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Central Bank Independence Revisited

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Abstract

In major advanced economies, including Australia, independent central banks have become established institutions. Yet there are reasons why the sustained presence of such an institution in a democratic society should be challenged. This paper considers the arguments usually advanced for central bank independence, and the underlying arguments for a failure of democracy including the standard argument based on the importance of central bank credibility. This argument depends crucially on the role of inflationary expectations on the actual inflation rate. We question whether the standard story is really relevant – and, if not, then independence depends on the argument that politicians may not always act in the best long-term interests of their constituencies but bankers are more likely to. We show that this is a questionable assumption. The post Wold War 2 development of Europe and the emergence of the European Central Bank is examined to illustrate our underlying proposition that Central bank independence is not the result of economic argument, but of political ones leading to suboptimal economic results.

JEL Classification: E58, E50, G20
Keywords: Central bank independence, democracy, European Central Bank, inflation, inflationary expectations

Introduction

In major advanced economies, including Australia, independent central banks have become established institutions. Most economists have commented favourably on their performances as wise, even effective, policy makers (see, for example, Fischer 2017, Yellen 2017), mainly through their influence in setting levels of interest rates, principally to impact on rates of inflation, even though, in some of their charters, the level of employment – the full employment objective

– is stated to be of equal importance. Regardless of this, democratic governments of all persuasions enthusiastically support the maintenance of such an institution to play a key role in the implementation of overall economic policy.

The main rationale for central bank independence is the importance of credibility – which is argued to have a fundamental impact on inflationary expectations, which are a major factor in the perpetuation and acceleration of inflation. Governments, it is argued, can not be trusted to focus on inflation because they are concerned with electoral success and are prepared to sacrifice higher inflation at the cost of lower unemployment in the short run.

Yet there are two principal reasons why the sustained presence of such an institution in a democratic society should be challenged. The first is a philosophical argument, the second is an economic argument.

The first argument goes to the core of what is meant by a democracy with a representative government[1]. Implied in such a form of government is the principle that the government and its ministers are ultimately responsible for policies implemented. This proposition dominates all other relevant considerations. The government and its ministers therefore are directly answerable to the people who voted to elect them, for the implementation and performance of the policies rather than *unelected* Central Bank Governors and Central Bank Boards of advisors. It is not consistent with the philosophical idea

[1] In coming to the conclusions presented below, we have been much influenced by James Forder's many writings on the issues, see, for example, Forder 2004a, 2004b.

of a democracy, or its ultimate axiom, to have it otherwise. To argue that the government does not have the best interest of the country at heart, while the Central bank Governors do implies that the latter have solely altruistic goals, even though they are not answerable to the people. This will be examined.

The economic argument, while one of principle too, has pragmatic and practical aspects as well. For overall policy to be effective, there must be created package deals of policies that take in and combine fiscal policy, monetary policy, equity considerations and permanent incomes policies. Integrated together, these are the means by which to attain the overall ends of full employment, liveable – with rates of inflation and just and equitable distributions of incomes and wealth. How far such ends have been or will be achieved affects what voters have to decide when voting.

The relevant decision makers in government, while considering the advice of the technical experts in central banks, treasuries and other relevant sections of civil (public) services, are, it must be stressed again, ultimately responsible for policy and its implementation.

In advising how the major parts of policy are to dovetail with each other, persons in the relevant institutions are doing their jobs, performing the roles that should be expected of them in a properly functioning democracy. Their advice should be dispassionate, backed up by arguments based on their expertise. Of course, political considerations and accompanying constraints – the underlying philosophy of the government in power, for example – should be taken into

account in their advice and it is certainly within their brief for them to suggest alternative paths along which to reach the same end. Nevertheless, that is where their responsibilities end and it is then the role of voters to decide how well the policies designed for the government that implements them have achieved what they wished to have. The buck stops with elected politicians, not with their expert advisors.

It is hard to see why anyone who claims to be a democrat could not accept these arguments! In any case, the rationale for Central Bank independence is premised on the view that inflationary expectations have a profound impact on the inflation rate – a view which we question.

The next section considers the arguments usually advanced for central bank independence, and the underlying arguments for a failure of democracy. We then consider the standard argument for independence based on the importance of central bank credibility. This argument depends crucially on the role of inflationary expectations on the actual inflation rate. We question whether the standard story is really relevant – and, if not, then what arguments remain for independence? This is answered in the section where we consider the argument that, whereas politicians may not always act in the best long-term interests of their constituencies, bankers are more likely to act in accordance with the public good. As we illustrate, this is a questionable assumption. The final section uses the post Wold War 2 development of Europe and the emergence of the European Central Bank as a case study to illustrate our underlying proposition that Central bank

independence is not the result of economic argument, but of political ones which often lead to suboptimal economic results.

Arguments for Independence

As Central Bank independence means that one of the major policy institutions is taken away from the democratic control of the populace, the arguments for doing so must either represent a rejection of the merits of democracy, or, rather, an argument that this is an exceptional case which merits being excluded from democratic processes (Forder 2004a). Underlying all the arguments for independence is the neoclassical view of the economy – with the "natural rate" of unemployment being established by markets in the long run leading to the long run neutrality of money. Monetary policy, according to this view, cannot influence the real economy in the long run, so that its only impact is on the inflation rate. This, of course, is associated with a vertical long-run Phillips curve.

In this case, the supposed failure of democracy is the result of elected politicians enacting policy which is inflationary in the short run if, by temporarily reducing unemployment, it increases the probability that they will be re-elected. This is the theory behind the "political business cycle". By leaving control of monetary policy in the hands of an independent central bank, this temptation will be removed so that inflation will generally be lower. This is reinforced by the fact that independent central banks will be seen as more credible in reducing inflation, which will significantly impact on inflationary expectations. So the supposed

failure of democracy is the specific result of the underlying economic model. As a result, the argument is that the monetary authority should solely concentrate on fighting inflation, and should not concern itself with employment – as the natural rate will establish itself in the long run regardless.

Credibility and inflationary expectations[2]

According to the conventional wisdom, the danger associated with inflationary expectations is that they are self-fulfilling. If economic agents expect inflation to rise, for example, then they will act on those beliefs. Workers will demand higher wages in anticipation of these price increases, while employers will, in view of their expectations, be more willing to grant them:

> Private agents' expectations about future monetary policy actions affect their current decisions. … For example, suppose that, for some reason, private agents come to expect future inflation. This expectation leads them to raise wages and prices immediately. Eichenbaum (1997, p. 238)

This view of the relation between inflationary expectations and the inflation rate is a key factor in the argument for the independence of central banks. This is due to the belief that independent central banks will be seen as being more credible anti-inflationary institutions, and therefore will have stronger inflationary dampening influences on expectations.

Despite the general acceptance of this view, it should be regarded as seriously deficient as no transmission mechanism from expectations to actual price changes are specified. If we accept that prices, particularly in the industrial

[2] For a discussion on the limitations of credibility with respect to Central Banks see Forder 2004b

sector, are a mark-up on costs, then, unless inflation has some impact on mark-ups, which is unlikely[3], it must operate through costs, in particular, wages. What the analysis requires, therefore, is that labour's wage demands are in terms of expected inflation. However, as far as we are aware, this has not been the case in any known labour bargain. Where inflation is explicitly acknowledged, it is usually the previous period's inflation, so that the negotiation is an attempt to allow real wages to recover to the pre-inflation level, rather than to have them anticipate inflation. There does not appear to have been a significant instance of successful wage negotiations on the basis of expected inflation. In other words, because wage demands usually represent an attempt to regain previous losses caused by inflation, they do not attempt to anticipate inflation. If this is correct, then inflationary expectations play little role in wage bargaining. In this case, although inflationary expectations may influence other variables indirectly, there does not appear to be any direct channel of influence whereby they can effect inflation, and so the idea that they are self-fulfilling must be significantly revised. Although more work needs to be done on the "inflationary expectations transmission mechanism", it appears that to simply assume that such expectations are self-fulfilling, without a detailed account of exactly how, is extremely problematic, to say the least.

[3] According to the late Fred Lee, the author of a number of important studies on prices and the determination of the mark up, expected inflation has not played any role in any theoretical or empirical study of the determination of the mark up. (in conversation with the authors)

Politicians v Bankers

An important argument made in favour of Central Bank Independence is that politicians may not always act in the best long-term interests of their constituencies. The example usually given is that, due to their concern with being re-elected, they may sacrifice price stability for temporary gains in employment which are more electorally popular. This argument, of course, relies on mainstream economic theory – in particular, the idea of a vertical long-run Phillips curve. In the short run, due to some systemic rigidity, there may be a trade-off between more inflation and lower unemployment, but in the long run unemployment will return to its natural rate but with a higher rate of inflation. If we reject this theory and instead argue that a more likely scenario is a horizontal Phillips curve up to the level of full employment of labour and capital, with underutilization being the norm (Freedman, Harcourt and Kriesler 2004; Kriesler and Lavoie 2007), then this argument for independence loses much of its validity. The argument is further undermined when we consider the motivation of central bankers. Those people arguing that the motivations of politicians may interfere with the workings of the economy are assuming that bankers either have no motivations, or that their motivations are in line with what will benefit the economy. However, there is no reason to assume this. Central bank boards do not represent the interest of all society: "the supposed independence of the central bank from political manipulation. The quaint notion that the central bank is above the fray, formulating policy in an objective manner free of ideological

considerations, is patently absurd given what we know about actual policy formation. The members of the U.S. Board of Governors (BOG) are political appointees who bring their ideologies with them to Federal Open Market Committee (FOMC) meetings. Even a quick perusal of the transcripts of those meetings will reveal a nearly infinite number of openings for politics to enter the decision-making process …... For example, as I have detailed previously, there is a strong bias against the interests of workers in favor of those of entrepreneurs…. the Fed is ultimately a creature of Congress—a fundamentally political body, even if the range of ideologies represented is narrow. Notwithstanding the fact that Congress typically chooses not to exercise its authority, it is clear from the transcripts that the FOMC does consider possible Congressional reactions in its policy making" Wray 2007, 121

In other words, most central bank boards are filled with capitalists and their representatives– while workers and unions are significantly unrepresented. As a result, the decisions have and will favour capital over labour.

In any case, it is unclear that Central Bankers will act on the basis of longer term considerations. Interviews with Central Bankers reveal that independence "runs the risk of replacing the 'short-termism of politicians', by dependence on the short-termism of financial market pressures" (Pixley 2004, 101), , and that "[t]hey are more obsessed with keeping their reputation, also measuring it as a 'thing'". (Pixley 2004, 113) As a result of this, they may not act to "prick" bubbles early if the problem is not generally perceived due to the resulting "odium".,

despite the fact that this means that the bubble, when it eventually bursts will be much bigger and, as a result, there will be more and heavier losers (Pixley 2004, 113-6). Central banks' concern with their reputation profoundly influences their actions, as is obvious from Pixley's interviews with central bankers and members of the financial sector. (Pixley 2004 especially chapter 6): "The effects of their decisions – whether they follow or lead markets – often is not clear cut, *unless* they are bold, and central bankers aren't bold, you see. They don't want to rock the boat" (Caroll in Pixley 2004, 118, emphasis in original).

As governments increasingly stressed the role of independent central banks in determining the state of the economy, attention focused on these banks, and on their executives. "The central bank might be independent, but its executives are part of the same old government-press-lobbying nexus" (Zeilger in Pixley 2004 119).

This section has argued that central bankers have their own objectives, which may conflict with the national interest. This is well summarised by Forder: "it is a very peculiar doctrine that the way one causes agents to make policy in a principal's interest is to make them free from reproach or censure. And yet the emphasis often put on the value of 'complete' independence, or desirability of 'constitutional rank' for independence-granting statues (sic), or simply the presumption that it is desirable that the ECB's independence be embedded, as it is, in international treaty, all rest on that view. And it does nothing to diminish one's concern that an error has been made that the most voluble source of

comment to the effect that none of this matters because of course central bankers will always act in the public interest is central bankers themselves."[4] (Forder 2006, 238)

In examining the argument for central bank independence, there does not seem to be an overwhelming case in terms of economic benefit. Rather, we would suggest that the underlying motivation is political, a theme which we examine in the next section.

Central Bank Independence: implications for fiscal policy through the lens of the European experience

Central bank independence has been often discussed first at its own face value, then in relation to the question of active fiscal policies. It should also be looked at more pragmatically through the lenses of the interests political, state as well as private, that push for it. In this section, we consider some aspects of the post 1945 European history as a case study of our argument that central bank independence usually is politically, rather than economically motivated. Our starting point is with the Barre Plans sponsored by France from the first version in 1968 to the second in 1970, named after Raymond Barre who was Vice President of the European Commission and in charge of its financial affairs. Interestingly Barre would become the most financially conservative Prime Minister of post 1945 France up to his time, engineering in 1976 the worst

[4] See also Prasch (2004) 253-4

postwar recession which led to the formation of a permanent large pool of unemployed people in the country. The Barre Plans were based on the principle of monetary convergence among the different EEC countries which were still the six original members of the Common Market: the Benelux, France, Germany, Italy. The Plans by giving priority to monetary convergence were called 'monetarists' and they led to a sharp difference between France on one hand and Germany and the Netherlands on the other. It represented the different interests of countries perceived as having potentially weak currencies relatively to those deemed to have strong ones. The prioritization of monetary convergence and of monetary solidarity, as it was called, would have entailed a *de facto* subjugation of fiscal policies, although there was no clear cut political ideology yet about the necessity to split apart the two wings of policy making. Looking at the Barre ideas in historical terms we can grasp why France was interested in creating a framework of monetary convergence for the EEC. In the end it had little to do with some *a priori* monetarist ideas, though the long standing financially conservative thinking of the core of the French elite certainly helped in that direction.

One of the main objectives of General de Gaulle upon assuming power in 1958 was the stabilization of the French Franc, which underwent several 'one off' devaluations due to the unending colonial wars which engulfed the country for about 15 years. Carrying the last devaluation in December 1958 the Franc remained fixed to the US dollar, as per Bretton Woods' arrangements, until 1969.

But confidence in its stability began to wane by 1968 in the wake of the May strikes which ended with nominal pay rises of between 15 and 30%. Growth rates and profitability were not affected, quite the contrary, thereby lending support to what Kalecki would theorise a year later (Kalecki 1971). Inflation obviously rose - but not to the extent as to nullify the increase in wages - and so did imports, on account of a stronger domestic demand, generating an external deficit. Yet that was enough to create financial - not real - worries for France's capitalists and the like. In particular, up came the imaginary spectre of a weak Franc, which in their heads translated into a weak France facing a strong Deutsche Mark, and, by the same logic, a strong (West) Germany. That France was weak was false, that Germany was strong was true. Throughout the second half of 1968 financially driven pressures to devalue kept mounting but de Gaulle resisted calls to depreciate the currency. Yet by April 1969 he was gone. The 1968 events ate - through the financial fears - at his system and power base notwithstanding his massive victory at the elections he himself called after the strikes. By mid 1969 under the new President, and former de Gaulle's Prime Minister, Georges Pompidou, himself a financier by background, the value of the French Franc was lowered by 11.1% vis à vis the US $. In the same period West Germany exhibited a rising balance of trade surplus and an upward pressure on the Deutsche Mark via what were then called hot money movements. By October 1969 the Deutsche Mark was revalued by 9% relatively to the $. Germany up, France down, or so it seemed to the geopolitical thinking of France's policy makers

The context of the Barre plan was a financial cum geopolitical fear by the French elites who thought that the whole of de Gaulle's power edifice was crumbling: France was - perceived to be down, because of its social madness, while Germany was way up there. The central idea of the second and final Barre Plan was a mechanism devised to support, through a special fund, the weak currencies in the convergence process or in case they were thrown off balance. Evidently Germany and the Netherlands would not agree as they would be required to fork out the money to shore up the weak currencies. Thus they suggested a more gradual real process of convergence which, in parts, found its way into the Werner Plan of economic and monetary union. Nothing came of either plan because of the crisis of the 1970s and of the messy and failed attempts to coordinate exchange rates through the monetary snake. Nevertheless, certain ideas regarding strict monetary convergence did stick, and they were ready for fruition during the formulation of the Maastricht Treaty and, especially, during the Franco-German process leading to the creation of the EMU in 1999. By then a full blown ideological system of the desirability, both economic and moral, of budget austerity cum monetary scarcity was in place, ready to be institutionalized with the added paraphernalia of testable econometric models (Parguez, 1998, 1999).

Usually it is Germany's authorities which are blamed for the rigidity regarding the European Monetary Union. This is not so. German authorities were initially against moving quickly towards monetary union. They were dragged into

accepting the formation of the EMU by the French President Jacques Chirac who mobilized that quintessential eminence grise of France's élite interests (political, economic, military) embodied in the former president Valéry Giscard d'Estaing, where among his mischievous deeds one should count the support towards the establishment of Ayatollah Khomeini's rule in Iran at the bloody expense of the democratic and leftwing opposition to the Shah. As detailed by the late Marcello De Cecco (1998), President Chirac sent Giscard d'Estaing to Germany in 1996 in order to threaten Helmut Kohl with the delinking of the French Franc from the DM if the Berlin Government did not move against the Bundesbank's refusal to lower interest rates proceeding quickly towards the creation of the EMU. France was in fact claiming, with reason, that the post-unification interest rates set by the Bundesbank were making it too costly for France to keep the exchange parity with the Deutsche Mark, then an axiom in both France's and Germany's policy making. Giscard's mission succeeded. It is true that Germany's exports had proven to be capable of overcoming several revaluations of the DM, but in all these events the link with France was crucial: on it depended not just, and even not primarily, on the quantitative relations of the current account balance and of capital movements but the whole political economy of Europe and of Germany within Europe. Helmut Kohl complied, thereby compelling the Bundesbank to follow suit.

From that point onward the German authorities worked relentlessly to make the European Central Bank in the image of the Bundesbank, a not too

accurate replica though as we shall see. This suited the Banque de France rather well since, as Alain Parguez (2016) has shown, its ideology has always been far more austerian than anywhere else in Europe. The Maastricht parameters were the cornerstone of that construction, its main pillar being that the EMU should by no means become a transfer union. This second aspect did not sit all too well with France for a reason related to a fact of life: the Godley equations of sectoral balances showing the relations between external and public sector balances (Godley and Lavoie 2007)have not been working in France's favour for decades and they are still not working. This is because France has deficits ion both balances leading to huge surpluses in the private sector balances. Hence France did and does need some kind of a transfer either openly or by some surreptitious means. For balance of power reasons, France cannot possibly fall within the category of the 'weak' countries, this would simply wreck 'Europe'. Hence, she must get, in one way or another, a sort of seignorage in her favour. Indeed the press, even the specialised papers, treat France as part of the so-called 'surplus' non PIIG countries. But the Godley equations, which act as a lie detector for macrobalances, present the opposite picture: France is a PIIG.

At the practical level the German negotiators during the meetings for the foundation of the ECB knew what was happening and were savvier in their judgment, but obstinate in their no transfer position. As, a decade later, the Greek crisis erupted and widened the *Financial Times* opened its pages to invited articles by notable European policy makers. No relevant contribution came from

France. Romano Prodi, former President of the European Commission and himself a former professor of Industrial Economics at the University of Bologna, was beating about the bush presenting the *ad hoc* palliatives for financial help as heralding bold moves towards fiscal union (Prodi 2010). The contribution by Otmar Issing (2010), the chief negotiator for the Bundesbank during the formation of the ECB, put everyone on the straight and narrow. It is a remarkable piece for its lucidity and obstinacy. It therefore tells in a nutshell the whole story of the EMU failure, now kept in suspended animation by Mario Draghi who just swept aside the rules. Issing begins by laying out the obstinate position against those who argue for a Greek bail out:

> It is certainly true that this is a decisive moment for EMU – but for the opposite reason. Greece will continue to receive support from several European Union funds. But financial aid from other EU countries or institutions that amounted, directly or indirectly, to a bail-out would violate EU treaties and undermine the foundations of EMU. Such principles do not allow for compromise. Once Greece was helped, the dam would be broken. A bail-out for the country that broke the rules would make it impossible to deny aid to others.

He then correctly summarises the nature of the EMU:

> It seems that quite a number of observers have forgotten what EMU is, and what it is not. The monetary union is based on two pillars. One is the stability of the euro, guaranteed by an independent central bank with a clear mandate to maintain price stability. The other is fiscal solidity, which has to be delivered by individual member states. Member countries are still sovereign. EMU does not represent a state; it is an institutional arrangement unique in history.

And now comes the most lucid statement ever made by a eurobanker:

> In the 1990s, many economists – I was among them – warned that starting monetary union without having established a political union was putting the

> cart before the horse. Now the question is whether monetary union can survive without such a political union.

Of course it cannot survive but, for Issing, the rules, which in fact are yardsticks to define the balance of powers within the EU and the EMU, as they do not apply equally to all, must be kept in place: By joining EMU, a country accepts its rules. Therefore the conclusions are:

> For EMU, the crisis represents a final test of whether such an institutional arrangement – a monetary union without a political union – is viable for an extended period of time.

It proved not to be viable and is being held in suspended animation since the famous whatever it takes 2012 London speech by Mario Draghi. Admittedly the EMU is a case of central bank independence gone mad, but it is the most relevant case, enough to destroy the whole idea, given the countries and the area involved. Within this madness, however, different weights apply, such as the untouchable status of France despite being a PIIG, but also the markedly different legal and institutional behaviour of Germany.

It is, indeed, well known that neither the ECB nor any of the national central banks belonging may buy government bonds on the primary market. The ECB can operate only on the secondary market, i.e. it can only transact bonds already in existence. Italy implemented such a 'divorce', as they called it, between the Treasury and the Central Bank way back in 1981. It was conceived as an antinflationary step inducing credibility and received support from the Communist Party of Italy which, mistakenly, saw in the 'divorce' a way to rein in the clientele driven public spending by the Christian Democrats and the

Socialists. Instead the separation of the Italian Treasury from the Bank of Italy contributed to the massive explosion of Italy's public debt on ac-count of interest charges, doubling it in roughly a decade (Graziani 1991). A similar phenomenon occurred in France around 1984 when the Socialist government cut the circuit - so it was called, *le circuit* - between le Trésor and la Banque de France for anti-inflationary credibility (Lemoine 2016). Not so in Germany. Since the formation of the EMU and, in particular, since the outbreak of the Great Financial Crisis, many commentators wondered how it was possible that the Bundesbank kept buying bonds at the date of issuance, i.e. on the primary market, thereby ensuring a very low or even zero interest rate on their service. We know that in this situation the Luigi Pasinetti (1997) equation regarding the burden of the debt is likely to work in favour of the public finances since it makes it lighter. The burden is in fact defined in terms of any initial ratio of debt to GDP multiplied by the difference between the nominal interest rate and the nominal growth rate: $(i - g)d$, where d is the initial debt to GDP ratio. Thus with i at zero or very near it, even with a tiny positive growth rate, the debt burden will fall. In other words, the amount of income that has to be given up to service the debt. A little search revealed that in 2000, just one year after the launching of the Euro, the Federal Government of Germany founded the Finanzagentur, the Financial Agency. This is an institution wholly owned by the government on whose behalf the Bundesbank buys and holds freshly printed government bonds. A conclusive

example that central bank independence cannot exist and it was used as a weapon to destroy government finances.

Conclusion

As a result of Central Bank independence one of the central economic institutions of modern capitalist economies is not subject to basic principles of democracy. The reasons advanced for this supposed instance of the failure of democracy are strongly tied to the underlying neoclassical model of the economy – and particularly of the natural rate of unemployment and the long run neutrality of money. This is often summarised by the vertical long-run Philips curve. However, this is shown to rest on shaky theoretical foundations. In addition, the notion that Central Ban credibility is important is tied to the role of inflationary expectations in perpetuating inflation – again an idea resting on shaky foundations. If we reject both of these as arguments for independence, then what remains is the idea that governments are motivated to act in their own interest which is suboptimal with respect to their constituencies, while central bankers have much “purer” motivations. Evidence based on both the typical membership of the executive of Central Banks, and of interviews with central bankers and financial journalists suggest that this is not the case – that central bankers have their own agendas which are often not in the best interest of the population.

As a result of these arguments, we conclude that central bank independence is the result of political, rather than economic factors. We illustrate this with a

consideration of the factors leading to the emergence of the European Central Bank

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