Beyond Central Bank Independence:

Rethinking Technocratic Legitimacy in Monetary Affairs

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Abstract (150 words)
How can central bank independence (CBI) be reconciled with the modern need for political accountability in times of unconventional monetary policy and increased financial oversight powers? The world experienced a startling convergence towards CBI during the 1990s, as interests and ideas combined to make the notion into a virtually uncontested institutional norm. The ensuing boom years added credibility to the view that technocrats were superior to politicians in dealing with monetary affairs. However, the global financial crisis exposed central bankers as powerful political actors rather than mere technocrats. Moving far beyond their narrow mandates, they became more overtly distributive and increasingly politicized agents. While unconventional monetary policy and financial supervision offer short-term benefits, they create future uncertainty and raise questions of political accountability. This paper argues that central banks will need to channel monetary policy contestation into a more conventional political arena if they are to maintain their democratic legitimacy.

Key words (6)
Central banks, democratic legitimacy, financial regulation, fiscal policy, independent agencies under stress, monetary policy.

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Central Bank Independence and Its Modern Discontents

One fault line in the architecture of today's economic governance exposed by the global financial crisis (GFC) is in the organization of central banks and their relationship to the political sphere. The world economy saw a startling level of convergence towards central bank independence (CBI) starting in the 1990s, as ideas and interests combined to make a notion – that monetary policy should be shielded from partisan politics – into a virtually uncontested norm. Although a few naysayers questioned its wisdom, the boom years that followed seemed to lend credence to the view that technocrats would be superior to politicians in conducting monetary policy.

During 'normal' times, central banks' 'conventional' monetary policy decisions have ambiguous effects in the short term, while promising greater stability and flexibility in the long term. However, the GFC has exposed central bankers as powerful political actors rather than mere technocrats. As they have gone far beyond their organizational mandates, their actions and policies have become more overtly distributive, with clear winners and losers. The combination of 'unconventional' monetary policy along with increased financial oversight powers offers clear short-term benefits but creates new uncertainties about the future. We therefore ask a very simple question in this paper: Is the technocracy argument for 'apolitical' central banks still valid today? How can the idea of central bank independence be reconciled with the modern need for political legitimacy and accountability in extraordinary times of ultra low interest rates and amplified financial supervision and resolution powers?

There are many good reasons – both theoretical and practical – to open up existing central banks to greater levels of public scrutiny. Indeed, central bankers seem to

be bending over backwards to make themselves more accountable. Nevertheless, they are being attacked by those who not only benefited from the extraordinary actions of central bankers but also hold no small measure of responsibility for the state of their country's economic performance. Their main goal is to scapegoat central bankers rather than shore up the central banking community or reform the practice of central banking in some intelligent, evolutionary manner.

This paper aims to contribute to our understanding of the central role of ideas in the design of policy institutions, the evolution of policy paradigms, and the prospects of self-interested capture. Our overall argument proceeds in five sections.

The first sketches the recent attacks on central bankers to give a sense of the new politicization in the aftermath of the recent economic and financial crisis. The second establishes a baseline for interpreting the accountability structures of modern central banks and specifically the consensus surrounding central bank independence. The third section advances our main theoretical contribution, explaining why some criticism of CBI is justified, not because of what central bankers have done as individuals, but because of how the decisions they took violated the assumptions upon which they were granted independence. The fourth section then empirically illustrates how central bankers since the GFC have become implicated in decisions that can only be described as 'political' because they have relatively transparent distributive consequences, including decisions about the use of unconventional monetary policy instruments and about the recovery or resolution of financial institutions. The fifth and final section concludes by suggesting how we might organize a rational reform of central banking that the central banking community itself would likely embrace.

Boring Bankers No More

Central bankers used to be boring. They were comfortable playing the role of faceless technocrats who quietly lived in the shadows instead of being featured like international celebrities on the front pages of leading financial newspapers. Most central bankers used to genuinely cherish their less than exciting reputations. Long-time US Federal Reserve Chairman Alan Greenspan was a rare exception, but even he was careful to communicate through actions rather than words (Mallaby 2016: 379-81). The 'rational fiction' they held up was that since their public policy domain constituted a highly technical one – requiring expert knowledge of the macro economy – they should be isolated from the day-to-day noise and scrutiny of political life (McNamara 2002: 50). They actively nurtured their hard-fought political independence, justified by their popularly accepted narrow mandates of maintaining stable prices (Fernández-Albertos 2015).

Those days now seem like ancient history. In the past few years, pretty much everywhere you look, politicians have been eager to pick public fights with their central bankers. As the economic fallout and political gridlock caused by the global financial crisis has forced them to reinterpret their mandates in imaginative ways, and as their powers have widened by including financial supervision and banking resolution, central banks as institutions have de facto become "the 'leaders' of last resort" (Blyth and Matthijs 2017: 207). As a consequence, the independent institutions that set monetary policy and are now also in charge of regulating the financial system have become much more overtly politicized. The unelected agents running central banks have been turned into their elected principals' favorite targets of blame for much of what is going wrong

with the economy. These attacks are usually part of a broader effort by politicians to gloss over their own shortcomings.

During the 2016 presidential election campaign in the United States, Republican candidate Donald Trump repeatedly criticized Chair of the Federal Reserve Board Janet Yellen, accusing her of "doing political things."[1] Trump asserted that "[Yellen] should be ashamed of herself" for keeping interest rates too low for too long, adding that she was "obviously political and doing what [then President] Obama want[ed] her to do."[2] In Britain, after the shock referendum vote to leave the European Union in June 2016, the influential Conservative backbench MP for North East Somerset, Jacob Rees-Mogg, systematically singled out Bank of England (BoE) Governor Mark Carney as an "enemy of Brexit" who had been "consistently wrong" in his predictions.[3] The pro-Brexit Rees-Mogg believed that Carney's public statements were hostile to Britain leaving the European Union, going so far as calling Carney's many warnings that Brexit constituted the greatest risk to financial stability in the country, "beneath the dignity of the Bank of England."[4]

In Germany, two-term finance minister Wolfgang Schäuble personally admonished Mario Draghi, the president of the European Central Bank (ECB), for the electoral success of the *Alternative für Deutschland* (AfD), the German far-right party that is both anti-immigration and critical of euro membership. Schäuble considered the ECB's 'easy money' policy of quantitative easing (QE) one of the main culprits for a

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[1] Torry, H. (2016, September 26). Donald Trump Attacks Federal Reserve, Yellen During Debate. *The Wall Street Journal.* Retrieved from https://www.wsj.com
[2] Mui, Y. Q. (2016, September 12). Donal Trump says Federal Reserve Chair Janet Yellen 'should be ashamed of herself. *The Washington Post.* Retrieved from https://www.washingtonpost.com
[3] Rutter Pooley, C. (2017, October 25). Rees-Mogg brands Mark Carney 'enemy of Brexit'. *The Financial Times.* Retrieved from https://www.ft.com
[4] Giles, C. (2016, October 30). How star central banker Mark Carney turned into a Brexit target. *The Financial Times.* Retrieved from https://www.ft.com

populist backlash in Germany, due to the persistently low returns on German pensioners' savings that he claimed were the direct result from QE. In public remarks, Schäuble told his audience: "I said to Mario Draghi… be very proud: you can attribute 50 per cent of the results of a party that seems to be new and successful in Germany to the design of this policy."[5]

Those examples – the Fed's Yellen, the BoE's Carney, and the ECB's Draghi – are just the 'big three.' There are many smaller countries where central bankers have earned the public scorn of politicians or electorates. In Cyprus, central bank governor Panicos Demetriades was all but forced to resign after sustained criticism by the country's president, Nicos Anastasiades, who had mounted a campaign to remove Demetriades on dubious grounds of 'incompetence,' in what *The Economist* called a "blow against independence."[6] In Slovenia, central bank governor Bostjan Jazbec was under investigation for irregularities after a police raid authorized by national authorities had seized documents from the central bank's premises.[7] Finally, the chairman of the Swiss National Bank (SNB), Philipp Hildebrand, stepped down following revelations that his wife Kashya had bought over half a million US dollars just three weeks before the central bank intervened to put a cap on the Swiss franc – money she later converted back into francs at a handsome profit.[8]

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[5] Wagstyl, S. & Jones, C. (2016, April 10). Germany blames Mario Draghi for rise of rightwing AfD party. *The Financial Times.* Retrieved from https://www.ft.com.
[6] Hadjipapas, A. & Hope, K. (2014, March 10). Cyprus central bank governor resigns. *The Financial Times.* Retrieved from https://www.ft.com; The departure of Cyprus's central-bank governor: A blow against independence. (2014, March 10). *The Economist*. Retrieved from https://www.economist.com.
[7] Slovenia central bank confirms investigation of Governor Jazbec. (2016, July 7). *DW*. Retrieved from http://www.dw.com8.
[8] Swiss National Bank chairman Philipp Hildebrand resigns. (2012, January 9). *BBC News.* Retrieved from http://www.bbc.com.

What is behind this recent surge of political scrutiny and public controversy? We put forward two principal causes. First, since the global financial crisis, we have developed a very different understanding of monetary policy as part of a much broader array of macroeconomic policy instruments, especially in times dominated by fiscal retrenchment and public concerns over debt sustainability. Central banks today possess much broader policymaking authority and larger discretionary powers than they possessed before the GFC – both of which have clear distributive outcomes. Second, also as a direct consequence of the GFC, we have started to see the interaction of monetary policy and financial supervision in a completely different light. Central banks now have a much heavier hand in private financial institutions' regulation and resolution, bringing them into frequent conflict with private interests and their political patrons.

In effect, the more obvious distributive consequences of monetary policy decisions and the more prominent role of central bankers in financial supervision bring central bank governors much more directly into the political crosshairs. At the same time, the larger political profile of central bankers has made it easier for other macroeconomic policymakers and financial market regulators to avoid being blamed for their own pathologies or lack of effectiveness by using central banks as scapegoats for their own failings. There are two important implications of this: one for the design and one for the implementation of public policy.

First, we are forced to reconsider how central banks are connected to political institutions given the shifting nature of accountability in democratic systems. This is hardly the first time. There have been times when central bankers were thought to be private actors, and times when they were considered to be optional or even unnecessary

(Shubik 2010: 255-259). Hence, the institutional evolution of central banks during the nineteenth and twentieth centuries should make us very skeptical of any positive or normative argument that major public policy instruments with distributive consequences should be located outside of traditional accountability structures. While there may have been many good reasons for central bank independence in the past, we should not delude ourselves that the once supportive underlying conditions are immutable. Circumstances have changed, and it is only natural for the accountability requirements to change along with them.

Second, we need to think again about how central banks might be manipulated by other stakeholders (Jacobs and King 2016). Here, we need to pay particularly close attention to two constituencies. On the one hand, those who benefit *directly* from the conduct of monetary policymaking are an obvious source of threat. On the other hand, those who benefit *indirectly* by trying to offload their own responsibility for public policy outcomes may be even more important. Two kinds of manipulation are possible. One is a form of bureaucratic capture through which either or both constituencies try and 'lock in' institutional designs long after they are found to have become dysfunctional. In the other, either constituency or both could attempt to bring down the whole existing policy paradigm, throwing the proverbial independence baby out with the monetary bathwater. The growing chorus of populist forces in advanced democracies suggests that this is a real risk to our modern central banks (Best 2017).

The Long Road to Political Independence

The modern consensus on the desirability of political independence for central banks is not an obvious historical development. On the contrary, it is a retreat from much of the history of the 19th and early 20th centuries. For more than 150 years, central banks became more rather than less overtly political in their design and function. Then, once they reached the greatest height of their power and influence, central bankers changed direction and moved outside direct political control.

In order to appreciate this back-and-forth history of central banking, it is important to note that central banks are banks, first and foremost. At the end of the 18th and beginning of the 19th centuries, central banks were essentially business-to-business service providers – often given unique charters by the government, but usually controlled through cooperative-style share holdings linked to their largest clients, the money-center banks. The role of the central banks was to provide liquidity in the form of broadly accepted negotiable instruments that could be used to purchase bank paper at a discounted value. Such instruments could be commodity money, foreign currency, or sovereign debt. What mattered was that these instruments could be accepted as payment by the money-center banks or their clients. In essence, central banks were banks for banks (King 2016: Chapter 5).

The liquidity that central banks provided came originally from instruments set aside by the money-center banks themselves. The owners of the central bank paid in capital so that there would be resources to draw upon in the event that they found themselves short of liquidity to meet the demands of their own creditors. They also used the central bank to safeguard the deposits they wanted held in reserve in case they faced a

sudden surge in redemptions from their creditors (like a run on deposits). In turn, the discount that the central bank applied on its lending to other banks was a function of the quality of the assets that the money-center banks could pledge in collateral and the central bank's own assessment of the creditworthiness of the money-center bank needing assistance. Like any other bank, a central bank made money by charging a higher discount for its lending than it paid as interest on the deposits it safeguarded.

The money-center banks provided similar services to other credit institutions in the economy. The difference was that their client base was much larger and more diversified than the clientele faced by the central bank. Hence the money-center banks played a more central role in the system. They also absorbed more risk – both in terms of the quality of the assets they purchased or created and in terms of the volatility in their access to credit (or deposits). The central banks operated as a kind of mutual insurance, underwriting the liquidity of individual institutions in order to prevent the spread of panic across the financial system as a whole.

From this perspective, it is easy to see why some policymakers could consider central banks optional. Financial institutions can exist without underwriting so long as investors and creditors are prepared to take the associated risks. It is also not difficult to understand why policymakers might regard central banks with suspicion. The banks that act as shareholders have a distinct market-competitive advantage over other financial institutions. The central bank also has influence over the allocation of credit through the collateral rules it introduces – which give greater liquidity to some assets over others – and through the discount rates it charges. Finally, the central bank can effectively make the difference between liquidity and solvency, saving those institutions it deems worthy

through timely intervention and condemning those it decides to deny access to the discount window.

The problem with not having a central bank, however, is that some institution must provide liquidity in times of financial distress. The Bank of England played a prominent role in stabilizing the British financial system during the panic of 1866, for example. In the United States, there was no analogous institution. Hence, during the panics of 1893(-6) and 1907, U.S. financial institutions faced much greater vulnerability. Distortions in the credit markets triggered deposit flights that could not be absorbed, bringing down otherwise sound financial institutions. During the 1907 panic, the principal New York banks relied on existing clearing houses to provide emergency liquidity assistance. While this worked as a stopgap measure, it was not enough to stabilize the whole system (Bruner and Carr 2007).

The alternative was to create a central bank (or network of regional central banks) that could maintain a continuous pool of highly liquid assets and even issue its own paper if necessary against adequate collateral. Doing so, however, was an intensely political act. The money-center bank might play a role in the governance of this new institution, by sitting on the boards of directors for the different regional branches, but it would be a public institution and not a financial cooperative while the governors would be political appointees (Lowenstein 2015).

The creation of the Federal Reserve System in the United States in 1913 took place just prior to the Great Depression and therefore also well before the Keynesian revolution in economic policymaking (Keynes 1936). This is an important period because of the consolidation of central banking as a locus for macroeconomic policymaking –

moving beyond the stabilization of the financial system to the maintenance of monetary aggregates or macroeconomic performance. One of the elements Keynes and others noted about central banking, both in the UK and elsewhere, is how the interest rates banks charge one-another and other clients are closely intertwined. By implication, the interbank lending markets are also tied to the central bank's discount. This means that the banking activities of the central bank can have a considerable influence on the level of economic activity both directly, through the bank lending channel, and indirectly, through the relative rates of return on bank loans (or deposits) and other assets (Skidelsky 1992: 556-564).

The use of central banking instruments for macroeconomic purposes culminated with the widespread nationalization of central banks during and immediately after the Second World War (Mehrling 2011: 36-46). This tied central banking directly to government policy. Moreover, because it took place during an era of capital controls, the influence of monetary policy on macroeconomic performance was at its apex. Hence governments that made a public commitment to full employment, price stability or international competitiveness relied heavily on central bankers to achieve their objectives. Monetary policy was the essential tool to achieve virtually any macroeconomic goal. Therefore, political control over monetary policy was at the heart of electoral politics (Alesina and Stella 2010).

The explicit political use of monetary policy caused problems. Policymakers who relied on changes in the interest rate to drive the economy were likely to run afoul of the balance of payments, resulting in a *stop-go* dynamic as central bankers alternated between setting their instruments to achieve internal and external balance (Brittan 1970;

Blank 1977). Even focusing more narrowly on the trade-off between inflation and unemployment created problems. Not only did it lead to alternations of power across left- and right-wing coalitions, it also resulted in opportunistic attempts to game the electoral calendar by creating booms that would benefit the incumbent at the polls only to have to deflate the economy once the votes had been counted. Soon enough, financial market participants began to build the political manipulation of monetary policy into their expectations for future price inflation. Consequently, central banks chipped away at their own perceived legitimacy and would quickly lose their leverage over the marketplace's 'animal spirits' (Alesina, Roubini and Cohen 1997).

The progressive weakness of central bankers to wield influence over the macro economy also resulted from the gradual integration of global capital markets and the subsequent spread of cross-border banking. Capital market integration tightened the connections between the setting of policy instruments to achieve domestic objectives and the unintended consequences those instruments would have on the balance of payments. This tightening complicated the conduct of monetary policy and increased the likelihood of negative interactions between domestic and other countries' monetary policymakers. Meanwhile, cross-border banking created a whole new array of unintended consequences as the scope of the 'financial system' exceeded the national economy. While this did not completely deprive national governments of control over their economies, it did make control more difficult to establish (Kapstein 1994).

The consensus surrounding central bank independence hence emerged from the growing recognition of the problems associated with political business cycles and rational expectations (Kydland and Prescott 1977; Barro and Gordon 1983). It also drew support

from the economics of interdependence. This consensus argued that central banks should be insulated in their use of traditional banking instruments (like discounting or liquidity management) to achieve macroeconomic objectives. If possible, central bankers should be relieved as much as possible of responsibility for prudential oversight of the financial system and decisions related to the solvency or liquidity of particular institutions. Such connections cannot be severed entirely, of course. Central banks remain banks for other banks. But the political ring fencing of central bankers as macro-economic policymakers is an ideal type in terms of institutional design (Rogoff 1985).

The European Central Bank is a good illustration of this (Marshall 1999). The ECB is unique among the world's great central banks as it was designed almost exclusively for macroeconomic policymaking. The central banks of its member states retained their links to the local financial economies of their countries and engaged in open market operations, while the ECB deliberates monetary policy. The ECB is also the most politically independent of them all. It has a mandate for price stability that it alone is allowed to interpret. It was designed to have the choice about whether to participate in the setting of exchange rate policy or in the supervision of financial markets; both of which it originally declined. And it is protected by a treaty obligation not to accept political instruction and a further treaty injunction on both EU institutions and member state governments not to influence the macroeconomic policies of the ECB (Berman and McNamara 1999). Moreover, these protections are practically written in stone, since European treaties can only be amended by unanimous accord of the EU member states. Finding consensus on how to amend the provisions related to the ECB would be almost impossible (Howarth and Loedel 2003).

Winners and Losers: How Distribution and Accountability Are Related

After the GFC, the challenge for academics and policymakers is to reconcile the institutions designed to provide for central bank independence with the modern need for political accountability and democratic legitimacy. This is especially problematic in extraordinary times of ultra-low interest rates and increased powers of financial supervision and resolution. The theoretical argument we present below therefore concerns the relationship between the transparency of distributive outcomes (winners and losers) and the location of contestation over the actual conduct of monetary policy (inside or outside of central banks) (Figure 1).

The basic claim is that where the distributive consequences are either ambiguous or opaque (right column of Figure 1), any contestation over the conduct of monetary policy should take place within the central bank and in the interests of the economy as a whole. This logic follows the classical 'time inconsistency' argument for central bank independence, in that it shares the presumption that any determination of the optimal monetary policy in the aggregate is better left to experts (upper-right quadrant). Under these circumstances, attempts by politicians to interfere in the conduct of monetary policy are likely to serve electoral or partisan interests and will ultimately rebound to the detriment of the economy as a whole.

Whenever the distributive outcomes of monetary policy are immediately transparent and create clear winners and losers (left column of Figure 1), central bankers will find it difficult to hide behind the veil of technocratic legitimacy and the presumption of political independence. In this case, central bankers will themselves become the focal

points for distributive politics. Therefore, it will be useful to channel any contestation over the conduct of monetary policy outside of the remit of the central bank and into a more conventional 'political' arena – like an elected parliament or government cabinet (lower left quadrant). By doing so, politicians can be held accountable for either the delegation of monetary policy authority to a particular group of central bankers, or for setting monetary policy instruments.

Figure 1: Transparency and Contestation in Monetary Policy

		Are the distributive outcomes of conducting monetary policy transparent?	
		Yes	**No**
Where does the contestation of monetary policy take place?	**Inside** the Central Bank	*Weakened political legitimacy*	Political independence of Central Banks
	Outside the Central Bank	Political accountability of Central Banks	*Weakened economic performance*

Source: Authors

The other two possible combinations are less attractive. Giving politicians direct control over monetary policy instruments when the distributive consequences of their choices are either invisible or unknowable has already been rejected in the original argument for central bank independence (lower-right quadrant). That combination has also generally been bad for economic performance. Giving unelected technocrats free

rein and discretionary powers to allocate winners and losers through the setting of monetary policy instruments is likely to undermine democratic accountability (upper-left quadrant). Hence, that combination is questionable for reasons of political legitimacy.

Given that only two combinations are 'stable' (*CBI* in upper-right quadrant, and *Political Accountability* in lower-left quadrant), the institutional challenge will be to come up with an arrangement that can alternate smoothly between them – that is, allowing for technocratic determination of monetary policy when the distributive consequences are ambiguous and yet providing for adequate political accountability when they are not. Most democratic governments achieve this balance by drafting the principles of central bank independence into normal legislation and by assuming responsibility for the conduct of monetary policy in extremis. Striking such a balance is more challenging in the context of the European Union (EU). Not only is it much more difficult to change the statute of the European System of Central Banks than it is to amend normal legislation, it is also less obvious which other European institution could channel the contestation over unconventional monetary policy. If there is were to be a collection of design flaws in Europe's single currency, the lack of a politically accountable forum for the deliberation of macroeconomic policy choices belongs on the top of that list.

The vulnerability is compounded by the growing recognition of the need for central banks to tie their authority over monetary policy with their responsibility for regulating financial markets. Two illustrations, concerning the Bank of England and the ECB, are relevant.

The problems for the Bank of England emerged at the start of the global financial crisis. British banks were highly vulnerable to liquidity shortages given their dependence on interbank markets for funding. At the time, however, few financial market participants or policymakers considered the possibility that interbank markets would suddenly dry up (Turner 2016: 29). Post-1997, Britain had some of the world's most up-to-date monetary policy institutions and financial regulatory authorities. The Bank of England was politically independent and focused primarily on the conduct of monetary policy; the Financial Services Authority (FSA) was a separate institution that engaged in the regulation and supervision of banks and other financial institutions (Daripa, Kapur, and Wright 2013). When interbank markets seized up in August 2007 and again in September 2008, this bifurcated structure turned out to be problematic. The two institutions did not automatically share information, coordinating across the institutions was time-consuming, and the process of communication from one institution to the next invited public scrutiny at a time when discretion and decisiveness were important to maintain public confidence (Darling 2011: Chapters 1, 5). As a result, the Bank of England had to re-absorb responsibility for financial market supervision and to re-balance its role as monetary policy authority and bank for banks.

The ECB followed a similar trajectory. When the ECB started operating in 1998, the Governing Council had the opportunity to assert its authority over financial market supervision. Instead, it declined in favor of national authorities. The presumption was that European banks differed significantly from one country to the next so it made more sense to allow national regulators with more local contacts and experience to play the supervisory role. This presumption ignored the transformation of national banking

institutions into pan-European or even global conglomerates with complexity that often exceeded the expertise of national regulators and balance sheets that dwarfed national resources for resolution and deposit insurance. Even those corresponding central banks in the European System of Central Banks that were actively engaged in financial supervision could not act as an effective lender of last resort because they could not create liquidity autonomously given their involvement in the single currency (De Grauwe 2016: Chapter 11). When the ECB finally moved decisively to stop the crisis, it not only committed to do 'whatever it takes' to safeguard the single currency but also became a single supervisory mechanism for those financial institutions operating in the Eurozone (Van Rompuy 2014).

The institutional challenge for the Bank of England and for the ECB was two-fold. On the one hand, they had to strike a new balance between their responsibilities as macroeconomic policymakers and financial market supervisors. On the other hand, they had to justify the obvious distributive consequences of their actions on both sides of that divide. The first challenge is harder to address than it seems at first glance. The Bank of England can easily set up a financial policy committee to run alongside its monetary policy committee, just as the ECB can insist on the erection of a Chinese wall between its Governing Council and the Single Supervisory Mechanism (SSM). The problem runs deeper than just decision-making insofar as it touches on the actual instruments and settings used by central banks to connect to the rest of the financial system. As a result, not only do monetary policy decisions have clear implications for banks, but financial policy decisions also have implications for the growth of the money supply and hence macroeconomic conditions.

This fundamental tension is the most obvious in the context of the ECB. Its President, Mario Draghi, may have committed to do 'whatever it takes' to safeguard the euro, but that commitment does not extend to bailing out the Cypriot or Greek banking systems. Even though it is clear to everyone in the markets that the failure of those banks would drive both countries out of the euro, and that the exit of even one Eurozone member state could pose an existential threat to the single currency. Similarly, the ECB could look the other way as Italy resolves or restructures some of its own systemically significant banks outside a strict interpretation of the Banking Recovery and Resolution Directive, even though this might create incentives that would undermine the stability of the European financial system in the long term.

These are only the most obvious headline illustrations from the front pages of European newspapers. Digging deeper into the financial pages, it is easy to find examples of the intertwining of monetary policy and financial market supervision as it relates to the ECB's large-scale asset purchasing program, the structure of bank balance sheets, and the prospects for the completion of a European Banking Union. These illustrations explain why Europe's central bankers have come under closer public scrutiny.

How the GFC Messed up the CBI Model

As we argued in the previous sections, the problem with the model for central bank independence is two-fold. First, the instruments available to central bankers have different implications in different settings. Second, in times of crisis, the boundary between macroeconomic performance and financial market stability tends to blur. At the

juxtaposition of these two problems, central bankers receive more attention. In turn, they look less like they know what they are doing.

Instruments

The instruments central bankers use to influence macroeconomic conditions are mostly related to the role of central banks as banks. The headline instruments are the rates central banks charge for access to different types of liquidity and the rates they pay on balances (or deposits) placed by financial institutions above any reserve requirements. The size of required reserves is also important. But there are a host of other instruments such as the rules imposed on collateral, the term structure for any liquidity provision, the rules for auctioning and apportioning available liquidity, and the possibility that the central bank might purchase assets outright – to hold on its own balance sheet – rather than against a commitment to repurchase the assets by market participants.[9] Finally, there are those instruments that central bankers use to influence market expectations directly, which includes both formal presentations of data and policy decisions and informal meetings with market participants or other stakeholders.

Under normal economic conditions, a central bank will fine-tune macroeconomic performance through incremental changes in the policy rates – which usually move in lockstep. However, central bankers rarely change reserve requirements or any of the other technical details related to collateral rules, term structure, auction pattern, and the like. They may change these more technical aspects in response to technological developments or other external conditions, but they do not usually use them as instruments to move the

[9] This reference to outright purchases as distinct from repurchase agreements is important insofar as the Fed relies on repurchase agreements (plus reverse repurchase agreements) as the main vehicle for providing liquidity.

macro economy.[10] Central banks also do not often talk about the assets they hold outright, although every central bank has an investment committee that tracks the art, buildings, and other investments that the bank makes. Again, though, such outright asset purchases are not part of the central bank's normal toolkit of macroeconomic policy instruments. Finally, the central bank's communication strategy is also routine. Indeed, the pattern is often so ritualized that central bank watchers have to keep track of subtle changes in the use of specific language modifiers or phrases to anticipate whether and when an actual change in the policy rates will take place.

In extreme circumstances of unconventional monetary policy, however, the situation is very different. The policy rates fall toward and perhaps even below the zero lower bound and the introduction of quantitative easing – the expansion of central banks' balance sheets through buying large quantities of public and private debt – benefits some parts of the economy while hurting others. Although there are always distributive consequences from setting interest rates, these were far larger after the GFC affected different constituencies in radically different ways.

Governments, for example, gained tremendously from reduced debt service costs and increased seigniorage profits sent back to their treasuries from their central banks.[11] Households, however, saw their collective net interest income fall significantly, though the impact was radically different depending on the demographic group. Older households with significant savings invested in interest-bearing assets saw their return fall, while younger households with large mortgages and other types of debt experienced

[10] Manipulation of reserve requirements is more common in systems without active capital markets.
[11] McKinsey calculated that the US, the UK, and Eurozone governments collectively benefited to the tune of $1.6 trillion (McKinsey Global Institute 2013).

huge benefits, creating an inter-generational transfer of wealth.[12] Non-financial corporations also tended to benefit from lower debt servicing costs. The effects on banks varied greatly. While ultra-low interest rates ate into the profitability of European banks, for example, American banks saw a substantial increase in their net interest margins as the interest rates they paid out to deposit holders decreased by more than the interest they received on outstanding loans and other assets.

A negative deposit rate, which the ECB introduced in the spring of 2014, meant that the central bank was charging a tax on banks for maintaining surplus balances that were on deposit at the central bank. Its policy rates also stopped moving together. Because it is a tax in the negative domain, the deposit rate can fall further than the interest rates charged on lending facilities.

Technicalities

The technical details of central banking also took on exaggerated significance during unconventional times. Collateral rules effectively set the constraints on how much liquidity financial institutions are able to borrow. Terms structures determine how easily financial institutions can translate central bank liquidity into lending to firms and households. Auction patterns create incentives for banks to access central bank liquidity in the first place. And large outright purchases of assets in secondary markets not only push liquidity into the financial economy but also encourage financial institutions to take on more risk.

As central bankers apply policy rates in unfamiliar settings and begin using more technical arrangements to influence macroeconomic performance, the central bank

[12] Ibid. McKinsey calculated a collective loss of household interest income in US, UK, and Eurozone of $630 billion between 2007 and 2012.

creates distortions across the financial economy. Ultra-low interest rates squeeze savings into cash and cash-equivalents. Looser collateral rules draw risk onto the balance sheets of the central bank. Easier access to central bank liquidity distorts the funding side (or liability structure) of financial institutions. Outright purchases compress the risk-return structure within and across asset classes and encourage asset price bubbles. These distortions accumulate over time. They also create institutional winners and losers. Investors who were over-exposed to risk before the crisis and found themselves short of liquidity clearly benefit. Those who were in a more conservative position and who had already stockpiled highly liquid assets or savings clearly lose out.

Communications

Even the communications strategy becomes much more complicated (King 2016: Chapter 5). Central bankers need to explain why they are using multiple instruments in unfamiliar ways in an effort to influence macroeconomic performance. They also have to shape expectations about how those instruments will achieve their targets. This is a complicated message to get out under the best of circumstances; it is even more complicated given the experimental nature of many of the new instruments. Moreover, given that each of these creates distortions with obvious distributive consequences, having prior knowledge of what the central bank will do is a form of informational advantage for market participants. By implication, the usual interaction between central bankers and market participants comes under closer scrutiny and any communication lapses provide fodder for conspiracy theories.

Nevertheless, central banks are justified in adopting unconventional policies. It is the only way to stabilize the financial system – a prerequisite to influencing

macroeconomic performance (Mehrling 2011). The monetary transmission mechanism is key. Central banks interact with a limited group of financial market participants that interact both with one another and with everyone else. If the banks do not interact with one another or if non-financial firms bypass the banking system altogether, then the central bank has little influence on macroeconomic performance. The confidence that financial market participants have in the banking system is where macroeconomic performance and financial stability overlap. So long as market participants are worried about financial stability, the central bank is helpless to influence the macro economy.

If it is to restore confidence in the financial system, the central bank has to behave more like a bank than like an institution devoted to monetary policy (Geithner 2014: Chapter 6). The unconventional use of banking instruments is an important part of that process. Nevertheless, these instruments are confusing for a public that knows very little about the central bank's role as a bank and knows only about the central bank's status as a monetary policy authority. This creates a kind of cognitive dissonance as central bankers appear to be engaged in activities that are well beyond their usual remit. Worse, the central bankers at that point seem to be privileging the interest of big banks over the rest of the financial economy. At the same time, they are perceived to be rewarding those who have taken on big risks while punishing those who were behaving more cautiously with their savings (Jacobs and King 2016). Giving political independence to such actors under those circumstances therefore becomes a hard argument to publicly support.

Conclusion: How to Reform the Central Banking Model

The original argument for CBI in the late 1970s and early 1980s was made during a very specific 'macroeconomic regime' in which the main policy target was price stability (Blyth and Matthijs 2017). At the time, it was also assumed that there was a clear distinction between fiscal and monetary policy, and that the main goal should be to stop fiscal policymakers from running budgetary deficits that would then be monetized by monetary authorities. The most obvious distinction between monetary and fiscal policy lay in their different policy instruments. Monetary policymakers could manipulate reserve requirements, policy rates, and open market operations. Fiscal policymakers could influence taxes and spending.

The distinction between monetary and fiscal policy was also clear in terms of different policy targets. While monetary policymakers were supposed to focus on 'nominal' variables like market interest rates, monetary growth rates, and consumer price inflation, fiscal policymakers targeted 'real' variables like output, employment, and capital formation. The two sets of variables – nominal and real – are obviously connected, at least in the short run. Nevertheless, the two different kinds of policymakers – monetary and fiscal – implicitly accepted a division of labor.

As a consequence of these differences in instruments and targets, the two different groups of policymakers accepted that they would be subject to different kinds of oversight. Though fiscal policymakers might try to constrain their more irresponsible tax and spending tendencies, everyone accepted that budgetary policy was at the heart of distributive politics, of 'who gets what, when, and how,' resulting in winners and losers (Lasswell 1936). Monetary policymakers, on the other hand, preferred to think of

themselves as experts rather than politicians. They were the guardians of price stability, which would benefit everyone in the economy in the long run and was therefore beyond political contestation. As a result, instead of constraining themselves within their area of responsibility, they looked for political independence.

Since the global financial crisis, those distinctions have become much less clear-cut. Negative interest rates have a similar effect to taxes on savings, while large-scale asset purchases look like spending. When central banks were forced to resort to these measures – as they were after the GFC – they rightly complained that the division of labor between monetary and fiscal policy had broken down. It does not matter here whether the explanation is that fiscal policymakers have already borrowed excessively or that they are committed to enforcing fiscal austerity measures: monetary authorities ended up doing the heavy lifting for both the nominal and the real economy – driving both economic activity and price expectations at the same time.

This systematic conflation between roles and responsibilities will inevitably raise important questions about political oversight and accountability. If monetary authorities are using what looks like budgetary instruments to achieve budgetary targets, then to what extent can they claim the expert privilege of political independence? To answer that question, we need to focus on the distributive consequences of the policies that they have adopted. The main democratic concern is therefore less about the instruments used and targets eyed than about who wins, who loses, and the process by which these outcomes are determined. Furthermore, it is important to point out that the consequences that matter lie in the realm of perception and attribution rather than anything more objective.

While every relative change in government policy will inevitably create winners and losers – even under the most benign circumstances – not every policy change is salient in the minds of the electorate. Indeed, for the most part, electorates tend to focus on taxation and public spending. They may well complain about monetary policy actions, but unless they are homeowners on variable rate mortgages, they can rarely trace the direct impact of a marginal shift in reserve requirements or interest rates on their household wealth or income.

Unconventional monetary policy is different. Both the introduction of large-scale asset purchases and negative deposit rates has lifted the 'veil of ignorance' that usually shrouds the conduct of monetary policy from close scrutiny. These policies have made voters in many countries much more aware about the distributive consequences of actions taken by their central banks. Moreover, voters can trace those actions almost directly from policy decision to their wallets. Unsurprisingly, they are less comfortable with the idea that central banks should be given political independence as a consequence. If there are going to be winners and losers from the unconventional turn in monetary policy, then the people would like an actual say in how those outcomes are decided and how the gains and the losses will be distributed. Transferring the area of contestation over monetary policy from inside the central bank to a more conventional political arena would be a good place to start.

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