

The Global Politics of Central Banking: A View from Political Science

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### Abstract

This paper reviews the political science literature on central banking from the early 1990s through the present, paying particular attention to the explicit or implicit conception of politics in the works reviewed. I begin by reviewing rationalist approaches to central bank independence, considering the outcome of central bank independence from both the policy supply and demand sides, as well as reviewing a handful of more detailed single case studies. In the second section, I review the literature that challenges to this rationalist/institutionalist paradigm and in particular the assumptions and vision of politics it relies on. The third section of this paper focus on studies of central banking that move beyond the determinants of central bank independence or capture. In this section, I review studies that locate politics squarely within central banks themselves and consider the practices and political consequences of decision-making within central banks. This section incorporates the most recent ripple of political science scholarship on central banking, one that responds to the 2008 financial crisis and considers the role of central banking in times of crisis. The final section concludes by considering the future trajectory of political science scholarship on the global politics of central banking, paying particular attention to the post-crisis context.

*Keywords:* central banking, Political Science, central bank independence, monetary policy, financial crisis

## I. Introduction and Overview

In December 2007, at the first signs of trouble in the interbank lending market, the United States Federal Reserve announced the creation of reciprocal currency arrangements with the European Central Bank and Swiss National Bank (so-called “swap lines”) in order to maintain these foreign central banks’ capacity to provide dollar funding to financial institutions within their national jurisdictions (Fleming and Klagge, 2010, p. 2). Throughout 2008, swap lines were also extended to the central banks of England, Japan, Australia, Canada, Sweden, Denmark, Norway, and New Zealand, with foreign drawing on Fed swaps peaking at nearly \$600 billion at the end of the year (Helleiner, 2014, p. 40). Although these swap lines received only limited public attention and were largely absent from mainstream narratives of the crisis, Eric Helleiner holds that they not only played an instrumental role in maintaining international liquidity and a degree of stability throughout the global financial crisis, but also reaffirmed American primacy in global financial politics (2014, pp. 38-45). Nor is the salience of central banking to the global financial order confined to the actions of the US Fed. The quick response of national central banks to the 2008 financial crisis and the European Central Bank’s role as a principal protagonist (or antagonist) in the Greek sovereign debt crisis have recently thrown the politics of central banking -- and in particular, the *global* politics of central banking -- into sharp relief.

The global politics of central banking has been an object of inquiry in political science since at least the early 1990s, when the effects of global capital mobility on national economic policy drew political scientists’ attention to the nexus of globalization, macroeconomic policy, and domestic politics. Starting from an appreciation of the Mundell-Fleming condition -- the simultaneous incompatibility of intervening in currency markets to maintain a stable exchange rate, conducting an autonomous national monetary policy, and eliminating capital controls to

take advantage of the post-Bretton Woods power of global financial markets -- political scientists turned their attention to identifying the determinants of national macroeconomic policy. What leads states to forego exchange rate stability in favor of monetary policy autonomy or vice versa? What institutional arrangements ensure that governments can credibly commit to either fixed exchange rates or low inflation rates, given political pressures to deviate from both? Given the seeming costlessness of central bank independence, what accounts for the variation in levels of central banks' autonomy from national policymakers? From these initial research questions, over the past twenty-five years, the political science research agenda surrounding central banking has expanded and changed, in particular with respect to its conception of politics. Once seen as a force antagonistic to optimal macroeconomic policy arrangements, politics is increasingly understood as inhering in central banks themselves, as well as the transnational social, political, and normative environment in which they are embedded.

The overwhelming majority of the literature on central banking in political science focuses myopically on questions of central banks' independence from more obviously political governmental institutions. The dynamics of democratic politics, in particular, are assumed to be antagonistic to the desideratum of macroeconomic stability. Central bank independence has historically been of analytical interest insofar as it is seen as a means to insulate monetary policy from the effects of perverse electoral incentives, sectoral pressures, and partisan politics and to credibly commit to anti-inflation policies or fixed exchange rate regimes. A related literature examines the decision to fix the exchange rate from a similar perspective. Whether implicitly or explicitly, and with some notable exceptions that I examine in more detail in what follows, scholarship in political science has primarily located politics at the level of formal and informal state institutions, generally at the domestic or European Community level. Economic sectors and

classes are portrayed as having coherent and identifiable preferences over macroeconomic policy outcomes, these preferences are channeled through various institutional arrangements that determine the extent to which policy decisions are influenced by domestic social groups, and the outcomes of these processes are regarded as having predictable distributional consequences that benefit some groups at the expense of others. This highly stylized model of monetary politics, however, has been rightfully criticized for inadequately capturing many of the most salient aspects of the global financial crisis and responses to it.

In recent years, studies of central banks in political science have challenged such narrow models of the politics of central banking, focusing on the politics inherent in even ostensibly independent central banks, as well as the ideational power that underpins and promulgates central bank independence. Such studies attribute the dominance of independent central banks not to objectively and universally valid economic logic, but rather to the social power and legitimacy of this institutional form. Most recently, political scientists have begun to examine the politics of central banking in the context of financial crisis, focusing less on the question of independence and more on changing international monetary norms and governing ideas. While still in its early stages, this literature builds on critiques of rationalist theories of central banking by displacing the traditional view of politics and central banking as (ideally) separate forms of social interaction and focusing more on the transnational dynamics of power in which national central banks, as political actors in their own right, are embedded.

Given the long-standing dominance of various theories of central bank independence in political science's study of central banking, this paper begins by reviewing this literature, paying particular attention to the explicit or implicit conception of politics in the works reviewed. In this first section, I review rationalist approaches to central bank independence, considering the

outcome of central bank independence from both the policy supply and demand sides, as well as reviewing a handful of more detailed single case studies. In the second section, I review the literature that challenges to this rationalist/institutionalist paradigm and in particular the assumptions and vision of politics it relies on. The third section of this paper focus on studies of central banking that move beyond the determinants of central bank independence or capture. In this section, I review studies that locate politics squarely within central banks themselves and consider the practices and political consequences of decision-making within central banks. This section incorporates the most recent ripple of political science scholarship on central banking, one that responds to the 2008 financial crisis and considers the role of central banking in times of crisis. The final section concludes by considering the future trajectory of political science scholarship on the global politics of central banking, paying particular attention to the post-crisis context.

This review follows a loosely chronological trajectory, one that charts not just what Bernhard, Broz, and Clark (2002) term “generations” of political science scholarship (they identified two such generations in 2002; ideational and transnational approaches to central bank represent, in my analysis, subsequent generations) but also changes in global political economy, most notably the shift to independent central banks first in the developed, then in the developing world. All inquiries must start somewhere and I have chosen to begin my analysis in the 1990s, as most of the current scholarship on central banking either builds on or critically responds to this wave of scholarship. In keeping with the conception of this paper as a disciplinary literature review, I have attempted to confine my analysis to articles and books published by political scientists or in journals of political science. However, disciplinary boundaries are, of course, porous, malleable, and defined differently in different national academic contexts. Omissions and

questionable inclusions are, accordingly, ascribable to my own limited and American perspective, grounded in the study of international political economy.

## **II. Central Bank Independence**

### **The Building Blocks of Rationalist Approaches: Interests, Policies, and Outcomes**

Jeffrey Frieden's 1991 article, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance" is a classic within the field of international political economy and illustrative of rationalist theories of institutional choice. The motivation for Frieden's analysis comes from the wave of international capital mobility instigated by the collapse of the Bretton Woods system of fixed exchange rates and capital controls in the 1970s. As formalized by Robert Mundell (1962) and Marcus Fleming (1962), once capital markets are opened, national policymakers face a trade-off between intervening in currency markets to maintain stable exchange rates and conducting an independent monetary policy. In fixing a state's currency value, national policymakers effectively tie their national interest rate to that of the currency to which their own is pegged. Conversely, lowering interest rates will lead to a capital outflow, destabilizing the exchange rate.

Frieden draws upon models from international economics to analyze how capital mobility affects the interests of domestic interest groups, remaking political coalitions, and ultimately influencing the choice made between fixed exchange rates and monetary policy autonomy. Rejecting a straightforward application of the factor-abundance Heckscher-Ohlin model (which holds that capital mobility benefits owners of capital in capital-abundant countries and hurts owners of capital in capital-scarce countries by pushing down interest rates to match the world level), Frieden instead uses a specific-factors model to evaluate sectoral, rather than factoral, preferences over macroeconomic policy (1991). Recognizing that political behavior is more

often sectoral -- with producers divided in preferences according to whether they produce tradable or non-tradable goods and services and further divided according to whether the tradable goods are for a domestic or international market -- Frieden generates a theoretical set of expectations for various social groups' preferences over monetary policy autonomy and exchange rate level. Per his analysis, monetary policy autonomy is preferred to exchange rate stability by both import-competing producers of tradable goods for the domestic market and producers of non-tradable goods and services (though the latter prefer a lower exchange rate than the former). Variation in the relative power of these social groups across national economies both accounts for variation in exchange rate regimes and, Frieden argued in 1991, presents obstacles to international macroeconomic coordination.

### **Rationalist Theories of Monetary Institutional Choice**

**The puzzle of central bank independence.** Notwithstanding Frieden's pessimism, the states of the European Union of course ultimately decided to forego monetary policy autonomy in favor of a common currency -- the extreme version of exchange rate stability. Political science's central banking research agenda kept pace with these changes, though often while maintaining Frieden's attention to domestic actors, turning to the question of central bank independence: having committed to some measure of either exchange rate stability or monetary policy autonomy, how did states choose to organize their monetary institutions? Writing in 1991, John B. Goodman noted that, "Most governments have placed their central banks directly under political control; others have granted their central banks greater autonomy, that is, the authority to act independently from the instructions of the government" (p. 329). Just over a decade later, Kathleen McNamara observed that, "Central bank independence has achieved an almost taken for granted quality in contemporary political life ..." (2002, p. 47). How did the institutional



common sense shift so rapidly? Charting this real-world shift in governing macroeconomic ideas, the key – and indeed virtually the *only* – question for political science scholarship on central banking during the 1990s and early 2000s, concerned the extent to which central banks were independent from policymakers.

Central bank independence is widely seen to be a solution to the inability of policymakers to credibly commit to an announced monetary policy. As Bernhard, Broz, and Clark observe, policymakers have an incentive to announce low inflation policies and then renege on those policies in order to achieve short-term growth and increases in employment (2002). This tendency is particularly acute in democracies, where electoral incentives enhance politicians' preference for short-term gains over long-run costs (known as the political business cycle). As Schamis and Way contend with respect to exchange-rate based stabilization, if elections can be made to coincide with economic booms, incumbent governments may increase their likelihood of winning re-election and any longer term negative consequences will only be realized when they have been safely re-elected (2003). Such explanations are supported by an extensive and statistically robust literature in political science examining the economic determinants of (re-)election. In reviewing this literature, Lewis-Beck and Stegmaier conclude that, "For all democratic nations that have received a reasonable amount of study, plausible economic indicators, objective or subjective, can be shown to account for much of the variance in government support. In multivariate competition, controlling for other aggregate issue measures, the economic indicators hold their own. Indeed, the savvy modeler, given the choice of only one predictor, would do well to select an economic measure" (2000, pg. 210).

However, according to the theory of rational expectations, private economic actors are aware of policymakers' electoral incentives, and, anticipating a likely defection from low-

inflation commitments, make their pricing and wage decisions accordingly, undermining monetary policy pronouncements and producing an inflationary bias. Formally granting the central bank a measure of decision-making autonomy from policymakers is seen as a means of insulating monetary policy from the incentives to inflict “inflationary surprises” on economic actors, thereby enhancing the credibility of low-inflation commitments. However, political scientists observe, this relatively straightforward justification for central bank independence is not an apolitical one. Although a benevolent social planner who cared about reducing inflation would clearly delegate considerable authority to an autonomous central bank, states are not run by benevolent social planners, and in practice, policymakers care about a range of macroeconomic and other outcomes. As Bernhard et al. (2002) observe, central bank independence requires a trade-off between policy credibility and flexibility: although delegation enhances credibility and makes limiting inflation easier, it comes at the cost of flexibility; central bank independence may make stabilizing output during crises and shocks more difficult. Delegation to an independent central bank is therefore a political decision -- one driven not by objective logic but by the prioritization of some policy goals over others.

The costs associated with central bank independence (as well, as we shall see, as its relatively different benefits to different types of regimes) suggest that the significant observed variation in states’ levels of central bank independence may not simply be irrational, but the result of identifiable political forces. Central banks vary according to procedures for appointment, term duration, and procedures for the dismissal of central bank directors; budgetary autonomy; government veto power over monetary policy; explicit policy goals; performance incentives for bank directors; limitations on the monetary financing of budget deficits; and control over monetary instruments -- indicators which are typically combined to produce an

index of central bank independence (e.g., Cukierman, Webb, & Neyapti, 1992). Bernhard et al. (2002) find a fairly similar distribution of countries above and below the median level of central bank independence leading them -- and others -- to inquire into the political determinants of central bank independence. A related research agenda concerns the potential substitutability of central bank independence and fixed exchange rate regimes which, in the absence of capital controls and per the Mundell-Fleming model, allow governments to effectively import policy credibility from the state to which their currency is pegged. If the two policies can achieve the same effect, this further motivates an inquiry into the determinants of monetary institutional choice.

In rationalist explanations of variation in central bank independence across national contexts, domestic political factors are the key independent variables, building on Frieden's sectoral analysis of macroeconomic preferences, as well as on Goodman's attention to the preferences of societal actors.<sup>1</sup> Per Bernhard et al.'s analysis, rationalist explanations for central bank independence can be divided into two groups: those that focus on the incentives of "policy suppliers" (politicians and political parties) and those that focus on "policy demanders" (the social groups that feature so strongly in Frieden's account of macroeconomic policymaking under capital mobility).

**Policy supply-side determinants of central bank independence.** Multiple policy supply-side variables have been identified in the political science literature as plausibly accounting for variation in central bank independence. For example, Susanne Lohmann finds that in political systems with multiple veto players, central bank independence is more likely since undoing institutional autonomy will be more difficult (1998). Keefer and Stasavage (2002) build

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<sup>1</sup> Goodman also includes the expectations of political leaders regarding the likely duration of their tenure in office in his analysis, noting that, "Political leaders who expect that their party will be in office for a long period of time will want to maintain a high degree of freedom" (1991, p. 333).

on this finding and demonstrate that it is *only* in systems with multiple veto points that delegating authority to a central bank is likely to be an effective check on inflationary tendencies since in a system with one veto player, attempts to impose a lower-than-preferred level of inflation would be overridden. But in systems with multiple veto points, “[p]rovided that veto players do not share the same preferences, the central bank can now successfully implement a policy which one veto player would prefer to override, as long as a second veto player would refuse to override. The end result is that the inflation outcome will be different from the outcome in the case where there has not been a prior decision to delegate and veto players must bargain over the inflation rate” (2002, pp. 755-756). Hallerberg (2002), too, considers the existence of veto players to be an important independent variable in accounting for central bank independence, distinguishing between partisan veto players and subnational veto players (in federal systems). He finds that multiparty coalition governments in unitary systems are the most likely to have independent central banks, since they can effectively use fiscal policy to manipulate the economy and have less compelling need to retain direct control over monetary policy. Hallerberg goes a step further in connecting central bank independence to the choice of exchange rate regime and concludes that in systems in which fiscal policy control is more difficult, actors will forego fixed exchange rates in favor of preserving monetary independence; conversely, systems in which fiscal policy control is preferred are more likely to peg their exchange rates.<sup>2</sup>

Another supply-side independent variable that affects the degree and likelihood of central bank independence is the electoral value of monetary policy: central bank independence is less likely where control of monetary policy is unlikely to influence electoral outcomes. The electoral value of monetary policy has been analyzed as a function of politicians’ time horizons (Goodman, 1991), domestic political institutions (Bernhard & Leblang, 1999), and, similar to

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<sup>2</sup> See also Bernhard & Leblang, 1999.

Hallerberg's analysis above, the extent to which incumbents are able to use fiscal policy as a substitute for monetary policy to respond to electoral pressures (Clark, 2002).

A third supply-side variable that has been hypothesized to affect central bank independence is partisanship. Political scientists start from the assumption that left parties are principally concerned with employment and wealth redistribution, whereas right parties are more concerned with controlling inflation. On the one hand, the might lead us to expect that governments controlled by parties on the right are more likely to favor central bank independence in order to effectively achieve their low inflation targets (e.g., Goodman, 1991).<sup>3</sup> On the other hand, left parties might actually be more likely to push for central bank independence in order to shore up their lack of inflation-fighting credibility by, in effect, tying their own hands (e.g., Milesi-Ferretti, 1995). According to Bernhard et al., the empirical evidence concerning the effect of partisanship on central bank independence is inconclusive.

**Policy demand-side determinants of central bank independence.** Explanations for central bank independence that focus on "policy demanders" look to the distributional implications of monetary policy, finding that anti-inflation groups (such as bond-holders, much of the financial sector, and publics who were affected by hyperinflation in the past) may exert a significant influence over the shape of monetary institutions (e.g., Posen, 1995). Broz (2002), for example, argues that while all societies have anti-inflation groups, there is significant cross-national variation in how easily societal groups can verify governmental commitments to low inflation. In otherwise transparent political systems (roughly, democracies), the opacity of an independent central bank is acceptable to domestic political actors and enhances the credibility of a low-inflation commitment. But in credibility-seeking autocracies, governments are more

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<sup>3</sup> This is also consistent with Thomas Oatley's public choice analysis of the politics of European monetary integration (1997).

likely to choose fixed exchange rates over independent central banks, effectively importing policy credibility from abroad, since it is much easier to monitor an exchange rate peg than an independent central bank (Broz, 2002).

**Moderators, mediators, and the conditions under which central bank independence is effective.** A final set of broadly rationalist analyses of central bank independence focus not on cross-national (or cross-temporal) variation in levels of central bank independence but rather on the effectiveness of central bank independence for monetary policymaking. These studies examine how the effectiveness of central bank independence is affected by other national economic institutions, most notably coordinated wage bargaining. For example, Hall and Franzese (1998) challenge the assumption that central bank independence will always send sufficiently credible signals to overcome wage contractors' mistrust of inflationary commitments in the face of electoral incentives. They contend that in economies with decentralized wage bargaining, unions are likely to seek "inflation increments" on top of the negotiated real wage in case other unions' settlements are more inflationary. Because each union (or bargaining unit) is too small to have an effect on the economy as a whole, in decentralized wage bargaining systems, economic actors tend not to be responsive to monetary authorities' threat to respond to inflationary settlements with deflation. In contrast, in a coordinated wage bargaining system, where wages are coordinated at either the peak or sectoral level, whatever agreement the lead bargaining unit comes to is likely to be replicated throughout the economy, so those negotiating the settlement know that the central bank is likely to respond directly. Accordingly, bargainers are highly sensitive to signals from the central bank about likely monetary responses to wage settlements. Through analyzing Germany as a critical case, as well as a cross-national analysis, Hall and Franzese demonstrate that although central bank independence consistently lowers

inflation, in countries without coordinated wage bargaining, it does at the expense of employment since the signaling mechanisms that work so well in coordinated systems are not developed enough for the bank to reduce inflation without implementing tight monetary policy that increases unemployment.

Torben Iversen (1998) is similarly interested in the interaction of central banking and centralized wage bargaining, developing a game theoretic model in which the structure of wage bargaining and the type of monetary regime jointly determine the equilibrium level of unemployment. Drawing on time-series data for fifteen OECD countries, Iversen finds that central bank independence improves employment levels in countries with intermediately centralized wage bargaining systems and, in contrast to Hall and Franzese's conclusion, hurts employment in countries with highly centralized systems.

This finding, he argues, also helps account for variation in levels of central bank independence across national jurisdictions: monetary policy has effects on the real economy that vary systematically across bargaining systems (taken to be exogenous) and governments have different preferences over possible trade-offs between unemployment and price stability.

### **Moving Beyond Economics vs. Politics: Country-Specific Case Studies of Central Bank Independence.**

The insights of rationalist analyses of the political determinants of central bank independence, while most often tested using cross-national or time-series statistical analysis as in the preceding examples, have also been applied to specific cases of interest, with greater attention paid to the plausibility of the mechanisms linking domestic – and in some cases, international – political interests to monetary institutional outcomes. Somewhat ironically, given their focus on single countries, several of these case studies are more attuned to the transnational

politics of central bank independence than the large-n cross-national studies that locate the politics of central banking at the domestic level, where it is variously portrayed as an obstacle or a handmaiden to states realizing economic logic. Given their attentiveness to historical detail, these case studies offer a richer and more complex picture of the shift to central bank independence than the statistical and game theoretic models surveyed above.

For example, Maman and Rosenhek (2007) employ historical process-tracing methods in their analysis of Israel's decision to prohibit its central bank from providing loans to the government to finance budgetary deficits, which they contend set the country on the path to greater central bank independence in the years that followed. Using detailed historical data, they conclude that a new configuration of political interests was instrumental in the shift to Israeli central bank independence and that the recent memory of hyperinflation in the early 1980s provided a crucial window of opportunity for change. Rather than confining their analysis of politics to Israeli sectoral interests and economic institutions, Maman and Rosenhek place greater emphasis on transnational politics and U.S. power in particular in pushing for central bank independence in Israel, as well as on the role of expert power, in the form of a cross-national network of American and Israeli economists, in providing and legitimating a solution to Israeli fears of hyperinflation in the 1980s. Although not a single-country case study, Ethan Kapstein's (1992) explanation of convergence in capital adequacy standards among national monetary policymakers in the twentieth century is similarly attentive to the role of (Anglo-)American power and transnational epistemic communities in diffusing and actively pushing for international monetary policy norms.

Though hewing closer to rationalist analyses of (or perhaps justifications for) independent central banks, Chung and Tongzun's (2004) analysis of China's central bank



complicates the formal institutional indicators typically used to assess central bank independence. Although a 1995 law specifies that the central bank is to “independently implement monetary policy,” they note that in practice the bank is far from politically independent and, crucially, is not perceived as such by domestic economic actors (Chung & Tongzun, 2004). Without significant reforms to the relationship between state and party, they are skeptical that legal assurances of independence are likely to have any effect. By moving beyond formal institutional indicators of central bank autonomy and examining instead how the bank actually operates and is perceived in the context of Chinese party politics, Chung and Tongzun implicitly complicate analyses of central bank independence that reduce it to an index that can be readily compared across national contexts.

### **III. Critiques of Rationalist/Institutionalist Approaches to Central Bank Independence**

While case studies of the transition to central bank independence complicate the picture of the politics of central bank independence, they are generally not intended as outright critiques of the main assumption that underlies rationalist analyses: that central bank independence bolsters the credibility of low-inflation commitments, given economic actors’ rational expectations of defection from these commitments in the face of electoral incentives. In rationalist explanations of the rapid spread of institutionally independent central banks, politics is of analytical interest insofar as it accounts for deviations from what would otherwise be (economically) rational. In such explanations, politics inheres in democratic governments and the incentive structures of both policymakers and domestic actors. But these assumptions, as well as those underlying the time inconsistency justification for central bank independence, have been critiqued by political scientists who emphasize the power dynamics that undergird the economic justification for central bank independence.

At the root of most political science scholarship on central banks is the assumption that low inflation is economically and therefore normatively desirable as the primary macroeconomic policy goal. However, as Kirshner observes, the economic evidence that low inflation should be the ultimate macroeconomic goal is “modest and ambiguous” (2002, p. 7). While the evidence supports the conclusion that monetary expansion cannot improve growth and employment in the long run, it is much less clear on the question of whether inflation, in and of itself, is costly enough to warrant a single-minded focus on inflation targeting. While there are certainly costs associated with inflation, some models suggest that moderate inflation is a condition of possibility for maximizing growth and output, especially under the increasingly relevant condition of very low interest rates (Kirshner, 2002, pp. 8-9). Moreover, empirical evidence of the costs associated with inflation is confined to cases of very high inflation. Reviewing the economic literature on the subject, Kirshner concludes that, “any real economic costs of inflation, especially inflation below 20 percent, and certainly below 10 percent, are almost impossible to find” (2002, p. 9). This ambiguity is of special importance to political scientists: the less central bank independence can be explained by reference to ostensibly “pure” economic logic, the more it (and associated macroeconomic policies) demand a political explanation. Moreover, the economic common sense, widely shared by central bankers in rich countries, that the primary macroeconomic goal is to keep inflation low itself becomes an object of inquiry. In the absence of compelling economic evidence that low to moderate levels of inflation are detrimental to growth and employment, what accounts for the power of this belief?

Ilene Grabel (2000) offers one such critical analysis, situating the quest for policy credibility not in exogenous, apolitical economic logic, but rather within a broader neoliberal project intended to privilege the market over other, more democratic processes. Grabel attributes

the rise of independent central banks in Latin America and Asia in the early 2000s to the enforcement of such policies by domestic and foreign capital and by the state, rather than by the “truth status” of policy credibility.

Observing the endogenous and indeed circular nature of policy credibility (economic policies are effective only if they are credible to private actors but policies are credible only if they are seen as effective), Grabel examines the power and politics that goes into making alternatives to neoliberal policies – including central bank independence – un-credible, citing the withdrawal of loans and aid, as well as capital flight. In Grabel’s account, central bank independence is not just a product of political power rather than objective economic logic, but an explicitly anti-democratic political project: Because the credibility criterion requires that actors rely on the same models when forming expectations, the quest for credibility devalues and suppresses dissent from those holding alternative political or economic values.

Grabel’s interpretation of central bank independence as founded in politics, rather than “epistemological adequacy,” is broadly consistent with Jonathan Kirshner’s analysis of central bank independence as a “self-fulfilling prophecy” (2003, p. 655). States that deviate from low-inflation targets are punished with capital flight because foreign investors believe in a single “correct” monetary policy, despite a paucity of empirical evidence associating very low inflation rates with positive real economic outcomes (Grabel, 2000; Kirshner, 2003; McNamara, 2002). This dynamic leads to the appearance of an objective selection mechanism at work, when in fact capital flows are driven by shared expectations that may well be untethered from any necessary relationship between monetary policy and the real outcomes economic actors anticipate. “As a result,” Kirshner writes, “some policies, perhaps even the best policies, may be unsustainable solely because people (erroneously) think they are inefficient” (Kirshner, 2003, p. 655). Where

economic explanations fall short, Kirshner continues, political explanations must step in. In contrast to the explanations for central bank independence I've broadly termed "rationalist," Kirshner does not see politics as something separable from economics, but rather as animating macroeconomic ideas and especially the ways in which they are enacted. In delimiting what is seen as feasible, economic ideas (and their entrepreneurs) have significant power in shaping distributional outcomes: "Self-confirming ideas about money bestow a legitimacy to some choices that convinces the winners they are right while muting the protests of the losers. But many of these policies, justified and sustained principally upon claims of their theoretical soundness (and superiority to other options), are of predominantly political origin and effect" (Kirshner, 2003, p. 656).

Like Grabel and Kirshner, Kathleen McNamara (2002) critiques the assumptions underlying rationalist justification for central bank independence, systematically examining the empirical evidence a) that democracy produces a political business cycle and partisan bias producing inflationary outcomes; b) that inflation is detrimental enough to present a compelling justification for central bank independence; and c) that independent central banks produce more positive economic outcomes than politically dependent or accommodating central banks. McNamara finds a) that while governments may try to influence election outcomes, they are more likely to use pork barrel fiscal policies than macroeconomic policy to achieve this end; b) that moderate levels of inflation are associated with only very small deadweight losses and that inflation needs to exceed 40% per year for it to produce low growth (Bruno & Easterly, 1996); and c) that the strength of the correlation between central bank independence and low-inflation outcomes is highly sensitive to the criteria used to measure independence, the time period, and the countries included in the sample. Indeed, when only developing countries are included, the

effect disappears completely (Posen, 1993). According to McNamara, the spread of central bank independence is not the result of objective functional benefits, but rather because delegating authority to an independent central bank “has important legitimizing and symbolic properties which render it attractive in times of uncertainty or economic distress” (McNamara, 2002, p. 48). Adopting a sociological institutionalist perspective, McNamara still regards central bank independence as “rational,” but only within a neoliberal cultural and historical context. For McNamara, the politics of central bank independence are most salient in the way that conventional, economic justifications for independent central banks reify specific economic ideologies and obscure the distributional and anti-democratic consequences of monetary institutional choice.

Critics of central bank independence in effect accuse rationalist analyses of having conflated an ideological *justification* for central bank independence with an analytical *explanation*. If democratic politics are not associated with higher levels of inflation, if inflation is not inherently bad, and if delegating authority to central banks does not produce lower rates of inflation, rationalist analyses that position political actors as antagonistic to economically sound policy have taken an overly narrow view of the politics of central bank independence. These critiques tell us that the spread of central bank independence is a product of ideas – often backed by powerful state and international actors (notably the U.S., the IMF, the World Bank, and international capital markets) – that are rooted in reflexive expectations, self-fulfilling prophecies, and a broader social valuation of neoliberal norms. Accordingly, the politics of central bank independence are considerably more complicated than parsing the constellation of domestic interests and institutions that make central bank independence more or less likely.

This attentiveness to the politics inherent to central banking can be seen in political science literature that goes beyond the question of central bank independence to look at central banks, independent or not, as political actors in their own right and as embedded in systems of political and financial power that increasingly cut across national borders. Although these studies represent a much smaller volume of the political science literature on central banking, they are worth reviewing here for their sensitivity to the complex global politics of central banking.

#### **IV. The Politics of Central Bank Practices and Decision-Making**

Consistent with the idea that politics inhere not just in the interactions between interest groups and central banks but within powerful macroeconomic ideas themselves, a small body of work in political science studies central banks not as influenced by and optimally isolated from outside political interests but as political actors in their own right. This relatively recent group of studies engages with a much broader range of research questions than the very narrow focus on central bank independence that characterized political science scholarship on central banking throughout the 1990s and early 2000s. As befits a greater diversity in research questions, this literature also makes use of a wider variety of both theoretical and methodological tools, borrowing frequently from sociology and drawing on both internal and published central bank documents and interviews with key decision-makers.

For example, Stephanie Bell-Kelton (2006) examines the factors that influenced Federal Reserve policy during the 1990s, focusing not only on institutional reforms and changing economic conditions, but also on a “common intellectual framework regarding what central banks can and should do, as well as how best to achieve their goals” (p. 5). Bell-Kelton’s data source is distinctive in comparison to works focusing on the determinants and consequences of central bank independence: rather than identifying statistical correlations between

macroeconomic policies and outcomes, she instead looks at published transcripts from the Federal Reserve itself. Bell-Kelton's analysis reveals that the Federal Reserve sees its role as managing not only interest rates (via the federal funds rate) but also expectations (via public communications) (2006, p. 8). Her article also brings to light tensions within the U.S. central bank itself, an actor that, in general, is assumed to be a unitary actor with easily imputed preferences. She documents, for example, the conflict between the Federal Open Markets Committee (FOMC) and the Fed staff over the appropriate use of the Taylor rule in setting interest rates.<sup>4</sup>

The 2008 global financial crisis has intensified interest in monetary policymaking and drawn scholarly attention to central bank activities that go beyond setting interest rates. While Bell-Kelton's analysis of Fed decision-making is primarily descriptive, Stephen Golub, Ayse Kaya, and Michael Reay (2015) similarly draw on FOMC transcripts to make the more pointed case that the Fed's intellectual paradigm limited the institution's capacity to recognize the crisis-prone dynamics of the U.S. economy prior to 2008. Borrowing from organizational sociology, they contend that despite the Fed's unrivalled access to data, economists, and financial institutions, their institutional routines and primarily reactive paradigm of "post hoc interventionism" undermined the impact of those voices within the Fed that did interpret the housing bubble and mortgage securitization as potentially dangerous at a systemic level.

Also motivated by the 2008 financial crisis – and speaking to the significant role of ideas in central bank decision-making – is Lucy Goodhart's 2015 analysis of the impact of the post-crisis turn to macro-prudential policy on Federal Reserve policymaking. Drawing on interviews with financial regulators and relevant journalists, Goodhart considers the extent to which the

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<sup>4</sup> Bell-Kelton also describes a protracted debate within the Fed over how to interpret structural change in the U.S. economy and how to respond appropriately.

Fed's new mandate to gauge systemic risk is likely to politicize the Fed's activities and undermine its institutional independence. Like previous work on central bank independence, Goodhart's analysis primarily examines power dynamics between market participants (who generally oppose the higher capital ratios macro-prudential policy calls for during times of growth), Congress, and the Federal Reserve. In contrast to earlier work, however, Goodhart affords a significant role for expertise in her analysis and is far more measured in her assumptions about actors' interests, noting that, "In the absence of a fully-fleshed out causal account of risk and financial crises, groups or individuals may not yet be able to identify their preferences over MPP [macro-prudential policy] quickly or easily" (2015, p. 301). Goodhart's analysis is also significant in that it acknowledges the changes and complexities in central bank politics that were instigated (or perhaps revealed) by the financial crisis, contending that the Fed was "in a different setting following the crisis," one no longer characterized by a world-view of self-correcting markets and one in which unpredictable populist reaction to financial scandal is likely to play an important role (2015, p. 301).

Analyses of central bank decision-making have not been confined to the United States Federal Reserve. David Howarth's (2007) article on the 2002 reform of decision-making procedures within the European Central Bank (ECB) is a primarily interest-based account, but it nonetheless goes beyond the focus on central bank independence to consider the ECB as embedded in social and political networks, in which questions of representativeness and legitimacy play a significant role. The euro zone provides an especially interesting context for examining these questions, given the wide range of economic situations that the ECB represents and responds to (despite its official requirement to target euro zone-wide inflation). In emphasizing the trade-offs between equality, representativeness, and decision-making efficiency



and effectiveness, Howarth's analysis positions central bank policymaking as inevitably political, with its legitimacy deriving not just from its ostensible isolation from politics, but also from the irreducibly political question of democratic representation in decision-making.

Manuela Moschella (2015), too, focuses on non-US central bank decision-making in her analysis of the Swiss National Bank's 2011 decision to intervene in foreign exchange markets and introduce an exchange rate floor. Like Goodhart, Moschella is interested in the post-crisis shift to macro-prudential policymaking, affording this ideational shift a central place in her account of the Swiss National Bank's willingness to jeopardize its anti-inflationary reputation. While acknowledging the significance of the Swiss export sector (who supported limiting the appreciation of the Swiss franc), Moschella nonetheless regards domestic interests and institutions as inadequate causes for the shift on central bank policy. Instead, drawing on public pronouncements from the SNB, she makes the case that the post-crisis debate over what monetary policy should entail afforded the SNB space for experimentation with policy instruments intended to manage risks in the Swiss financial sector, rather than focusing myopically on price stability (Moschella, 2015, p. 136). Her account affords a significant role for the international central banking community and transnational ideas, positioning the Swiss central bank within a changing global context rather than a purely domestic one.

Taken together, these analyses of central bank decision-making represent a significant and welcome departure from the narrow focus on central bank independence in at least three respects that are increasingly important in the post-crisis world of global economics: they acknowledge central banks as fundamentally political actors; they emphasize the importance of governing ideas and paradigms in the politics of central banking; and they are attentive to the

changing role of central banks in the global economy, especially following the financial crisis. I shall conclude by considering these departures in more detail.

### **V. Conclusion – The Politics of Central Banking in a Post-Crisis World**

It is ironic that politics is the lacuna in most political science scholarship on central banking. The vast majority of political science scholarship on central banking effectively omits politics – as characterized by contestation over not only the means but the goals of policymaking and the deployment of multiple dimensions of power – from its analysis. The first generation of political science scholarship on central banking effectively reduced politics to a single dimension: the conflict between inflationary political pressures and central bankers intent on maintaining a credible commitment to low inflation. While there is no doubt that this conflict is central to the global politics of central banking, politics is about far more than the distributional consequences of given policies. As the sociology literature on central banking shows, questions of legitimacy, which are poorly captured by a distributional model, are central to the global politics of central banking (Doherty Bea, 2016). Moreover, as critiques of this large rationalist literature reveal, the economic assumptions about the consequences of monetary policymaking are not as unimpeachable as these analyses would suggest. The scholarly consequences of this narrow focus were laid bare in the 2008 financial crisis, an event about which political science scholarship had relatively little to say (Helleiner & Pagliari, 2011; Katzenstein & Nelson, 2013). Having implicitly restricted its definition of politics to the ability of actors' interests to be effectively channeled through institutions, political science was very poorly positioned to account for the uncertainty, complex transnational networks, and diverse forms of power in global financial politics that characterized the crisis and shaped the responses to it. The third

generation of political science scholarship on central banking represents a promising, albeit very belated, corrective to this single-minded approach.

By focusing on central banks as political actors in their own right, scholarship on central bank decision-making makes visible the sometimes taken-for-granted, sometimes clashing ideas that guide monetary policy-making. In contrast to studies that assume that, in the absence of politics, all central banks would follow a purely apolitical economic logic centered on credibly minimizing inflation, this third generation of scholarship rejects the very notion of “the absence of politics” as a meaningful analytical category. Instead, monetary policy-making is portrayed as having an irreducibly interpretive – and therefore contestable and often contested – component. This is especially visible in the post-crisis transnational shift to macro-prudential approaches to economic governance, in which the goal of minimizing inflation nationally coexists with the goal of minimizing risk in a systemic global context.

While much of the political science literature takes for granted the normative value of central bank independence, this narrow focus is poorly suited to a post-crisis world, in which central banks are tasked with a much wider range of policy goals, many of which can only be pursued in a global context.<sup>5</sup> While some post-crisis scholarship has maintained this traditional focus (e.g., Bodea & Hicks, 2015), it is imperative that political science scholarship on central banking move beyond domestic politics accounts to consider the transnational vectors of power – and their non-material and ideational dimensions – that shape the politics of central banking. Moreover, an exclusive focus on central bank independence is of questionable relevance to a global or comparative perspective; for many central banks, especially those outside of political science’s traditional focus on the developed world, reducing the politics of central banking to

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<sup>5</sup> And which may require tools beyond the traditional levers of monetary policy. Various forms of quantitative easing are a prominent example (albeit still within the paradigm of affecting interest rates), but see also Blyth and Lonergan (2014)’s call for central banks to issue direct transfers to citizens.

measures of political independence overlooks many of the most important dimensions of monetary politics, including domestic corruption, competing policy goals for developing economies, and international pressures from both capital markets and international institutions.

In the post-crisis world of near-zero interest rates, central bank activities that extend well beyond inflation targeting, attentiveness to systemic risk (Buiters, 2012), a heightened appreciation of uncertainty, and regulatory fragmentation despite an increased need for transnational cooperation, political science must broaden its focus beyond the relationship between domestic actors and central banks. Continuing to draw on theories and approaches from sociology represents one promising trajectory, given sociology's focus on central banks as heterogeneous institutions rather than unified actors (Doherty Bea, 2016).

Political science might also benefit from further engagement with the legal aspects of central bank politics, particularly in a comparative perspective. It is essential that scholars recognize that central banks do not exist in an apolitical vacuum but are rather enmeshed in nationally specific legal, social, economic, and political contests. The legal literature, taken as a whole, emphasizes the essentially contested nature of central banks' mandates, especially as they concern unconventional policy tools (Prates, 2016). This contestability should drive political scientists to look beyond banks' formal institutional position and to consider the politics of interpreting, justifying, and legitimating central banks' authority under conditions of uncertainty.

Political science stand to gain, finally, from a sophisticated and critical engagement with contemporary research in economics, including heterodox economics, rather than to continue to rely on economic assumptions from decades ago. However, this engagement must go beyond a straightforward importation of economic theory. Political science scholarship on central banking in the 1990s and early 2000s was effectively colonized by an uncritical adoption of mainstream

economic models in a manner that was ultimately costly for the discipline's explanatory potential and imaginative scope in generating research questions (Nelson & Katzenstein, 2014). Going forward, political science must be reflexive about the status not only of central banks' but especially its own uncritical reliance on economic models and theories. Such reflexivity should not be understood as academic navel-gazing; rather, it is essential to the discipline's ability to engage usefully and critically with the complex and changing landscape of global monetary politics.

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