Beyond Central Bank Independence:

Rethinking Technocratic Legitimacy in Monetary Affairs

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Abstract (100 words)
How can central bank independence be reconciled with the need for political accountability in times of crisis? Established as an institutional norm during the relative stability of the 1990s, the "great moderation" confirmed the view that technocrats were better money managers than politicians. However, the global financial crisis forced central bankers to move beyond their mandates, transforming them into overtly distributive and increasingly politicized agents. In that context, they struggled to retain legitimacy without democratic oversight. The challenge is to build a two-tiered accountability structure – giving technocrats independence under normal conditions but providing them with political authorization in hard times.

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Central banks, crisis, democratic legitimacy, financial stability, monetary policy, technocracy.

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One fault line exposed by the global financial crisis in the architecture of today's economic governance 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 beginning 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 recent global financial crisis has revealed central bankers as powerful political actors, not mere technocrats. As they have gone far beyond their institutional mandates, their actions and policies have become more overtly distributive, with clear winners and losers. We therefore ask a simple question: Is the technocratic argument for 'apolitical' central banks still valid today? How can the idea of central bank independence be reconciled with the need for political legitimacy and accountability in extraordinary times of ultra low interest rates and financial fragility?

There are many good reasons – both theoretical and practical – to open up existing central banks to greater levels of public scrutiny, particularly during hard times. 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 their extraordinary actions but also hold no small measure of responsibility for the state of their country's economic performance. The main goal of these critics 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.

We aim to push the debate in a more constructive direction. We believe there are moments when it is useful for central banks to be independent from political oversight in the conduct of monetary policy. We also realize that there are times when central bankers must execute policies that are more overtly political. In those moments, we think central bankers' decisions should be embedded in democratic political institutions and made subject to political oversight. The challenge is to imagine how exactly to switch from one regime to another, and under what conditions.[1]

Not So Boring

Central bankers used to be bland. They were comfortable playing the role of faceless technocrats who quietly lived in the shadows. Long-time US Federal Reserve Chairman Alan Greenspan was a rare exception, but even he was careful to communicate through actions rather than words. 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. They actively nurtured their hard-fought political independence, justified by their popularly accepted narrow mandates of maintaining stable prices.[2]

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. 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 often part of a wider effort by politicians to gloss over their own failings.

During the 2016 presidential election campaign in the United States, Republican candidate Donald Trump repeatedly criticized Fed Chair Janet Yellen, accusing her of "doing political things." 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." 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. The pro-Brexit Rees-Mogg believed that Carney's public statements were hostile to a British exist from the EU ('Brexit'), 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."[3]

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 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."[4]

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 their 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. The latter had mounted a campaign to remove Demetriades on dubious grounds of 'incompetence,' in what *The Economist* called a "blow against independence." 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. Finally, the governor of the Bank of Italy, Ignacio Visco, came under sustained assault by then ruling Democratic Party leader Matteo Renzi when Visco came up for reappointment in 2017.[5]

What is behind this recent surge of political scrutiny and public controversy? We put forward two principal explanations. First, during and since the global financial crisis, central bankers had to change the way they used their policy instruments both to stabilize the financial system and to restore their influence over the wider economy. As a result, central banks today possess broader policymaking authority and larger discretionary powers than they possessed before the financial crisis – both of which have clear distributive outcomes. Second, also as a direct consequence of the crisis, elected politicians have started to see the interaction of monetary policy and financial supervision in a 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 lack of effectiveness by using central banks as scapegoats.[6]

There are two important implications of this politicization of central banking: one for the design and one for the implementation of public policy. To begin with, 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 long periods when central bankers were thought to be private actors, and even periods when they were viewed as optional or even unnecessary.[7] 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 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. Here we need to pay 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.[8]

The Long Road to Political Independence

The modern consensus that central banks should be independent from politics is not an obvious historical development. On the contrary, it is a retreat from much of the history of the nineteenth and early twentieth 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 height of their power and influence, central bankers changed direction and moved outside direct political control.

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 eighteenth and beginning of the nineteenth centuries, central banks were essentially business-to-business service providers – often given unique charters by the government, but usually controlled by their largest clients, the money-center banks. The role of the central banks was to provide liquidity – or 'money' – in the form of broadly accepted negotiable instruments that could be used to purchase bank paper at a discounted value. Such instruments could

be based on commodities, foreign currency, or sovereign debt. What mattered was that these instruments could be accepted as payment by the money-center banks or their clients. Central banks were simply the bankers for other banks.[9]

The liquidity that central banks provided came originally from the money-center banks themselves. Those banks placed capital into the central bank so that there would be resources to draw upon in the event that they found themselves short of money to pay back their own depositors or other creditors. They also used the central bank to safeguard the deposits they held in reserve in case they faced a sudden 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 bank needing assistance. Like any other bank, a central bank made money by charging a higher effective rate of interest on the money it lent 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 the loans they made and in terms of the volatility in their access to credit (or deposits). The central banks operated as a kind of insurance agency, 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 competitive advantage over other financial institutions because they can access money more readily and more cheaply.

Policymakers also worried about the power that central bankers wielded. Because of the role it plays at the center of the financial system, the central bank has influence over the rates charged and paid by other institutions. More importantly, 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 its 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 clearing houses to provide emergency liquidity assistance. While this worked as a stopgap measure, it was not enough to stabilize the whole system.[10]

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 the central bank would be a public institution and its governors would be political appointees.[11]

The creation of the Federal Reserve System in the United States in 1913 took place prior to the Great Depression and well before the Keynesian revolution in economic policymaking. 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 the money supply. 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 rate. This means that the banking activities of the central bank can have a considerable influence on the level of economic activity across the whole economy (or 'macroeconomy') both directly, through the bank lending channel, and indirectly, through the relative rates of return on bank loans and deposits.[12]

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. This tied central banking directly to government policy. Moreover, because this nationalization of central banks 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 goals.

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.[13]

Over the longer term, however, the explicit political use of monetary policy started to cause 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. 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 prices. Consequently, central banks chipped away at their own perceived legitimacy and they also lost leverage over the marketplace's 'animal spirits.'[14]

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 international balance of payments. This tightening complicated the conduct of monetary policy and increased the likelihood of conflict 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.[15]

The consensus surrounding central bank independence emerged from the growing recognition of the problems associated with political business cycles and rational expectations. It also drew support from the economics of interdependence. The consensus view became that central banks should be insulated in their use of traditional banking instruments to achieve macroeconomic objectives. If possible, central bankers should be relieved as much as possible of responsibility for oversight of the financial system and decisions related to the solvency or liquidity of specific banks. Such connections cannot be severed entirely, of course. Central banks remained and remain the banks for other banks. But the political ring fencing of central bankers as macro-economic policymakers was an ideal type in terms of institutional design.[16]

The European Central Bank is a good illustration of this ideal type, 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 unique in this sense among the world's central banks, while also being 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. Moreover, these protections are practically written in stone, since European treaties can only be amended by unanimous accord of all EU member states. Finding consensus on how to amend the provisions related to the ECB would be almost impossible.[17]

How the Global Financial Crisis Reset the Clock

The heyday of central bank independence with a narrow focus on monetary policymaking ended in 2007. When the international financial system risked collapse during the global financial crisis, central bankers had no choice but to shift from macroeconomic policy to financial stability. For some, like the Bank of England, this meant retracing the long road to independence in the opposite direction. For others, like the ECB, it meant creating a whole new competence for financial supervision.

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. 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 was a separate institution that engaged in the regulation and supervision of banks and other financial institutions. When interbank markets seized up in August 2007 and again in September 2008, this bifurcated structure turned out to be problematic. The Bank of England and the Financial Services Authority 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 central to maintain public confidence. 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.[18]

The ECB followed a similar trajectory. When it started operating in 1998, its Governing Council had the opportunity to assume 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 national central banks that were actively engaged in financial supervision could not act as an effective lender of last resort because they could no longer print money. When the ECB finally moved decisively to stop the crisis, it not only committed to do act as the lender of last resort but also became a single supervisory mechanism for those financial institutions operating within the Eurozone.[19]

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). But 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, 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. They also suggest that central banks have two different modes of behavior – one that is better suited for 'normal' situations where central bankers can concentrate on steering the macroeconomy and another that is better suited for 'crisis' moments when central bankers lose leverage over the macroeconomy and must focus on stabilizing the financial system. Importantly, these two modes of operation have very different political implications.

The crucial link between these two modes of operation is called the 'monetary transmission mechanism.' This is that complex set of relationships that links the instruments controlled by the central bank in its role as banker for other banks to the performance of the macroeconomy. When that monetary transmission mechanism is broken because of the changes in behavior across the financial system in times of crisis, then the central bank can no longer influence the larger economy through its actions. Instead, central banks must focus on stabilizing the financial system and restoring normal financial relationships. They will also look for new ways to influence macroeconomic performance. However, when central bankers focus on restoring or working around the traditional monetary transmission mechanism, they quickly get into political trouble.

Winners and Losers

The trouble for central bankers is that they cannot restore the monetary transmission mechanism or work around a broken one without creating winners and losers that are readily apparent to everyone. Since creating winners and losers is an inherently political act, it is hard to justify why central bankers are independent from politics. Of course, the central bankers can respond that they need to restore the monetary transmission

mechanism so that they can get back to a situation where their particular expertise reigns supreme. They can also respond that picking winners and losers is necessary to achieve their price stability mandate. The problem is that such claims do not square with the original logic of making central bankers independent, which rested on the idea that no-one really knows who wins or loses in the short run and that central bankers offer a better long-term policy outcome. When the short-term winners and losers are obvious, people are likely to recall Keynes' famous dictum that 'in the long run we are all dead.'

This is especially problematic in times of ultra-low interest rates. Although there are always distributive consequences from setting interest rates, these were far larger after the financial crisis. Governments, for example, gained tremendously from reduced debt service costs and increased seigniorage profits sent back to their treasuries. Indeed, McKinsey calculated that the American, British, and Eurozone governments collectively benefited to the tune of $1.6 trillion. Households, however, saw their collective net interest income fall significantly. McKinsey calculated a collective loss of US, UK, and Eurozone household interest income in of $630 billion between 2007 and 2012. More importantly, 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 huge benefits, creating an inter-generational transfer of wealth. 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.[20]

The distributive consequences of saving some banks while winding up others is even easier to illustrate. Although central bankers like to describe such choices as a technical matter of liquidity and solvency, the general public sees the choice between bailing out and winding up banks as inherently political. Moreover, the situation is lose-lose for central bankers. When they bail out the banks, they are choosing Wall Street over Main Street; when they wind up the banks, they are wiping out the small investors. The central bank governors of Cyprus and Slovenia left office under death threats after facing that dilemma. Though the central bank governor of Italy held onto his office, the governing Democratic Party lost heavily at the polls in March 2018.

With these considerations in mind, the theoretical argument we present in figure 1 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).

The basic theoretical 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.

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

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.

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' (*Political Independence* in the upper-right quadrant, and *Political Accountability* in the 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.

How to Reform the Politics of Central Banking

What we need is a clear decision rule for elected politicians to use in determining when central bankers should be politically independent and when they should be made politically accountable. The theoretical point we made about distributive consequences is not going to work well in that context as it explains why central banks should move from one form of authorization to another. The test for how transparent or opaque the

consequences of central bank policy are is simply too vague to be useful in terms of institutional design. A narrow focus on the transparency or opacity of who wins and who loses is also unnecessary. Instead, politicians should focus on whether the monetary transmission mechanism is working properly and also whether central bankers are worried about the success or failure of individual financial institutions or the financial system as a whole.

When the monetary transmission mechanism that connects central banks to the wider economy is working properly and when the main financial stability risks are to individual banks, then the pre-crisis consensus on central bank independence still holds. There are many advantages to insulating central banks from political interference in the conduct of monetary policy in normal times. It is also easy for central bankers to distinguish between the goals of monetary policy and the requirements for overseeing the banking system when the economy is doing well.

Once the monetary transmission mechanism breaks down, however, and central bankers begin to focus more obviously on the stability of the financial system as a whole, then elected politicians should begin to assert a more active role in overseeing the activities of central bankers. This more active role does not have to be pre-emptive. Central bankers should have the liberty to respond to an emerging crisis in a timely manner. But the requirements for timeliness do not preclude the possibility that elected policy makers could be required to validate the actions of central bankers after the fact or that central bankers should be required to justify their actions before elected representatives, who are in turn empowered to overrule the actions of central bankers. Executive war powers and decree powers often function on the basis of such post-facto

validation by legislatures. There is no reason why central banking should be any different.

The crucial tests for when the monetary transmission mechanism is impaired or when systemic financial concerns predominate are already well-established in the central banking community. Indeed, many if not most of those tests were created in central banks and are carried out by the central bankers themselves as part of the justification for the unconventional use of traditional policy instruments. Hence the real innovation would be to take that justification to the next level. Central bankers are doing something unconventional when they respond to crisis; we do not violate the norm of central bank independence in advocating that central bankers should be subject to unconventional political oversight in such a context. On the contrary, the creation of this dual accountability structure is a necessary step in shoring up the democratic legitimacy of central bank independence.

NOTES

[1] This argument is also made by the former deputy governor of the Bank of England, Sir Paul Tucker, both in the context of central banks and more generally with respect to independent agencies in modern politics. See Paul Tucker, *Unelected Power* (Princeton: Princeton University Press, 2018).
[2] For Greenspan, see Sebastian Mallaby *The Man Who Knew Too Much* (New York: Penguin, 2016) pp. 379-81. See also Kathleen McNamara,'Rational Fictions: Central Bank Independence and the Logic of Social Delegation.' *West European Politics* 25:1 (January 2002) p. 50, and José Fernández-Albertos, 'The Politics of Central Bank Independence.' *Annual Review of Political Science* 18 (May 2015) pp. 217-237.
[3] Donald Trump's attack can be found at: Torry, H. (2016, September 26). 'Donald Trump Attacks Federal Reserve, Yellen During Debate.' *The Wall Street Journal.* Retrieved from https://www.wsj.com. The follow-up can be found at: Mui, Y. Q. (2016, September 12). 'Donald Trump says Federal Reserve Chair Janet Yellen 'should be ashamed of herself.'' *The Washington Post.* Retrieved from https://www.washingtonpost.com. Rees-Mogg's savaging of Carney can be found at: Rutter Pooley, C. (2017, October 25). 'Rees-Mogg brands Mark Carney 'enemy of Brexit'.' *The Financial Times.* Retrieved from https://www.ft.com. See also, 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.
[4] 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.
[5] For Demetriades, see Hadjipapas, A. & Hope, K. (2014, March 10). 'Cyprus central bank governor resigns.' *The Financial Times.* Retrieved from https://www.ft.com; On the departure of Cyprus's central-bank governor, see: 'A blow against independence.' (2014, March 10). *The Economist*. Retrieved from https://www.economist.com. For Jazbec, see: 'Slovenia central bank confirms investigation of Governor Jazbec.' (2016, July 7). *DW.* Retrieved from http://www.dw.com8.
[6] We say 'made it easier' because there are many who argue that central banks have always been scapegoated in times of crisis and so their political independence is a myth. See Sarah Binder and Mark Spindel, *The Myth of Independence* (Princeton: Princeton University Press, 2017).
[7] Martin Shubik, *The Theory of Money and Financial Institutions, Volume 3* (Cambridge: MIT Press, 2010) pp. 255-259.
[8] For the argument about stakeholder capture, see Lawrence Jacobs and Desmond King, *Fed Power: How Finance Wins* (New York: Oxford University Press, 2016). For the populist threat, see Jacqueline Best, 'Bring Politics Back to Monetary Policy,' *Foreign Affairs,* Snapshot (6 December 2017).
[9] Mervyn King, *The End of Alchemy* (New York: W.W. Norton, 2016), chapter 5.
[10] Robert Bruner and Sean Carr, *The Panic of 1907* (Hoboken, NJ: John Wiley & Sons, Inc., 2007).
[11] Roger Lowenstein, *America's Bank* (New York: Penguin Press, 2015).
[12] Robert Skidelsky, *John Maynard Keynes: They Economist as Savior, 1920-1937* (New York: Penguin, 1992), pp. 556-564.
[13] Perry Mehrling, *The New Lombard Street* (Princeton: Princeton University Press, 2011), pp. 36-46; Alberto Alesina and Andrea Stella, 'The Politics of Monetary Policy,' *Handbook of Monetary Economics, Vol. 3* (Amsterdam: Elsevier, 2010), pp. 1001-1054.
[14] For the 'stop-go' pattern of economic policy making, see Samuel Brittan, *Steering the Economy* (Harmondsworth: Penguin, 1970); Stephen Blank, 'Britain: The Politics of Foreign Economic Policy, the Domestic Economy, and the Problem of Pluralistic Stagnation,' *International Organization* 31:4 (Autumn 1977) pp. 673-721. For the problems of legitimacy and effectiveness, see Alberto Alesina, Nouriel Roubini and Gerald Cohen, *Political Cycles and the Macroeconomy* (Cambridge: MIT Press, 1997).
[15] Ethan Kapstein, *Governing the Global Economy* (Cambridge: Harvard University Press, 1994).
[16] See, for example, Finn Kydland and Edward Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans,' *Journal of Political Economy* 85:3 (June, 1977) pp. 473-491.
[17] Matt Marshall, *The Bank* (London: Random House, 1999); David Howarth and Peter Loedel, *The European Central Bank* (London: Palgrave, 2003).
[18] Adair Turner, *Between Debt and the Devil* (Princeton: Princeton University Press, 2016), p. 29); Arup Daripa, Sandeep Kapur, and Stephen Wright, 'Labour's Record on Financial Regulation,' *Oxford Review of Economic Policy* 29:1 (Spring 2013) pp. 71-94; Alasdair Darling, *Back from the Brink* (London: Atlantic Books, 2011), chapters 1 and 5.

[19] Paul De Grauwe. *The Economics of Monetary Union, Eleventh Edition* (Oxford: Oxford University Press. 2016), chapter 11.

[20] McKinsey Global Institute, 'QE and ultra-low interest rates: Distributional effects and risks,' *Discussion paper* (Paris: McKinsey Global Institute, 2013). Online available at: https://www.mckinsey.com/global-themes/employment-and-growth/qe-and-ultra-low-interest-rates-distributional-effects-and-risks.