Answer to the people, not greedy elites

By Mark Weisbrot
February 15, 2010 – *The Guardian*

The president of Argentina, Cristina Fernández, recently fired the head of the central bank, Martín Redrado, when he rejected the government's plan to use $6.6bn of international reserves to pay off debt.

The domestic and international press response was overwhelmingly negative, with complaints that this would "kill central bank independence".

Leaving aside the question of whether it is a good idea to use these reserves to pay off international creditors – something that perhaps only the future will tell – is there a good reason why central banks should be "independent" of their elected governments?

The business press, which has the support of the vast majority of economists on this question, thinks there is. The basic argument is that if the central bank is not able to determine monetary policy free of "political considerations", then politicians will force the bank to be "too loose" with monetary policy and the country will end up with dangerously high levels of inflation.

This would seem to be a tough argument to swallow for anyone who believes in representative democracy. Fiscal policy – the government's decisions with regard to spending and taxation – is also a major determinant of economic activity. There are important tradeoffs that affect the livelihood, income and employment of most of the population. Yet in the US, these decisions are entrusted to our elected representatives in Congress, together with the executive.

There is no obvious reason why monetary policy – the central bank's decisions with regard to interest rates and money supply – is so different from other major policy decisions that it should be specially insulated from the electorate. There is no valid analogy, for example, to the independence of the judiciary – which is based on a theory of separation of powers, or checks and balances, ostensibly to limit abuses of power or infringements on civil rights and liberties.

The argument for an independent central bank is more purely an elitist argument. It really boils down to the idea that monetary policy is too important for the "uneducated" masses to have an influence over it.

Ironically, the reality is quite the opposite: monetary policy is an area where pressure from the majority is sorely needed. There is a grand conflict of interest between the financial sector and the rest of society. This has become more painfully obvious in the last two years, as the unmitigated greed of this bloated collection of special interests collapsed the US economy and dragged a good part of the world down with it. Our conception of central bank "independence" is so extreme that Ben Bernanke, who was a Federal Reserve governor since 2002 and chairman since 2006, could not even be denied reappointment – despite his enormous share of responsibility for an economic train wreck that caused millions of people to lose their jobs and homes. He sat on his hands while an $8tn housing bubble accumulated, thus guaranteeing the collapse that followed. But our financial sector is so politically powerful that even this minimal level of government oversight – refusing to reward one of the worst failures imaginable – was seen as too offensive to the financial markets.

But even in normal times, the financial sector generally prefers higher interest rates and lower employment than the vast majority of citizens would choose. Most people want the economy to be closer to full employment, and appreciate rising wages. A central bank that is "independent" of the public's needs and wants, and caters primarily to those of the financial sector, is

therefore going to cause a lot of needless suffering.

For example, prior to the late 1990s, the Federal Reserve subscribed to a theory called the Nairu (non-accelerating inflation rate of unemployment). The Fed would tend to raise interest rates when unemployment fell below a presumed Nairu, thus slowing the economy, raising the unemployment rate, and reducing the growth of wages – on the theory that this was necessary to keep inflation from getting out of control. Before the 1990s, the Nairu for the US economy was generally considered to be between 5.8% and 6.6%. The empirical evidence for this theory was always very weak. After unemployment fell below 4.5% in 1997, and inflation still did not accelerate, Fed chair Alan Greenspan finally realised that this theory was wrong – and eventually abandoned it.

And now, International Monetary Fund (IMF) chief economist Oliver Blanchard, with a new paper Rethinking Macroeconomic Policy (pdf), offers that the preferred 2% inflation target of most central banks may be too low. He asks whether 4% would be better. The paper questions other central bank orthodoxies and is likely to cause a bit of a stir in the economics profession.

The problem of "independent" central banks is even more serious for low- and middle-income countries than for the rich countries, since they need more co-operation from the central bank with regard to development policy.

In Argentina's case, it is questionable whether the country could have even begun the remarkable economic recovery that started in 2002, in which the economy grew more than 60% in six years, if its central bank had the kind of independence that the US Federal Reserve has. One of the government's most important economic policies required the central bank to target a stable and competitive real exchange rate, something that would be anathema to most central bankers. (Interestingly, Blanchard also now suggests that central banks in emerging market economies may have good reason to pay attention to exchange rates and try to reduce their volatility.)

Here in the United States, the Federal Reserve's Federal Open Market Committee meets every six weeks to set policy, including short-term interest rates. Five of the 12 voting members are regional Fed presidents, chosen by local boards where the banking industry is heavily represented. The CEO of JP Morgan Chase sits on the board of the powerful New York Fed.

As sometimes happens, the business press – with the help of much of the economics profession – has turned reality on its head. The problem is not that central banks need to be "independent" of political influence – rather they need to be held accountable to the public instead of answering to the all-powerful financial sector.