Central bank independence: economic common sense and economic device

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Central bank independence, economics and economic experts

It is economic common sense that a high level of central bank independence – best coupled with an explicit mandate for price stability – is an important institutional device for maintaining that stability (for example, Eijffinger and De Haan 1996, 1). However, the idea that monetary policy works best when it is delegated to independent authorities averse to inflation, out of reach of politicians' influence, is historically contingent and part of a more or less neoliberal economic policy paradigm that became dominant over the course of the 1980s and the 1990s (Hall 1993; Blyth 2002). This ideational historical background is arguably particularly important for the establishment of the European Economic and Monetary Union (EMU) (McNamara 1998), which is designed around the European Central Bank (ECB), often perceived as being the most independent central bank in the world (Dincer and Eichengreen 2014).

In the European context, central bank independence became part of a flawed ideational consensus that continues to guide Europe's "self-defeating" (Matthijs and Blyth 2017) macroeconomic governance, with monetary and fiscal policy pushing in opposite directions. Today, a very expansive monetary policy conducted by the ECB is accompanied by very restrictive fiscal policy measures conducted by governments of Member States, with the latter constrained by binding European macroeconomic policy rules, such as the Two Pack and Six Pack reforms and the Fiscal Compact. The severe consequences of this policy mix probably deepen the divide between Member States of the European Economic and Monetary Union (EMU) due to divergent macroeconomic effects for northern European creditor states and the southern periphery (Heidebrecht and Kaeding 2018), as highlighted by key indicators such as youth unemployment. But it also has more direct political consequences, as indicated by the diverging votes for more radical right-wing parties in the European core and for more left-leaning parties on the European periphery (Kriesi 2016).

From the perspective proposed here, the problem with undeliberated central bank independence, besides its role in producing economic outcomes that are likely to benefit the winners of a low-inflation environment (Pixley et al. 2013), is that it serves as a powerful device for maintaining the ideational background of a flawed macroeconomic policy mix. This is an example of the performative influence of economic ideas developed in economics as a discipline: in other words, economic ideas and transferrable techniques can reformat and reorganize the phenomena its models in principle claim to describe (Callon 1998; MacKenzie and Millo 2003). The performative effects of economics are realized by economic professionals and popularizers who disseminate economic ideas – such as central bank independence – in the world. Ironically, some of the most influential economic experts are arguably – again – central bankers, and that is why this article is about their independent position and their expertise. They not only play an important role in the current macroeconomic policy mix, but in the case of the European Union (EU) they shaped, as experts, the design of EMU around the extremely independent ECB (for example, Verdun 1999).

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Central bank independence as a neoliberal idea

The assumption that central bank independence is necessary to counteract inflationary biases rests on a number of theoretical explanations. In a nutshell, the basic argument is that politicians are likely to have incentives to use monetary policy to stimulate the economy and boost output in the short run for electoral reasons, regardless of whether these policies are likely to produce economic trouble in the longer run. Therefore, monetary policy should be transferred to independent bureaucrats in central banks, irrespective of the potentially unequal political-economic effects such delegation might entail.

The intellectual history of this fairly technocratic concept of central bank independence goes back to such axiomatic economic assumptions as the Philips curve (Phillips 1958), which assumes that lower unemployment will lead to higher rates of inflation, and vice versa. This inverse relationship, theoretically, allows policymakers to use monetary policy to reduce unemployment by effecting a monetary stimulus. Hence, the Phillips curve was integrated into Keynesian macroeconomic policymaking in the Bretton Woods era. However, the possibility of rational steering of a capitalist economy was prominently rejected as too good to be true. Academic criticism was early raised from Chicago, among others by such prominent figures as Milton Friedman (1968). These proponents pointed to the difference between monetary and real aggregates, arguing that if economic agents took the view that new nominal wealth created through monetary stimulus does not represent an increase in real wealth, they would adjust their expectations accordingly, so that the economy would end up in a situation with high unemployment and high inflation. The high inflation/high unemployment rates of the 1970s seemed to confirm the monetarist line.

Alongside these developments, the political weather also changed, favoring a more monetarist template over the late 1970s and 1980s, with Keynesian macroeconomics falling into abeyance. In this intellectual climate, key politicians such as Ronald Reagan took the view that "government is not the solution to our problems; government is the problem" (Reagan 1981). British prime minister Margaret Thatcher also promoted an individualist thinking, asserting that "there is no such thing as society" (1987). There was a paradigm shift of key assumptions about the economy, and a fundamental change in the main goals of macroeconomic policy (Widmaier 2016). While Keynesian analysis treated the private economy as inherently unstable and in need of fiscal adjustment, monetarists saw the private economy as stable and discretionary public policy as an impediment to efficient economic development. This was coupled with a change in the main goals of policymaking: while inflation replaced unemployment as its main concern, macroeconomic efforts to reduce unemployment were sidelined in favor of balanced budgets and direct tax reduction (Hall 1993, 284).

In this looming neoliberal climate, the economy was put before the polity, markets were presented as a neutral solution to economic problems, and the state was theorized as an obstacle to economic success and individual freedom (Amable 2011). In this context, the idea of delegating monetary policy away from public institutions, overseen by elected politicians, towards technocratic bureaucrats in independent central banks became appealing. The economic idea of central bank independence became so powerful that, even in very distinct macroeconomic and institutional environments central banks became independent institutions all over the world, especially in the 1980s and 1990s (McNamara 2002; Marcussen 2005).

This was also the period in which EMU was designed. EMU is clearly the product of the prevailing ideational environment in its market-based design, with the ECB – the most independent central bank in the world – at its core. The goal was to shield the only supranational central bank in the world from the influence of elected politicians, and in order to support market-based macroeconomic coordination in EMU, the ECB became solely responsible for price stability (not full employment, TFEU Art. 127) and was legally prohibited from monetary financing (TFEU Art. 123). This market-based approach was further enforced through the institutionalization of the so-called "no bailout clause" (TFEU Art. 125), accompanied by the Stability and Growth Pact. Overall, this regime was designed to ensure macroeconomic stability, interpreted primarily as "sound (public) finances", through the disciplinary power of (financial) markets (Commission of the EC 1993; Yiangou et al. 2013).

The European Central Bank is independent – but of what?

Although the ECB is an increasingly important actor at center stage of EMU market-based governance, the central bank's independence from (direct) political influence remains unchallenged. However, the central bank's policymaking instruments are significantly dependent on financial markets (Braun 2018). As Greta Krippner has shown with regard to the US Federal Reserve, the reliance of government entities on financial markets is typical of our neoliberal and highly financialized era in which fiscally constrained governments seek ways to govern the economy (Krippner 2007, 506). However, especially in the case of EMU, this special kind of governability (for a discussion see Braun 2014) through financial markets has come at a price: in contrast to other currency areas, such as the United States and the United Kingdom, in EMU monetary policy is delegated to supranational technocrats, while basically all other macroeconomic policy areas remain at the national level. While the transfer of monetary policy to the supranational ECB can be interpreted as a success in terms of price stability, the period after the financial and economic crisis in particular revealed weaknesses in EMU's asymmetric design. In effect, EMU's main problem was its simultaneous exposure to two complementary kinds of problem, both related to issues of central bank independence.

Already relatively weak public finances worsened due to the financial crisis, in which policymakers took the view that they had to support financial markets by socializing losses and had little room to reverse the privatization of previous profits. The weakening of public finances, together with the costs of financial market support induced a "doom-loop" between sovereign debt and financial stability, especially in periphery Member States' banking systems. Although several Member States initially reacted to the crisis with a more Keynesian policy response (Blyth 2013; Vail 2014), their weak public finances and constraining EMU governance rules impeded them from going further down that road in the longer run. EMU restrictions left Member States without the capacity for significant fiscal maneuvers, not to mention bereft of national monetary policy instruments for stabilizing their economies. This subsequently pushed several economies into recession (for a similar discussion see, for example, De Grauwe 2013). The persistent sovereign–banks doom-loop was further exacerbated by the denominator effects of shrinking economies on public debt ratios, which culminated in financial market concerns about EMU concord and rising bond-spreads due to perceived re-denomination risks.

EMU's vulnerability to re-denomination points not only to issues concerning relations between sovereign states and financial markets, but also to the persistence of a politico-economic power vacuum at its core. The problem was that, confronted with the effects of the financial crisis, EMU was exposed to potential doubts on the part of key political actors and financial markets, which diagnosed parallels with the gold standard and the Bretton Woods system, both of which proved to be reversible (Dyson 2014, 586). These concerns were present in the euro zone because, in contrast to other currency areas such as the United States or the United Kingdom, EMU lacks a supranational executive that could make credible contingent commitments to take exceptional measures backing monetary union, like politicians backing the – now too independent – central bank by acting ultimately as lender of last resort in the euro zone (Dyson 2013). Although the economic struggle of many EMU Member States reflects developments arising from the so-called global financial crisis, its European features are also linked to institutional design failures of EMU. European policymakers' belief in market "rationality" and institutional reliance on financial markets' disciplinary power – exacerbated by the high degree of central bank independence – turned out to be misguided.

Unchanging economic expertise

Anyone seeking empirical disconfirmation of neoliberal economic expertise could hardly do better than the severe developments that arose from the so-called "euro crisis" (see Blyth 2013, 208 for a similar argument). However, the expertise of influential European monetary policymakers remained broadly the same.[1] European central banking remains largely the preserve of middle-aged men (only four women have served on the ECB's Governing Council, out of 70 persons), who are on average 57 years old at the time of their first appointment as a national central bank governor and approximately 55 when appointed to the ECB's Executive Board. More than 80 percent of them hold their highest degree in economics (taking into account the French École nationale d'administration), followed by degrees in law, especially among central bankers from Germany and Austria, with close to 50 percent holding PhDs in economics. Around one-third received their degree from a university in a foreign country and one-third received their degree from an Anglo-American university. Ninety percent of all degrees received abroad are from Anglo-American universities, which reflects the importance of a particular Anglo-American tradition of economics among European policymakers.

In order to compare developments in expertise over time, I calculated a single number allowing for aggregation and thus for cross-time and cross-country comparisons by using a new data set on all European central bankers who have served in a monetary policymaking position on the ECB Governing Council since its establishment. I refer to a method proposed by Christopher Adolph (2013, especially p. 70), whose approach, based on regression analysis, allows the construction of an index of what he labels "central banker career conservatism". Accordingly, I sum the past career experience of individuals with what he found to be inflation-reducing career expertise (finance ministry and finance) and subtract experience in inflation-increasing career expertise (central bank and government bureaucracy excluding the finance ministry), while excluding what he found to be neutral categories (all other categories), on a monthly basis for all individuals. To aggregate this individual data into a single number for the ECB's Governing Council I take the variable's median, which is in line with research suggesting that it is the preferences of the median central bank board member that matter (Chapell et al. 2004; Hix et al. 2010). The resulting index ranges from CBCC = –1 (all "liberal" experience) to CBCC = 1 (all "conservative" experience). Based on the underlying assumptions of the approach, lower numbers indicate a career composition that favors economic growth over low inflation, while higher numbers indicate a more finance-friendly expertise composition prioritizing price stability.

The following figures present the development of the expertise composition of the ECB's Governing Council by presenting the median CBCC score on a monthly basis. Figure 1 shows the CBCC results (on the left axis) in relation to the development of the ECB's key interest rate (main refinancing operations, scaled in percentage points on the right axis), because lower CBCC scores should lead us to expect monetary policymakers to set lower interest rates, and vice versa. Figure 2 presents the same results of the CBCC, this time in relation to the development of the ECB's balance sheet, which is scaled on the right axis in trillions of euros, allowing for inferences concerning the relationship of the changing composition of European central bankers' expertise and unconventional monetary policy. Note that in Figure 2 the CBCC index is inverted and scaled on the left axis, due to the assumed inverted relationship between the variable and the ECB's balance sheet expansion.

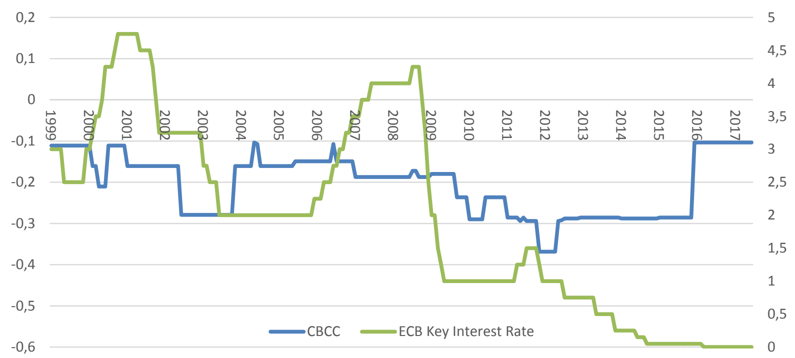

Figure 1. Central banker indices and key interest rate

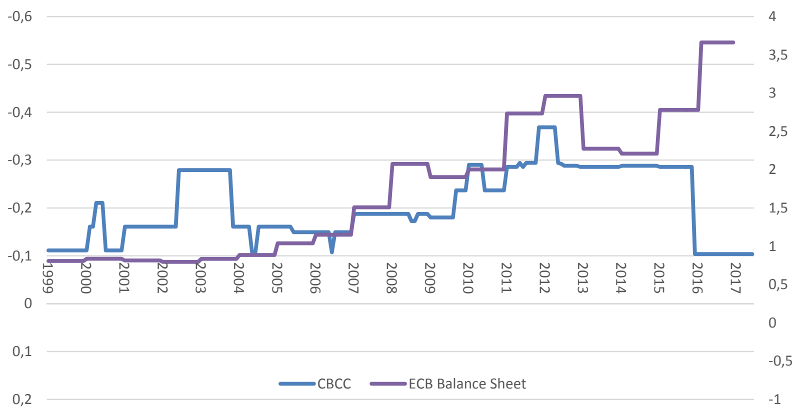

Figure 2. Central banker indices and ECB balance sheet

The data show that the expertise composition of the ECB Governing Council was relatively stable between 1999 and 2008–2009, with a more "liberal" deviation in 2002 and 2003. It again became more liberal subsequent to the financial crisis until the end of 2015; from that time on, the score for the ECB's Governing Council rises above even its highest pre-crisis level. The Governing Council started with a relatively conservative expertise composition, became more liberal especially in the aftermath of the financial crisis and reached its most conservative composition in late 2015, so that its members have a significantly more finance-friendly expertise composition.

In general, it is difficult to construct causal relations between Governing Council expertise composition and European monetary policy. Based on the data discussed here, I cannot substantiate – in contrast to Adolph's 2013 findings – a strong relationship between Governing Council composition and monetary policy, given their divergence in terms of developments of the key interest rate and use of the ECB's balance sheet as a proxy for unconventional monetary policy. While the relatively more liberal composition of the ECB's Governing Council between 2009 and 2015 might explain the ECB's use of unconventional monetary policy instruments and very low interest rates, I cannot report a strong relationship with interest rate setting or asset purchases over the whole period. Especially after Mario Draghi's (2012) prominent announcement in 2012 that he would "do whatever it takes" (to defend the euro), the relationship between expertise and monetary policy becomes rather arbitrary, and the variable cannot explain in particular both the close-to-zero interest rates and the ECB's balance sheet expansion since 2015.[2] The results, however, do allow me to report in cross-time comparison – despite short divergences in 2002–2003 and between 2011 and 2015 – a trend towards continuity rather than a change in the expertise composition of the ECB's Governing Council over time.

Central bank independence in political time

Given the divergent and severe economic consequences of macroeconomic policy within EMU, the continuity in expertise composition among some of its key economic experts is fairly surprising. However, it also reflects a "new normal" regime of economic policymaking, as nowadays economies are dependent on monetary stimulus. The ECB in particular is part of the specifically flawed macroeconomic policy consensus institutionalized in EMU, in which, since the financial crisis, European central bankers may pursue expansionary monetary policy, whatever their expertise composition. While monetary policy has to be expansionary, the dominant economic policy approach in EMU shifted from a short period of Keynesian measures towards more neoliberal and austerity-oriented approaches. Monetary policymakers, in turn, have to pursue massive expansionary monetary policy measures for reasons of financial stability, usually not despite, but because of the dominant austerity regime in EMU that leads to the appointment of more finance-friendly experts in the first place.

All this gives us reason to reconsider the role of independent central banks. Why does a European coalition of political actors support continuity in finance-friendly independent expertise, despite distinct and divergent economic developments? Who benefits from monetary stimulus? The ECB's market-based governance approach might give cause for concern. As Benjamin Braun (2018) rightly notes, the entanglement between technocrats in the central banks and financial sector counterparties boosts the political power of the latter. On one hand, my biographical data on the career paths of central bankers do not indicate on average – compared with other career experience – a strong or growing importance of both revolving doors and career backgrounds in the financial sector over time. On the other hand, the ECB reached its most finance-friendly stance at the end of 2015 and it is striking that I have to report the total absence of any experience with labor organizations among European central bankers since the ECB's establishment in 1999.

Central bank independence plays a prominent role in this story. The rise of neoliberal doctrine over the 1970s and 1980s made it possible to present central bank independence as both globally transferable (considering mostly differences in degree and neglecting differences in kind of political economic constellations in place and time) and transformative, thereby allowing for its transformation into a technology of political and bureaucratic power independent of national contexts (this is in line with arguments developed by Fourcade 2006, 152). The crucial case is arguably the establishment of EMU with the extremely independent ECB, despite all – also in its historical context – the well-known caveats in terms of politics, economics, accountability and legitimacy that this entailed. Further, in EMU, central bank independence was coupled with additional and corresponding institutional devices. According to the Protocol on the Statute of the ESCB and the ECB (Art. 11.2), ECB members should be "appointed […] from among persons of recognized standing and professional experience in monetary or banking matters" (Protocol on the Statute of the ESCB and the ECB, Art. 11.2).

This institutionalized form of central bank independence in EMU has maintained the reproduction of the composition of expertise among European monetary policymakers by means of formal and informal selection rules for individuals as the carriers of specific kinds of economic ideas. From this perspective, what makes central bank independence such a powerful economic device is the ideas' inherent performative power. In other words, it comes with a blueprint for institutional reform that shapes, on one hand, the expectations of economic actors, thus rendering institutional revision costly, while, on the other hand, central bank independence can consolidate neoliberal macroeconomic ideas in powerful independent institutions, thereby promoting the resilience of central components of this paradigm.

Economics presents central banking as a highly technical issue, which has tended to encourage those outside the discipline to treat monetary policy as something requiring the intervention of a kind of priesthood or, depending on one's perspective, in more Faustian terms as a kind of alchemy (for example, Greider 1989; Irwin 2012). However, recent developments might challenge this conviction. The key argument for central bank independence is its alleged effect on reducing inflation – but inflation is nowadays typically considered to be too low, so this argument can retaliate. Furthermore, given the ever-increasing competences delegated to independent central banks, it is clearer today than prior to the crisis that central banking is about more than setting interest rates in accordance with technocratic considerations. Most of what is new is political in nature and has to be coordinated with other policy areas. Discussing central bank independence therefore entails an even broader debate on macroeconomic policy. This is true, ironically, especially in context of EMU, given the ECB's increasing competences and its prominent role in EMU's rather obviously flawed macroeconomic policy mix. Nevertheless, while it is possible in principle to imagine devices such as inflation targets to be set by politically accountable officials, who could also establish the frameworks in which central banks should act, to date central bank independence has proved to be a powerful economic device for the purpose of perpetuating a rather technocratic economic common sense.

Endnotes

1 In this section we discuss empirical insights that are discussed further in Heidebrecht 2018, for example, with regard to differences between the European and Member State levels.

2 This could be due to the applied coding of the variable in accordance with Adolph's results – which somehow counterintuitively interprets career experience in institutions such as Deutsche Bundesbank as having a liberalizing effect.

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The legal independence of central banks has increased markedly since the 1980s, while the rise in transparency since the late 1990s has been less impressive. Exploiting the time dimension of our data to eliminate country fixed effects and using instrumental variable estimation to overcome endogeneity concerns, we present robust evidence that greater CBI is associated with lower inflation.Â Abstract. Over the past two decades, the pace of central bank reforms in terms of institutional independence and transparency has been particularly brisk. This paper examines the current level of central bank independence (CBI) and transparency in a broad sample of countries using newly constructed measures, and looks at the evolution in both measures from an earlier time period. Central Bank Independence, Accountability and Transparency: The Case of Ukraine. Gerhard SchwÃ¶diauer â€¢ Vladislav Komarov â€¢ Iryna Akimova. FEMM Working Paper Series, No. 30, December 2006.Â 1 Gerhard SchwÃ¶diauer: Professor of Economics, Faculty of Economics and Management, Otto-von-Guericke University Magdeburg, P. O. Box 4120, 39106 Magdeburg, Germany; eMail: schwoediauer@ww.uni-magdeburg.de 2 Vladislav Komarov: Economist, Bureau of Economics and Social Technology (BEST), 3a Desyatinnaya Str, Kiev 01025, Ukraine; eMail: komarov@best-ltd.com.ua 3 Iryna Akimova: Director, BEST, 3a Desyatinnaya.Â Central bank independence (CBI) is associated with benefits that are described by Grilli... Various indices of central bank independence have been compiled and used in empirical work to see how closely independence is related to such important performance characteristics of an economy as the rate of inflation, the growth of output, investment, and real interest rates. For industrial countries, central bank independence indices embodying definitions (2) and (3) appear to be closely related to low inflation and low variability of inflation without having any effect on output and its variability, investment, and real interest rates. In particular, factor (2) seems to be driving the results, and the various measures of factor (1) have a negligible effect, a finding that the authors tend to neglect.