The Missing Politics of Central Banks

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For a long time after the seminal works of Kydland and Prescott (1977) and Barro and Gordon (1983), the tendency of the macroeconomics literature on monetary policy and central banking was to deny that monetary policy could have durable real effects on the economy, either in the aggregate or distributionally. Instead, the monetary policy literature expended enormous effort on the question of whether political control of monetary policy could be made "time consistent." The basic problem is that political leaders facing close elections may be tempted to use monetary policy to stimulate the economy and improve their chance of reelection. Knowing this, economic actors will price in future inflation and offset any gains that such policy "surprises" could generate. Political leaders thus would be better off if they could constrain themselves not to give in to monetary policy temptation—and the idea that all central banks should be independent of elected control was born (Rogoff 1985). Driven by this idea, scholars focused attention on (1) technical issues of determining optimal monetary policies; and (2) insulating policy makers from elected governments so they could get on with the business of implementing the same. Although undoubtedly clever and staggeringly influential, this approach generated two blind spots with serious consequences for real-world policy.

BLIND SPOT 1: CENTRAL BANKERS ARE NOT NEUTRAL

The presumption that central bankers were neutral technocrats without interests of their own led to a preoccupation with institutional design—especially central bank independence—but little or no systematic attention to variation in the agents who assume the heightened powers of the independent central banker. For political scientists, this oversight should be doubly puzzling. It is otherwise difficult to find scholarship in political science or economics that assumes a class of political actors to be disinterested wise men whose personal motivations need not be examined. Yet, if central bank independence has any effect, it is only because political autonomy enables actors to make choices according to their preferences: institutions matter because of the way they channel interests. If we want to know how institutions that empower central bankers shape economic performance, we first must understand how those institutions interact with the interests of the central bank agents who inhabit them (Adolph 2013).

In reality, central bankers setting monetary policy do vary in their preferences, their behavior, and their policy outputs. They also vary in their pre–central-bank careers: some—but far from all—previously worked for private financial firms, many others worked elsewhere in the bureaucracy, and still others worked as academic economists. In *Bankers, Bureaucrats, and Central Bank Politics: The Myth of Neutrality* (2013), I argued that—based on a broad dataset of central bankers from the developed and developing worlds—prior careers provide important clues to central banker preferences. Central banks whose monetary-policy boards are stacked with former financiers deliver lower inflation and—in economies with weak labor movements such as the United States and the United Kingdom—higher unemployment. Central banks staffed by veterans of other public agencies tend to produce higher inflation but, in places such as the United States and the United Kingdom, lower unemployment. The reasons that past careers influence central bankers' policy choices are twofold: (1) past careers socialize central bankers to value the outputs of monetary policy differently, with private bankers giving much higher weight to keeping inflation low; and (2) central bankers often go on to hold either lucrative posts in finance or elite posts in government, but whether they succeed in doing so depends on previous career connections to these "shadow principals" and maintaining central bank policies that keep shadow principals happy.

Opening up the discussion of monetary policy to include the influence of shadow principals in banking and government reveals that there is no genuine way to insulate monetary policy or any other function of governance from outside influence. Central bankers with greater legal independence are more powerful agents. It follows that monetary policies selected by independent central banks are more subject to influences on monetary agents' preferences—especially influence from shadow principals, as cross-national evidence shows (Adolph 2013). Particularly when a central bank is "independent," it matters for the economy who is chosen to sit on its board: different agents make systematically distinct choices with consequences on monetary policy for citizens and for banks. Furthermore, to the extent that a central bank such as the Federal Reserve has long operated under pressure to please a major shadow principal—that is, the financial sector—the potential variation of central banker types under a different institutional arrangement (say, one more responsive to democratic politics) is greater still than what can be observed in recent history. In other words, central banker preferences could matter even more than they already do if they cease to be overlooked.

BLIND SPOT 2: MONETARY POLICY IS NOT NEUTRAL

The second blind spot comes from economists' preference for relatively stark political economy models in which monetary policy cannot be exploited to stimulate the economy in the long run. This led macroeconomists to overlook the differing consequences of conservative monetary policy on real economic performance across different types of economies. The point is contested, but there is evidence that even

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in a rational expectations framework, the negative impact of hawkish central banks on unemployment and growth is stronger in some economies than in others (Cukierman and Lippi 1999; Hall and Franzese 1998; Iversen 1999). This goes some way to explaining the difficulties that the European Central Bank (ECB) has faced in expanding German-style monetary policy to a Eurozone composed of economies with diverse labor institutions, industrial structures, and business cycles (Adolph 2013).

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However, the real consequences of monetary policy go beyond the ill-considered design of the ECB. As Jacobs and King (2016) argued in their provocative book *Fed Power: How Finance Wins* and in their contribution to this symposium, generations of scholars have mostly ignored the distributional consequences of monetary policy implementation, and in turn, inequality researchers have ignored the role of central banks and monetary policy. In 1998, blindness about these linkages helped the Fed to create, virtually overnight, a raft of new policy instruments for asset purchases—a decision with massive distributional consequences—without the kind of resistance and controversy that would confront any legislation to create similarly sweeping changes in the economy's winners and losers through fiscal policy.

Bringing the Fed and other central banks back into the broader political economy conversation is long overdue. It is time to subject central bankers to the same sort of scrutiny that we apply to judges and senators—and vice versa, because the promise of future private sector jobs from shadow principals can also overwhelm the electoral connection. But because central banks have been peripheral to mainstream political science for so long, there are overlooked political parallels to commonplace economic concepts relevant to understanding these actors. This article describes three such ideas: political multiplier effects, missing critical junctures, and systemic political risk.

POLITICAL MULTIPLIER EFFECTS AND THE BENEFICIARIES OF POSTCRISIS MONETARY POLICY

Jacobs and King (2016) make a strong case that the mechanisms of quantitative easing (QE) specifically and the support of central banks for financialization generally represent a policy bias toward greater inequality. For example, they contrasted the Fed's efforts to protect bank assets with its lack of effort to protect the assets of homeowners facing foreclosure. To highlight the salience of this comparison for broader debates on inequality, consider the disparate racial impact of this choice. In the United States, from 2007 to 2013, the median wealth of white households diminished from $192,500 to $141,900, a reduction of 26%, whereas for the median black household, wealth was nearly halved, falling from $19,200 to $11,000 (Survey of Consumer Finances, various years). Perversely, many of these households were scapegoats for a financial crisis that had more to do with defaults by middle-class homeowners, the systematic expansion of mortgage lending to buyers of all incomes, and especially the reckless securitization of those mortgages (Adelino, Schoar, and Severino 2016).

For most Americans, banks and their lending practices were the key culprits in the financial crisis, yet in its wake, banks arguably became more economically and politically powerful. This is because—at first as a matter of exigency in the face of imminent economic doom—the Fed chose to implement its unconventional monetary policy as quantitative easing (QE), or the purchasing of assets (in this case, mostly mortgage-backed securities) from large banks. But as Friedman's (1969) famous thought experiment about "helicopter money" suggests, the Fed could have chosen to counteract inequality by distributing its stimulus through new spending rather than through financial asset purchases that reinforce economic inequality—especially as the need for additional easing persisted (Bank of England 2012; Fontan, Claveau, and Dietsch 2016). (The appropriate person to carry out a helicopter money experiment was the head of the Fed, after all.) In effect, by recapitalizing the financial sector and not the broader economy, QE had a political multiplier effect that enhanced the political influence of banks at the expense of ordinary citizens. One payoff from the banks' paradoxical political recovery: the occasional one-liner aside, neither major-party candidate in the 2016 presidential election was eager to take on the political or economic power of major banks, despite the increasingly populist tone of American political debate.

WAITING FOR A CENTRAL BANK SAVIOR: THE MISSING CRITICAL JUNCTURES

Defenders of the recent performance of central banks may consider this criticism unfair. After all, following the financial crisis, few governments in North America and Europe seemed prepared to fight what promised to be a massive recession. In the United States, President Barack Obama faced fierce opposition to the kinds of fiscal stimulus that previously had been routine in the postwar period—even as recently as George W. Bush's administration. Moreover, if Keynesian stimulus in the United States was relatively small, it was nearly nonexistent in the European Union, where in country after country fiscal austerity carried the day. In this context, goes the argument, central banks could do nothing but invent new monetary policy techniques to fill the gap. It was a minor miracle that the head of the world's most powerful central bank was none other than economist and Great Depression expert Ben

Bernanke, who already had famously speculated about using the Fed's printing press to pay for broad tax cuts and spending measures aimed directly at households (Bernanke 2002). And it is surely the case that if the Fed had abdicated its de facto role as a source of economic stimulus—or if the ECB had dithered even longer in announcing in 2012 that to save the euro it would do "whatever it takes" as a lender of last resort—*and if no other actors had taken stimulative action*, then the economies of Europe and North America would be considerably worse off than they are today.

Imagine a historical counterfactual: suppose that in 2008–2012, central banks had either suddenly ceased to exist or somehow credibly committed to take no further monetary policy action once the zero-bound had been reached. Would elected governments have remained so reluctant to order fiscal stimulus if there were no hope of a central banker ex machina *waiting in the wings?*

But imagine a historical counterfactual: suppose that in 2008–2012, central banks had either suddenly ceased to exist or somehow credibly committed to take no further monetary policy action once the zero-bound had been reached. Would elected governments have remained so reluctant to order fiscal stimulus if there were no hope of a central banker *ex machina* waiting in the wings? Or would the divided and conservative governments of the time been forced to turn—as so many did in the twentieth century—to Dr. Keynes' usual remedy? A broad increase in spending and tax breaks surely would have reduced economic inequality, in sharp contrast to the persistent and rising inequality that followed the policy leadership of the Fed and the ECB.

Does the existence of a politically-insulated central bank savior crowd out more redistributive fiscal alternatives? Could it, in fact, foreclose public debates on the role of government in a recession because an actor with no electoral connection stands ready to staunch the bleeding? We often think of major changes in policy regimes coming only at critical junctures and thus tend to identify the causes of those junctures as underlying conditions for change (Streeck and Thelen 2005). What then of political institutions that help smooth away crises, and the biases implicit in the status-quo–preserving solutions these institutions provide? Critical junctures avoided are no less critical in explaining the course of policy (Capoccia and Kelemen 2007).

Consider the general reluctance of today's polarized Congress to pass any new laws. Most major legislation in the United States can muster a positive vote only under the "ticking-bomb" threat of sunset clauses that promise to obliterate popular policies if no renewal is passed (Adler and Wilkerson 2013). However, once Congress is forced to act, a critical moment arrives in which there is a chance to reshape major policies. The question is whether central banks, by their expanded monetary-policy role, spare elected governments from facing the rare and brief critical junctures that enable significant redistribution through peacetime changes in fiscal policy.

TIME-INCONSISTENCY PROBLEM, MEET SYSTEMIC POLITICAL RISK

Are independent central banks—and the technocratic insulation that they place around monetary policy debates—stable over time? There are two reasons to be concerned that they are not and to think that congressional pushback of the Fed—which Binder and Spindel (2017) documented as rising when the economy sinks—may eventually change the institution or its policy regime. One reason is related to the economic consequences of the modern Fed's approach to micromanaging inflation and economic growth; the second pertains to the ideas that ungird elite support for the Fed's independence.

If, as Fed Chairman William McChesney Martin (1955) famously said, the role of the central bank is "to take away the punch bowl just as the party gets going," what happens if the same people always miss out on the drinks? Following recent economic recessions, wage recovery for low- and median-wage workers lagged behind job recovery. As detrimental as this is for workers during a "recovery" that seems not to merit the name, consider the cumulative effect over multiple economic cycles. High-income earners tend to have more bargaining power in the labor market than low-wage workers, thereby receiving raises earlier in a recovery—especially if the labor unions that might empower those low-wage workers are weak and uncoordinated. Consider how this pattern intersects with Fed behavior, which in recent decades has sought to tame economic booms with rising interest rates once there is sufficient upward pressure on prices and wages. If high-income workers receive raises in all but the initial stages of a bust, and low-income workers receive raises only in the hottest stages of a boom, then the Fed is pulling away the punch bowl when it is finally low-income workers' turn. If this is the case, then conventional monetary policy is, intentionally or not, acting to reinforce wage inequality. This holds regardless of whether that inequality was initially caused by technological change, weaker unions, or globalization, and the effect is a ratchet, accumulating with every business cycle.

Circumstantial evidence from recent business cycles is at least consistent with the idea of such a "punch-bowl ratchet." I identified the Fed's significant recent turns to tighter monetary policy as occurring in 1977, 1983, 1987, 1999, and 2004. (A similar turn may be underway starting in late 2015, but it was too early to assess at the time this article was written. However, treating 2015 as a sixth tightening episode does

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not substantively change the results below.) Using data from the US Census Bureau (2017), I tracked the average annual change in real household income within high- and low-income quantiles before and after the year that the Fed turned to a tighter policy. Figure 1 shows the following emergent pattern: in the year before tightening, real income growth for the bottom 20% is a negligible 0.5%, lagging far behind the 2.4% and 2.8% growth enjoyed by the top 20% and top 5% of income earners, respectively. However, by the following year—in which the Fed decides the economy is running too hot and determines to tighten the money supply—real income growth for the bottom 20% finally begins to catch up, increasing to an average of 1.7% across the five cycles studied. The compression in economic fortunes across the income spectrum is short-lived once the Fed applies the brakes: a year after tightening begins, the old divide reappears between high-income groups (growing between 2.1% to 3.2% a year) and low-income groups (again barely growing at all, at only 0.6%).

These data cover only five economic cycles in a single country; therefore, the inference that central banks are partly to blame for rising inequality is far from certain. However, the possibility bears further investigation for three reasons. First, unlike many forces behind economic inequality, monetary policy theoretically is under the direct control of the state. Second, just as running QE through banks applied a political multiplier in favor of banks to the Fed's intended economic stimulus, so too does systematically holding back the recovery of low-income groups diminish their political influence over time by depriving them of the resources and economic security needed for effective democratic participation (Ojeda 2015; Verba, Schlozman, and Brady 1995). The third reason to ask whether the Fed is unwittingly ratcheting up inequality is that the Fed's tightening may be less necessary than commonly perceived. Many central bankers appear to overreact asymmetrically to the risk of inflation versus recession (Ainsley 2017). What if the Fed not only takes the punch bowl away from the same low-income households at the end of every recovery? What if it pulls that relief away, on average, too early or without cause?

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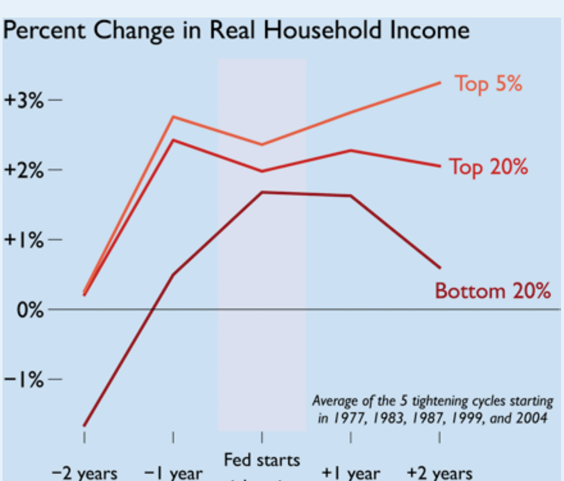
Figure 1

Who Gets the Punch Bowl? Trends in Household Income Before and After the Fed Starts to Tighten Interest Rates



Source: US Census Bureau (2017).

Whatever its ultimate sources, rising inequality is today's preeminent economic problem and, arguably, one of the key culprits behind growing discontent in established democracies. Whether or not the Fed has contributed to this problem, it eventually may reap the consequences of populist revolt. If the pitchforks come out, independent central banks may find that by failing to address a broader set of economic concerns and objectives, they have already dug their own political graves. Elite consensus in favor of central bank independence has given Fed officials the luxury of responding more to their shadow principals in the financial sector and the White House than to threats from fringe skeptics in Congress. Meanwhile, public confidence in the Fed has plummeted: an institution that enjoyed high confidence two decades ago is now held in lower esteem than Homeland Security, the Environmental Protection Agency, and the Internal Revenue Service (Jacobs and King 2016). In this new context, imagine that the Fed comes under concerted attack by other elite political actors. What happens when monetary policy justifications designed for a monocultural epistemic community of financial elites makes contact with the mass media and an enraged public? Set aside whether "time inconsistency" and "quantitative easing" are sound economic concepts. Would these terms and the ideas they represent sound persuasive to a broad audience that has been told by a trusted leader that the Federal Reserve is responsible for their economic decline?

Now add to the scenario these three words: President Donald Trump.

THE FUTURE OF THE FED

Central bank politics today implicates many of the most important forces shaping modern societies: populist distrust of elites; the tug-of-war between democratic responsiveness and delegation to complex, often quasi-public agencies; and disenchantment with an economy that seems to grow only at the expense of rising inequality. Ironically, although issues of technocracy, delegation, and economic performance have been at the core of the political economy of central banking for generations, the sterile conception of central bankers as selfless philosopher kings blocked realistic consideration of the role played by the state's most important economic agents. Reintegrating the study of central banks and political science is especially vital at a time when the future of central banking seems so politically precarious. I close by considering how the Fed might be at a turning point in terms of the people who staff it, public sentiment about its role, and the future of the institution itself.

The issue of who will run the Fed has never been more salient. Jerome Powell, Donald Trump's choice to succeed Janet Yellen as chair of the Federal Reserve, is similar to other financial sector veterans a Republican president might be expected to nominate. However, his selection means the rest of the Board of Governors faces near complete turnover. Filling these vacancies could remake the institution and send monetary policy in a new direction, regardless of who occupies the chair. Who will Trump appoint, and who will be their shadow principals—an emboldened financial sector or a loyalty-obsessed White House?

Beyond the immediate question of filling seats on the Board of Governors, the Fed's policies seem likely to face greater political scrutiny. Until recently, central banks largely ignored—or brusquely denied—the possibility that their actions and non-actions could have distributive consequences. At the same time, central banks justified their vast new powers with a mix of intellectual rationales for central bank independence aimed at elites, combined with the cultivation of a mystique of economic success to win over the general public. This set of communication strategies left a critical void filled only by the gold-standard–supporting fringe. However, as economic success—and, with it, Fed legitimacy—has fallen away, the long-term cost of the Fed's silence on inequality is coming into focus. Intellectually and rhetorically, the Fed and other central banks are poorly situated to defend the legal powers of their institutions or the process by which they develop policy. The Fed may soon regret encouraging an aloof technocratic mystique instead of nurturing an informed debate, whereas those who seek such a debate grounded in the real effects of monetary and fiscal policy may rue the way that discussion will unfold in today's populist times.

Declining Fed legitimacy could also expose the institution to successful congressional measures limiting its power, with unknown consequences for monetary and fiscal policy in future crises. Perhaps the support of major financial firms—bolstered by their recapitalization under QE—will help the Fed preserve its independence in the face of growing public skepticism. Members of Congress increasingly follow the lead of shadow principals instead of voters when considering unpopular legislation—if you might lose an election, it's good to have a more confortable and lucrative job lined up, and the financial sector has often provided soft landings to loyal former members of Congress (Egerod 2017). The Fed is especially likely to muddle through if Congress decides it is worth preserving the ability to "pass the buck" on economic stimulus.

Recent events suggest that it may be wiser for political scientists to describe elements of possible futures than to announce what will actually happen, so I will not venture to guess which way these scenarios will unfold. Yet, it seems likely that the era of political consensus over central bank independence is nearing its end. For political scientists, this means the task of incorporating the study of central banks and monetary policy into broader discussions of the political process is just beginning.

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