Central Bank Independence

The conventional framework for thinking about the legitimacy of central banks is a long-standing policy debate about central bank independence—How independent are central bankers from the political process? How independent should they be? Why is independence important and legitimate? And what combination of institutional arrangements or constraints best achieves competing goals of central bank independence and democratic governance?

For the past twenty to thirty years, many central banks in the developed world have set monetary policy more or less independently of formal political influence. This is a new state of affairs: in Japan, for example, the government only gave up direct political control over the Bank of Japan in 1997. In many other countries, from Brazil to China, the central bank is not independent—it is an arm of the government. The consensus that central banks should be divorced from politics is relatively recent. Prior to the

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1980s, only the United States, Germany, and Switzerland subscribed to anything resembling central bank independence. The original role of the central bank was highly integrated with the affairs of state governance: central banks provided liquidity to the banking system and financed government debt. Where central banks are independent, although the heads of these central banks are chosen by elected leaders and confirmed by legislatures, their decisions are generally not subject to review by courts, and at least until recently it was deemed inappropriate for politicians to interfere with central bank business directly.

The political independence of the central bank, with its enormous power over the economy, is justified on grounds that monetary policy is more akin to science than to politics. As Princeton professor and former vice chair of the Federal Reserve Alan Blinder argued in a recent lecture at Cornell, the nearly universal view since the late 1990s has been that central banking is primarily a technocratic activity that is purposely separated from the political process.

The economic argument for separating central banking from politics is that the role of monetary policy is to modulate market trends. Independent central banks are supposed to act as a brake on spending when times are good by making borrowing more expensive, and to encourage spending when times are tough and people have lost confidence in the market by making borrowing cheaper. This kind of “countercyclical” activity is by definition out of sync with the mainstream thinking of the moment. But it is precisely the need for monetary policy to be out of sync with the mainstream that justifies central bank independence. Politicians are held accountable to the public on relatively short election cycles. But central bankers should have longer time horizons, and for this they must be insulated from the political process.

The establishment of central bank independence “sounds like, in some ways, a right wing coup,” said Adam Posen in a lecture at Cornell University. “In many ways it actually was. But it was presented by the economics profession as straight up, Pareto optimization. . . . This over excess of democracy pushing for inflation made everybody worse off, and . . . in the end [by insulating central banks from the democratic process] you weren’t saving one group versus another. What you were doing was just getting the whole society to be more patient and everyone would be better off in the end.” A 1993 paper by Alberto Alesina and Lawrence Summers provides a typical example of this view of central banks as a check on the excesses of democ-
Using data from various countries, the authors examine the correlation between average inflation rates and the degree of central bank independence. They find that countries with more independent central banks have lower levels of inflation—presumably because central bankers have the autonomy to adhere to monetary policies that are unpopular in the short run.

Working on the assumption that the goal is to root out politics from central banking, political scientists have dedicated themselves to defining the political conditions that produce central bank independence from politics. As Erin Lockwood explains in her survey of the literature on the politics of central banking, the main focus of political scientists during the 1990s and 2000s was on calculating degrees of central bank independence. The “main assumption” driving this focus was that “central bank independence bolsters the credibility of low-inflation commitments, given economic actors’ rational expectations of defection from these commitments in the face of electoral incentives.”

Despite the apparent correlation between independence and low inflation, many scholars now doubt the claim that central bank independence necessarily leads to low inflation. Research by Adam Posen actually finds that the causation goes the other way: independence does not predict inflation levels—rather, low inflation levels lead to central bank independence. Moreover, in an era in which inflation is almost nonexistent in developed economies, curbing inflation is no longer an adequate rationale for central banks’ independence in those economies.

Even among proponents of central bank independence, the rationale for independent central banks and the breadth of powers they should have are contested. Should these powers be limited to inflation-targeting monetary policy through government bond purchases? Or should an independent central bank have the power to buy and sell other kinds of debt and assets? And should legislators give central banks a very clear and narrowly focused mandate to guide their actions, or should they instead be given discretion to manage different goals such as full employment and low inflation that may sometimes be in tension with one another? The situation gets even more complicated given that there are different explanations for why a central bank buys or sells assets in the financial market. We can interpret these actions as merely aimed at stabilizing interest rates, something traditionally within the authority of the central bank. Or we can interpret these actions as aimed at ensuring the wider financial stability of the national—or
global—economy, something that is more traditionally the responsibility of the political branches of government.

Moreover, central banks do many things other than monetary policy, including important regulatory and supervision work, both domestically and internationally. Should the central bank’s power be limited to monetary policy? Or should it also have powers to monitor or regulate market participants? Different central banks around the world have different authorities and responsibilities, especially in the area of regulation.

A further challenge is that central banks’ mandates are defined in terms of domestic economies. But financial markets are deeply interconnected, such that a problem in one place impacts another. We learned in the last financial crisis how the impact of something as local as bad loans in the U.S. housing market had repercussions for the livelihoods of people in far-flung parts of the world who were in no way “responsible” for the results. Our actions and political choices have consequences—and often adverse consequences—for people who live in faraway places we will never even visit. Likewise, our economic rights and obligations are shaped by international agreements and policies that are very distant from our local politician’s office. It is impossible to disentangle the global economy. Our economic fates are intertwined. Our options and standard of living are shaped by economic events elsewhere. For this reason, our choices need to take into account these wider effects and relationships.

Central banks are charged with the welfare of their own national economies and have no explicit mandate to take into account the suboptimal impacts of their policies on other economies. While central bankers are keenly aware of the possible conflict between domestic interests and global interests, and many appreciate that fulfilling their mandate to stabilize the domestic economy necessitates concern for the stability of the global economy as well, they are politically bound to prioritize domestic interests.

The important point for our purposes, however, is that regardless of the position one takes on these questions, central bank legitimacy turns on central bankers being a community apart. If central bankers are too close to politicians or the public, it is assumed that they are not doing their job. Yet even the strongest advocates of central bank independence recognize that the rule of the market by a handful of experts is something that somehow needs to be squared with democratic commitments to governance by the people through elected representatives. There is a trade-off here: the pub-
lic (through its elected representatives) voluntarily gives up political control in order to get the benefit of rule by experts.

How to manage this trade-off? Communication, or “central bank transparency,” is the mainstream answer. Communication addresses the problem of the central bank’s political legitimacy by treating its authority as delegated from the public. As Alan Blinder puts it, “In exchange for its broad grant of authority, the central bank owes the public transparency and accountability.”

Yet central banks are not entirely independent from the political process. The governors of central banks are typically appointed by the executive and must report frequently to legislatures. Moreover, as Blinder points out, unless central bank independence is mandated constitutionally (as is the case in the European Union, where it is enshrined in the Maastricht Treaty), independence can always be revoked by the legislature through the same simple process used to revise a law.

Any successful central banker knows that doing one’s job well entails navigating multiple layers of national politics—from battles with elected officials, to conflict among government divisions (a classic one of these being the perennial conflict between the Treasury, or the Ministry of Finance and the Central Bank). Managing this kind of politics is simply part of a day’s work at everything but the lowest echelon. From this point of view, a model of central banking premised entirely on political independence tells you little, at best, about how to go about doing your daily work. At worst, this model makes you feel like you must be doing something wrong, as though, as Adam Posen puts it, “you’re going to have to get your hands dirty.”

Could we imagine a way of thinking about what central banks do, a vocabulary and set of analytical tools for evaluating decisions, that would not leave this necessary, and indeed, important work, out of the picture?

The extraordinary actions taken by central banks in the context of the financial crisis raised questions, in the eye of the public, about central banks’ independence from governments and hence from the influence of interest groups that capture the political process. In the United States, for example, the close (and highly effective) coordination between the Federal Reserve and the Treasury Department during the crisis—and, indeed, the lengths to which Fed and Treasury officials went to portray a united front—had the collateral effect of shattering the image of the central bank as independent from the government.
If central banks are not, in fact, independent in times of crisis, can we speak of them as truly independent in ordinary times? Although some may wish to draw a clean line between how they justify their actions in ordinary times and in crisis times, as former deputy governor of the Bank of England Paul Tucker points out, it is in fact difficult to distinguish “peacetime” and “wartime.”15 The actions in each period shape the other—and so it makes more sense to think about the central bank’s role more globally.

The general story that central banks are divorced from the political process has a dangerous political consequence: when it is discovered (by the public, or by politicians, or indeed by insiders themselves) that central banks must engage in activities associated with the political process—that they don’t have “clean hands”—then central banks are opened up to criticism. It seems they have done something wrong. The public feels betrayed. Politicians seize on the contradiction between the story we tell about central banks and the reality of what central banks must (and indeed, should) do, to score political points by attacking bureaucratic “elites.” Central bankers themselves feel that they are failing to live up to their charge. The public story—which sophisticated insiders always knew to be incomplete at best—causes unnecessary damage.

From here, it is only a small step for some academics, politicians, and members of the electorate to ask why central banks should be independent from the political process in the first place. As Marcelo Prates points out, legislatures have responded to the collapse of faith in the independence of central banks postcrisis by paying greater attention to the oversight of central banks than before.16 Add to this also the increase in lawsuits against central banks. Most recently, the European Court of Justice (ECJ) has reaffirmed the authority of the European Central Bank in matters of monetary policy, and the judgment of the ECJ in turn squeaked by in the German high court. But whether courts will continue to back central bank independence in light of the restlessness of the public remains to be seen.

The Japanese Example: Abenomics

This question—Why should central banks be independent?—got an early hearing in Japanese prime minister Shinzo Abe’s 2012 campaign for office. The word “Abenomics” first appeared in the financial press during this
campaign. It referred to Abe’s promise to force the Bank of Japan to undertake unconventional monetary policies to spur the economy out of its decades-long stagnation. Many central bankers reacted with dismay at Abe’s willingness to thumb his nose at central bank independence and his promise to bring the central bank under his political control. Yet many financial market participants and citizens felt that the ends justified the means.

Almost five years after its launch in 2012, Abenomics has largely failed as an economic strategy. Haruhiko Kuroda, the governor of the Bank of Japan who was appointed by Abe to implement Abenomics, was not able to lift the nation’s economy out of its long-standing stagnation—interest rates remain more or less where they were at the launch of Abenomics. But as a political project, Abenomics has been highly successful. Abe’s political party has repeatedly won elections by landslide votes since Abenomics began. And beyond the narrow question of Abe’s own political future, Kuroda’s interventions in the market have had, arguably, a larger cultural impact on Japan. Abe was elected on the heels of the Fukushima disasters, in the midst of Japan’s never-ending “lost decades,” a time in which Japanese people’s confidence in the future and hope for themselves and their society were at an all-time low. For many, it was exciting to see something finally happening, to see Japan as a society turning a corner, taking a chance on a new approach.

Kuroda’s policies arguably rendered palatable a nationalist politics that most Japanese said they found distasteful. As long as Abe was getting economic results, people seemed willing to put up with political views and policies out of line with the mainstream, from changes to public school textbooks’ accounts of World War II to laws that limit freedom of the press. Although Abenomics failed in its goal of achieving two percent inflation within two years, it has translated into political results for Abe and his right-wing political coalition. For better or worse, this cultural and political effect of Abenomics is a highly significant consequence of central bank policy.

The U.S. Example: Trump, Occupy Wall Street, and End the Fed

In the run-up to the U.S. presidential election of 2016, central banking became a key theme. In January 2016, legislation proposed by libertarian sena-
tor Rand Paul and cosponsored by presidential candidates Marco Rubio and Ted Cruz on the right and Bernie Sanders on the left, passed in the House of Representatives before being narrowly defeated in the Senate.\footnote{17} The bill, known as Audit the Fed (H.R. 24/S. 264), aimed to eliminate the secrecy surrounding Federal Reserve deliberations and to allow Congress to review Fed monetary policy decisions. This bill proposed to do this by allowing “the [Government Accountability Office (GAO)] to view all materials and transcripts related to a meeting of the Fed’s Federal Open Market Committee (FOMC) at essentially any time and require the GAO, at Congressional request, to provide recommendations on monetary policy, including potentially on individual FOMC interest-rate decisions.”\footnote{18}

The Audit the Fed debate raised several disparate concerns about central banking. For libertarians such as Paul, the key issue was liberty. They were concerned in particular by the encroaching power of an executive branch of government that they believed was manipulating the Fed from behind the scenes. In an op-ed, Paul and his adviser Mark Spitznagel wrote that the bill, “if passed, would bring to an end to the Federal Reserve’s unchecked—and even arguably unconstitutional—power in the financial markets and the economy.”\footnote{19} Invoking the neoliberal economist Ludwig von Mises, they argued that the key issue is political—“a matter of liberty, not merely economics.”\footnote{20}

Beyond the libertarian point about the dangers of unrepresentative government, proponents of Audit the Fed on both the right and the left pointed to a cultural issue: the close personal relationship between individual Fed officials and Wall Street executives. Critics of the Federal Reserve have often intimated that this close relationship leads to policies that benefit Wall Street at the expense of ordinary people. Paul and Spitznagel seized on these social ties—“the revolving door from Wall Street to the Treasury to the Fed and back again”—as a cultural explanation for their political critique of Fed policy: “The Fed is, indeed, a political, oligarchic force, and a key part of what looks and functions like a banking cartel. During the 2007–08 financial crisis, the Fed’s true nature was clear to anyone paying attention. As the Treasury began bailing out the investment banks from the consequences of their profligate risk-taking (and in some cases fraudulent schemes), the Fed moved in tandem, further purchasing the underwater assets of these institutions, as well as actually paying interest to the commercial banks (hemorrhaging from risky loans) for reserves they kept parked at the Fed.”\footnote{21}
Bernie Sanders agreed: “Unfortunately, an institution that was created to serve all Americans has been hijacked by the very bankers it regulates.”

He raised concerns about conflicts of interest in bank chief executives serving on Fed boards. “These are clear conflicts of interest, the kind that would not be allowed at other agencies. We would not tolerate the head of Exxon Mobil running the Environmental Protection Agency. We don’t allow the Federal Communications Commission to be dominated by Verizon executives. And we should not allow big bank executives to serve on the boards of the main agency in charge of regulating financial institutions.”

In addition to the provisions in the Audit the Fed bill, Sanders proposed that all board members be nominated by the president and confirmed by the Senate. The goal, he stated, was “making the Federal Reserve a more democratic institution, one that is responsive to the needs of ordinary Americans rather than the billionaires on Wall Street.”

Fed officials and their defenders largely ducked the cultural question altogether. Mostly, they asserted that these proposals were unworkable. Janet Yellen asserted that the bill “would politicize monetary policy and it would bring short-term political pressures to bear on the Fed.”

In an influential blog post, Ben Bernanke emphasized the “technical” nature of central banking: “Congress is not well-suited to make monetary policy decisions itself, because of the technical and time-sensitive nature of those decisions. Moreover, both historical experience and formal studies . . . have shown that monetary policy achieves better results when central bankers are allowed to focus on the longer-term interests of the economy, free of short-term political considerations.”

Larry Summers, interestingly, accepted Bernie Sanders’s cultural critique: “Sanders is right that Fed governance has been and is overly tied up with the financial sector. Each of the 12 regional Feds has a board of directors that is made up of nine people—three banking representatives, three private-sector non-banking representatives and three public interest representatives. The fact that a member of Goldman Sachs’s board at the time of the 2008 crisis was the ‘public interest’ chairman of the New York Fed board is, to put it mildly, indefensible.”

Yet he went on to reject the idea of requiring congressional approval as unworkable on two further cultural grounds. First, he argued that the culture of Congress itself is dysfunctional, and hence Congress is not well suited to represent the people effectively in regulating the Federal Reserve.
He also pointed out that many other important government bodies meet in private and do not have to release their meeting minutes. Second, he implicitly argued for the benefits of a tight-knit culture of regulators and financial executives in suggesting that having industry leaders as senior officials at the Fed is not necessarily a bad thing. As Summers put it, “There is a tension between acquiring expertise and avoiding co-optation or cognitive capture.”

In the context of the 2016 political campaign, however, these debates morphed into a simpler and cruder set of political accusations. The claim was that Fed officials were playing partisan politics—that they were supporting Democrats in their election bids against Republicans because of close personal relationships between Fed officials and members of the “Democratic elite.” Janet Yellen was called before Congress to answer for the conflict of interest some senators saw in Fed officials donating private funds to Hillary Clinton’s political campaign. Donald Trump, the Republican presidential nominee, accused Janet Yellen of purposely keeping interest rates low so that the economy would be booming at the time of the election and hence make voters feel satisfied with the status quo and stick with Democrats. In his assertion that Yellen “should be ashamed of herself,” he insinuated collusion between the Fed and the executive on the basis of personal relationships: “She’s obviously political and doing what Obama wants her to do.”

The response of Fed officials to this particular accusation was swift and total denial. “Partisan politics plays no role in our decisions,” Yellen asserted. “We do not discuss politics at our meetings and we do not take politics into account in our decisions,” she said. Minneapolis Fed president Neel Kashkari echoed this sentiment, stating that in policy deliberations at the U.S. central bank, “politics does not play a part, I can assure you of that.”

For her part, Democratic presidential nominee Hillary Clinton played the expert card, arguing that Trump’s accusations were unsophisticated and dangerous: “Words have consequences. Words move markets. Words can be misinterpreted. Words can have effects on people’s 401(k)’s, their pension funds, their stock portfolios. [Mr. Trump] should not be adding the Fed onto his long list of institutions and individuals that he is maligning.”

Yet in matters of culture, the senators were arguably a bit more expert than the central bankers. Scott Garrett, Republican congressman from New
Jersey, put it as follows: “As the saying goes, perception is reality. Whether you like it or not, the public increasingly believes that Fed independence is nothing more than a myth.”

From Independence to Interdependence

For better or worse, the era in which central banks were entrusted with acting with little interference from the public or elected officials is probably over. “When I first worked at the Federal Reserve,” Alan Blinder joked in a lecture at Cornell University, “most members of the public probably thought that [the Federal Reserve] was a forest somewhere.” This is most definitely no longer the case. Central banks are now subject to increasingly stringent legislative oversight as legislators make growing demands for reporting on central bank policies, set the targets for those policies, and even float proposals to subject the specific policies central banks pursue to legislative review. We seem to be entering a new era in which more muscular executive branches feel no compunction about criticizing the central bank or its officials, or about expressing their own policy preferences clearly and directly.

What can or should policymakers do with or about the decline of political independence? Existing academic theories and policy playbooks do not teach central bankers how to anticipate and navigate the new political environment in which they now operate. These theories do not give policymakers, market participants, and the public at large the tools they need to productively define the issues and debate what should be done about them.

The old and perhaps still dominant approach would be to mimic the ostrich with its head in the sand—to simply ignore the situation or deny its existence completely; hoping the entire problem of the central bank’s political legitimacy will go away. Such, arguably, was the approach of Federal Reserve officials to President Trump’s attacks during the 2016 presidential election. This, of course, only succeeds in enraging the public and tipping the hand of demagogues.

A second and equally dangerous course of action is the exact reverse of the first. Faced with the overt politicization of central bank activities by governments and political movements, some central bankers may choose simply to cave to politics—to embrace or at least accept the overt politicization
of finance by nationalist leaders. Such is, arguably, the approach of Governor Haruhiko Kuroda of the Bank of Japan.

In the aftermath of the 2008 crisis, a number of other proposals have been made for increasing central banks’ accountability to elected officials and for increasing the transparency of internal decision-making processes. For example, some have suggested that central banks are akin to administrative agencies, and hence that we can find models for political accountability in the experience with other administrative agencies such as the Environmental Protection Agency or the Fair Trade Commission. Law professor Adam Levitin argues for the necessity of some kind of legal structure that would set competing political interests against one another in order to “neutralize” them. Yet these are not the only possible responses to the attack on central bank independence. The legitimacy of central banking involves much more than formal legal independence or institutional fixes on purported “capture” by special interest groups (such as banks).

Empirical evidence already demonstrates that legal guarantees of independence do not in fact suffice—there are many cases in which a central bank has legal autonomy and yet in practice there is substantial involvement of the government in policymaking. Rather, the evidence shows that the kinds of contacts and informal arrangements between various units of the central bank, from the research department to the foreign affairs department, and also the circulation of personnel between central banks and government offices—cultural and social factors—are better indices of actual independence.

How might one respond productively to attacks on central bank independence? One of the fundamental problems with the claim that central banking is technocratic work set apart from what happens in government, the market, or public life, and therefore not shaped by value judgments, is that it does not correspond to how either ordinary people or experts experience the issues. Because the decisions, choices, and personal networks of central bankers are already deeply intertwined with the political process, we need a new explanation of the purposes of central banking, and a new way of evaluating what central banks do. We need a story that fosters a richer conversation about political legitimacy—about how to reconcile the need for expert knowledge in financial regulation and policy with the democratic challenge to expert authority. We need a story that fits current realities, one that the citizenry can truly believe in.
We might begin with some introspection about how central bank independence became the holy grail of central bank legitimacy. As we saw, the (contested) rationale is that independence leads to lower inflation. Yet, as Jonathan Kirshner observes, the economic evidence supporting the notion that low inflation should be the ultimate macroeconomic goal is at best “modest and ambiguous.” Modest inflation can be a good thing, not a bad thing—in fact, in today’s deflationary era it is now the goal of most central bank policies.

If the dominant justifications for central bank independence do not make strong economic sense, perhaps they tell us more about the culture of central bankers, and about the wider economic culture in which they operate, than about economics. We will explore this culture in the next chapter.

When we speak of independence, from whom do we imagine that central banks are independent, anyway? The discussion has mostly focused on independence from government, but, as Adam Posen argues, central banks are certainly not independent from the leaders of the financial markets. Their political authority and independence from other branches of government turn on support from the financial sector, and they cannot engage in policymaking without this support. Legal scholar Peter Conti-Brown likewise proposes that the very term “independence” is misleading because it deflects attention from “a broader, more explanatory context where Fed insiders and interested outsiders form relationships using law and other tools to implement a wide variety of specific policies.”

A better way to think about central banks, therefore, is to see them not as independent but as interdependent actors in the economic and political spheres. Interdependence suggests that legitimacy comes from a different place—it comes from productive and principled collaboration, not from autonomy. Legitimacy, from this point of view, is a matter of cultural ideas and social relations as much as it is a matter of legal authority. Our ultimate goal should be legitimacy in the context of the cultural environment, not independence for its own sake. In the chapters ahead, we will explore the contours of collaborative legitimacy and how it can be achieved.