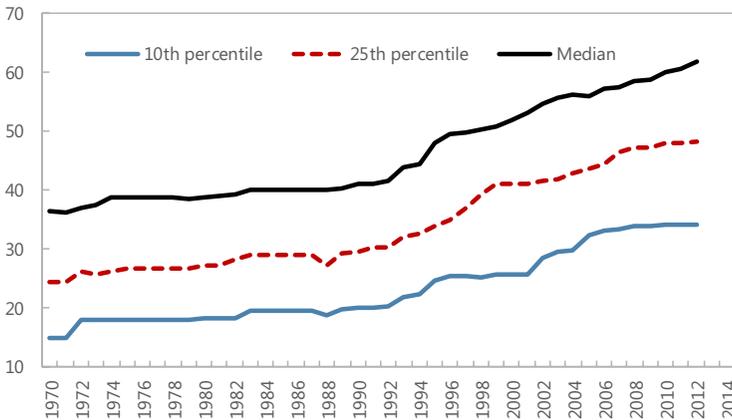
shows that countries with a nationalist chief executive (president or prime minister in DPI, depending on the political system) generally lag other countries in CBI, a gap that has been widening since the late 1990s. One might suspect that this follows from a selection bias, whereby less developed countries have both lower CBI and a greater fraction of nationalist governments. However, all economic development strata have on average witnessed a gradual rise of CBI since the late 1990s (Figure 3). The move towards increased CBI is not concentrated in specific economies but seen in a wide cross-section of development stages. The relationship hinted at by Figure 2, merits a deeper investigation, therefore.

Figure 2: CBI and nationalism



Sources: Garriga (2016), World Bank DPI, author calculations

Figure 3: CBI percentiles



Sources: Garriga (2016), author calculations.

We follow the regression analysis of Dincer and Eichengreen (2014), who run fixed effects panels to identify the determinants of *de jure* CBI. Dincer and Eichengreen (2014) compile an extensive *de jure* CBI dataset, and analyze its determinants. While their dataset has a broad cross-country dimension (100 countries), its time-series is too short for our purposes, starting in 1998. We therefore replicate their approach for determinants, but with the dataset of Garriga (2016). Following Dincer and Eichengreen (2014), we employ as macroeconomic control variables: GDP per capita, lagged inflation, trade openness, and financial depth as measured by M2/GDP.

Like Dincer and Eichengreen (2014), we also add a variety of institutional quality variables. For this, we use the International Country Risk Guide (ICRG). Including institutional controls is important to address the risk that a significant result for nationalism variables masquerades for other institutional variables. As each of the three nationalism variables (chief executive, largest government party, largest opposition party) has only limited variation over time, we combine these three variables into a single (unweighted sum) nationalism index, which can take values between 0-3. In addition, we also check the significance of each separate variable, in separate specifications. Our rationale for including the “largest opposition party” variable is that opposition parties can sometimes influence the direction of policy. Governing politicians may wish to placate the opposition party’s voters by showing sensitivity to the opposition’s political platform.

Table 1 summarizes our empirical results in six different specifications. The first specification uses only CBI, the macroeconomic variables and the nationalism index. Because this specification excludes the ICRG data, it has the largest number of observations (2,145 over 113 countries). The nationalism index has a negative impact on CBI, which is significant at 5%. Specifications (2)-(6) add in the institutional control variables. With institutional controls the sample becomes smaller. Specification (2) includes the full set of institutional controls, while specification (3) takes out the two institutional variables that are most costly in terms of lost sample observations. In both cases, the nationalism index is significant at 1%. Specifications (4)-(6) replace the nationalism index with its individual components. The nationalist largest government party and nationalist chief executive variables are significant at 5%, while the nationalist largest opposition party variable is significant at 10%.

Overall, our results provide support for the notion that one aspect of political populism is indeed related to CBI. The relation between politics (e.g., fiscal policy) and CBI has been discussed extensively (de Haan and Eijffinger, 2018). However, to our knowledge, this is the first empirical piece to connect CBI and nationalism.

Table 1: Panel regressions for CBI (country fixed effects). Sample period: 1975-2012 for baseline, 1984-2012 for other specifications

	(1)	(2)	(3)	(4)	(5)	(6)
	Baseline	Institutional controls 1	Institutional controls 2	Nationalist government	Nationalist chief exec.	Nationalist opposition
Trade openness	0.156*** (0.0239)	0.0874*** (0.0311)	0.127*** (0.0311)	0.0981*** (0.0298)	0.0920*** (0.0309)	0.0924*** (0.0309)
GDP per capita	0.159*** (0.0105)	0.149*** (0.0129)	0.182*** (0.0136)	0.148*** (0.0121)	0.154*** (0.0123)	0.149*** (0.0127)
Lagged inflation	-0.116*** (0.0149)	-0.0305 (0.0208)	-0.0764*** (0.0190)	-0.0333 (0.0205)	-0.0311 (0.0207)	-0.0316 (0.0207)
Financial depth	0.0780*** (0.0152)	0.0450*** (0.0160)	0.0454*** (0.0176)	0.0404** (0.0158)	0.0416*** (0.0159)	0.0448*** (0.0159)
Nationalism index	-0.0482** (0.0215)	-0.0762*** (0.0238)	-0.0826*** (0.0253)			
Ethnic tension index (up = lower tension)		0.0352* (0.0208)		0.0307 (0.0199)	0.0296 (0.0202)	0.0324 (0.0205)
Political risk index (up = lower risk)		0.219*** (0.0797)	0.130* (0.0680)	0.179** (0.0748)	0.169** (0.0754)	0.221*** (0.0796)
Government stability index (up = higher stability)		0.00154 (0.0285)	0.0459 (0.0299)	0.0154 (0.0274)	0.0158 (0.0276)	-0.000288 (0.0283)
Bureaucracy quality index (up = higher quality)		0.0175 (0.0238)		0.0132 (0.0225)	0.0136 (0.0227)	0.0158 (0.0237)
Political fragmentation index (up = more fragmented)		0.0568*** (0.0185)	0.0602*** (0.0194)	-0.000738 (0.0203)	-0.000975 (0.00205)	0.0564*** (0.0184)
Nationalist largest government party				-0.0793** (0.0401)		
Nationalist chief executive					-0.0862** (0.0409)	
Nationalist largest opposition party						-0.0560* (0.0330)
Constant	1.775*** (0.113)	1.188*** (0.308)	1.136*** (0.220)	1.264*** (0.293)	1.277*** (0.297)	1.183*** (0.307)
Observations	2,145	1,294	1,563	1,380	1,357	1,313
R-squared	0.266	0.239	0.281	0.218	0.221	0.231
Number of countries	113	77	84	80	80	77

Standard errors in parentheses
 *** p<0.01, ** p<0.05, * p<0.1

9.2. INSTITUTIONS AND CENTRAL BANK INDEPENDENCE³

Another angle at the relationship between populism and central bank independence comes from zooming in on the institutional variables themselves. To the extent that populist political movements erode a country's institutional quality, they may also affect CBI. CBI is intimately tied to the broader process of institutional development, and can also erode when institutional quality declines (Laurens et al., 2015; Masciandaro and Romelli, 2015; Agur et al., 2015; Goodhart and Lastra, 2018). Remarkably, however, the largest empirical study to date on the determinants of CBI, Dincer and Eichengreen (2014), finds that “there is no evidence that countries with more robust institutions strengthened the independence of their central banks, perhaps because the level of central bank independence was already high. If anything, the opposite is true.” Here, the last sentence refers to the negative and significant coefficients on all institutional determinants in their regressions. Rule of law, political stability, government efficiency, voice and accountability, and regulatory quality *negatively* affect CBI, according to these results.

However, behind Dincer and Eichengreen's (2014) clause “perhaps because the level of central bank independence was already high” lies what may be an important clue: the sample length. Their sample starts in 1998, possibly too late to fully capture a slow-moving interaction between institutions and CBI.⁴ We can use the longer sample of Garriga (2016) to re-examine the institutional determinants of CBI. We use similar institutional variables: ICRG variables on bureaucracy quality, corruption, democratic accountability, government stability, and law & order closely resemble the variables used in Dincer and Eichengreen (2014), which are sourced from the Worldwide Governance Indicators (WGI) database of the World Bank. In addition, we include ICRG measures that are indicative of stability and trust in society (“soft” institutional variables relating to the notion of social capital): ethnic and religious tensions, internal and external conflict, and socioeconomic conditions. Furthermore, we also include a country's investment profile, and composite indices of economic, financial, and political risk, and an overall composite index, as aggregate measures of the types of risks that relate to a country's institutional quality. The variables are all defined such that “up” is an “improvement”. For example, higher bureaucracy quality implies a higher score on the bureaucracy quality index, while lower corruption leads to a higher score on the corruption index.

³ This part of the chapter is based on Agur (2019).

⁴ Other studies tend to focus on specific political factors, rather than institutional determinants in general. For instance, Crowe and Meade (2008) and Bodea and Hicks (2015) examine CBI in relation to democracy versus dictatorship. See de Haan and Eijffinger (2018) for a survey of the literature on the politics of CBI.

As in the previous part, we run panel regressions with country fixed effects, where trade openness, GDP per capita, lagged inflation, and financial depth (measured as M2/GDP) are used as macroeconomic determinants.⁵ Most institutional variables are positive and highly significant. Of the fifteen institutional variables we investigate, eleven are positive at 1% significance, and one is positive at 5% significance.⁶ With twelve institutional variables pointing in the expected direction, there seems sufficient basis to conclude that, with a long enough sample period, central bank independence does tend to go hand-in-hand with stronger institutions.

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⁵ For regression tables, please see Agur (2019).

⁶ An additional test is to run regressions using the same WGI institutional variables used by Dincer and Eichengreen (2014). The six institutional variables in WGI start in 1996, thereby restricting the sample length. The sample breadth is widened, however, from 114 to 150 countries. Results of this analysis are reported in Agur (2019).

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