

Some Heretical Thoughts on Central Bank Independence

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Shadow Open Market Committee
Princeton Club, New York City, New York
September 27, 2019

E21 Manhattan
Institute

ECONOMIC POLICIES FOR THE 21ST CENTURY

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Prepared for SOMC meeting, September 27, 2019, New York City

1. Introduction and Summary

What are the economic, legal and political underpinnings for independent central banks in democratic societies? And what objectives, responsibilities and practices will allow central banks to best serve society while maintaining support for continued independence? The long-running debate over these questions has been reinvigorated by the extraordinary actions and expansion of central bank power on both sides of the Atlantic in the aftermath of the 2008 financial crisis, and the sharp differences of opinion on the effectiveness and advisability of those developments.

The aim of this short note is to begin to explore several fundamental issues that seem to me critical to the independence question, but that tend to be glossed over or dismissed out of hand. To some extent, it can be read as a critical review of some of the propositions put forth by Paul Tucker in his recent and excellent book, *Unelected Power*, and also a reexamination of some of the precepts espoused by my SOMC colleagues and other prominent commentators on these issues.

My concerns with omissions in conventional narrative(s) rest on several propositions:

- The case for independent central banks applies equally well to a number of other critical government functions.
- The distinction between monetary and fiscal policy is fuzzy, more semantic than functional. In principle, the economic effects of most monetary policies could be replicated through tax and transfer policies.
- Central bank policies—conventional, unconventional and regulatory--have first order distributional side effects.

- The state of knowledge about the effects of central bank policies on the macro-economy and financial markets supports only very limited delegation to experts on these matters.

Taken together, these present a challenge to what might be described as the doctrine of monetary exceptionalism—the belief that the advantages of insulating monetary policy from the political realm are unquestionably so large that it is worth skirting the normal channels of democratic oversight in favor of delegating to technocrats. Because I believe the above propositions are true (for reasons very briefly outlined below), I am doubtful that proponents of this doctrine will be able to shield central banks from a rapid loss of independence when inevitable future missteps shake the current political consensus that a high level of autonomy is warranted.

None of this is to deny the merits of constrained independence as conventionally enumerated, particularly for price level stability.¹ Rather, it is to suggest that if transparency by independent central banks is a prerequisite for legitimacy in a democratic society, and if central bankers seek to maintain independence, then they should proactively address the fiscal and distributional consequences of their actions to a much greater extent than they do currently. That includes developing standards for measuring and communicating those consequences to the public.

Further, I believe that when central bank policies have significant distributional and fiscal side effects, that it is appropriate for the political process to reinsert itself. That might entail instituting other policies to offset the side effects, or constraining the policy choices of central bankers. Central banks will naturally fight such interventions and strive to preserve operating flexibility. They also might voluntarily adopt policies perceived to be more consistent with the public's sense of distributional fairness. While unlikely to produce first-best outcomes, on the whole this seems a healthy dynamic, and one that perhaps will help sustain the legitimacy of independent central banks over the long run.

¹ The complicated question of to what extent financial stability and bank regulatory powers should also be delegated to independent central banks also deserve examination relative to these propositions. Here however, the emphasis is on policies directly at the price level and employment, not on regulation.