Populism and Central Bank Independence

Based on joint work with Jan-Egbert Sturm and Aline Scheurer (both at *KOF Swiss Economic Institute, ETH Zurich, Switzerland*)

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Can Trump fire Fed chairman?

Yes he can!

- Members of the board hold office for a term of 14 years “unless sooner removed for cause.”
- The chairman is to be appointed by the president, with Senate advice and consent, from among the board members, for a term of four years.
- Statute provides no express protection against removing Powell as chair – though under the statute, Trump would need “cause” to remove him from the board.
- While there may be a longstanding custom that presidents may not remove Fed chairs from their position, nothing in the statute prohibits them from doing so.

Questions addressed

- This presentation will briefly address the following questions:
  - (1) Does populism lead to increased political pressure on the central bank?
  - (2) Can the central bank control inflation when populism is widespread?
  - (3) Does populism undermine central bank independence?
  - (4) Do populist leaders remove governors before end of their term?

Political pressure on central bank (1)

- Politicians, not just populist ones, may be tempted to influence monetary policy.
- Recent papers have empirically examined political pressure on central banks.
- Binder (2021) finds that political pressure on central banks has been widespread since 2010, rising sharply in 2012 and especially since 2018. About 10% of central banks were reportedly subject to political pressure or government interference in an average year, and 39% were at some point.

Political pressure on central bank (2)

- Following graphs show relationship between political pressure on the central bank (data are from Binder, 2021). The graph on the left is based on populism data from Hawkins et al. (2019) for 47 countries over the period 1996-2018, with a total of 3,032 observations. The graph on the right is based on populism data from Binder (2021) based on the V-Party dataset for 63 countries over the period 1996-2018, with a total of 5,796 observations.


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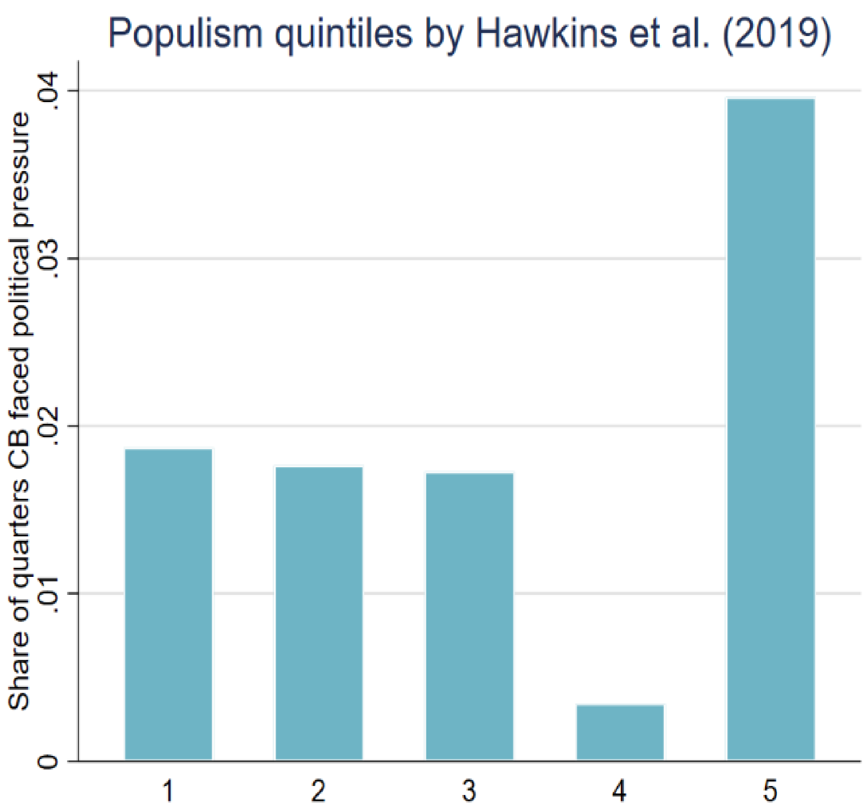
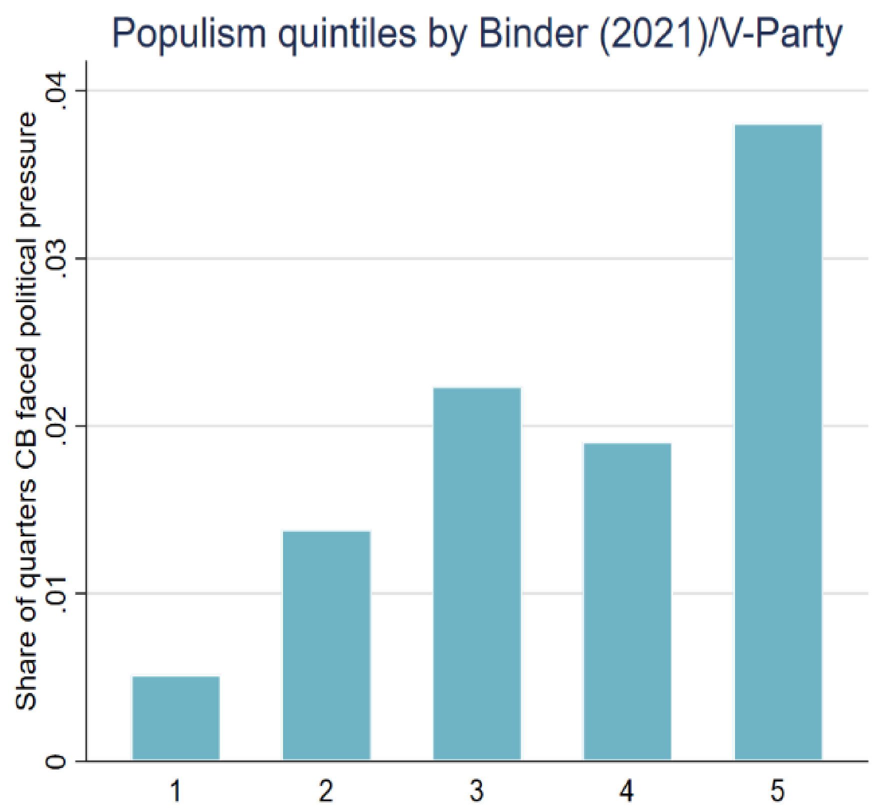

Populism quintiles by Hawkins et al. (2019)
Share of quarters CB faced political pressure
0
.01
.02
.03
.04
1
2
3
4
5


Populism quintiles by Binder (2021)/V-Party
Share of quarters CB faced political pressure
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Can CB control inflation under populism? (1)

- Two key questions arise: (i) do central banks give in to political pressure and change their monetary policy? and (ii) does political pressure lead to higher inflation?
- The results of Binder (2021) and Gavin and Manger (2023) suggest that central banks respond to political pressure, but these studies use a slightly different approach to reach this conclusion.

Can CB control inflation under populism? (2)

- Regarding the second question, Binder (2021) examines the relationship between political pressure and inflation. Political pressure on the central bank is associated with higher average inflation. The coefficient of the interaction between the political pressure variable and legal CBI is not statistically significant.
- Gavin and Manger (2023) find that central banks not only lower interest rates in response to pressure from highly populist governments, but also generate higher inflation as a result.
- The latter finding is consistent with earlier evidence on populist regimes in Latin America. Dornbusch and Edwards (1991) conclude that under populist governments fiscal balances deteriorated and inflation rose.

Does populism undermine CBI? (1)

- Some papers report that CBI is lower under nationalist governments as (poor) proxy for populism: Agur (2018) and Romelli (2022). Gavin and Manger (2023) examine the link between populism and change in legal CBI. However, legal CBI hardly drops.
- We estimate the relationship between the independence measures of Romelli (2022, 2024) and Garriga (2016), and some proxies for populism.
- The models are estimated using correlated random effects (CRE) (Wooldridge, 2019). CRE models enable us to examine both cross-country differences in populism levels and populism variation within countries over time.

Does populism undermine CBI? (2)

- Our results suggest a negative association between populism and legal CBI, which holds for both legal CBI indexes. This is based on the within-country variation, as the between-country coefficient on populism is never significant. Therefore, higher levels of populism are associated with decreases in legal CBI within-country. However, when considering a static view across countries, variation in legal CBI cannot be explained by different levels of populism.

Does populism undermine CBI? (3)

- Legal measures of CBI may not reflect the actual relationship between the central bank and the government (de Haan and Eijffinger, 2019).
- One way in which politicians have interfered with the central bank, without legally limiting its independence, is by simply replacing the central bank governor before the end of his or her legal term and appoint a ‘political ally’. Populist governments are no exception. Think of Hungary and Türkiye.

Does populism undermine CBI? (5)

- Using data on central bank governor turnover rates (published on the KOF website) and the data on populism from Hawkins et al. (2019) and Binder (2021), we examine whether the irregular turnover rate is higher in countries with populist governments than in other countries.
- We follow the same procedure as with estimates for legal CBI. In the probit model for governor turnover, we account for time dependence using cubic splines with two knots, which are selected via the Bayesian Information Criterion (BIC) (Beck et al., 1998).

Does populism undermine CBI? (4)

- We distinguish between regular and irregular turnovers.
- The coefficient on populism is found to be insignificant in both models. Therefore, populism neither explains cross-country nor within-country variation of regular and irregular turnovers.

Conclusions

- It is often argued that populism is a threat to CBI.
- The literature reviewed suggest that populist politicians are more likely than other politicians to pressure the central bank to lower interest rates, and that this pressure and lax fiscal policy may ultimately lead to higher inflation.
- Our results also suggest that populist regimes are not more likely to replace a central bank governor before the end of their term in office. Türkiye is a clear exception.
- This surprising finding may indicate that political pressure, is sufficient to alter monetary policy as desired. In other words, replacing the governor is unnecessary.

Thank you for your attention