The paradox of monetary credibility

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The Brexit vote, the election of Donald Trump, and the rise of the extreme right in Europe all remind us that no matter how hard economic policymakers try to insulate their decisions from politics, they will never succeed. In fact, recent events demonstrate that not only are economic policies inherently political, but the very attempt to separate them from political pressures can very easily have the opposite effect.

One of the hallmarks of the recent sharp veer to the right has been a growing suspicion of so-called elites and experts—chief among them, those very central bankers who were only recently being celebrated for saving the global economy (Mallaby, 2016). If this suspicion of expertise continues to grow, it has the potential not only to precipitate the coming economic crisis by eroding monetary credibility, but also to frustrate policymakers' attempts to respond effectively.

There are of course a great many factors driving the rise of the right, and to suggest that they can be reduced to the effects of failed economic policies would be to oversimplify in the extreme. Certain economic policies do nonetheless bear some responsibility for our present predicament—notably the last two decades' trend towards a particular kind of politically-insulated, rule-based form of monetary policymaking. Central bank independence and rule-based monetary policy became the norm over the past few decades on the assumption that requiring policymakers to follow simple rules, like meeting an inflation target, would make their policies credible.

Yet, policymakers forgot that credibility is not a natural phenomenon, granted by the laws of orthodox economics, but a profoundly social and political one (Braun, 2017). For a policy to be credible, it must be believed. In the context of a democratic society, that belief also depends ultimately on the legitimacy of those policies and the institutions and individuals who produce them. Recent electoral events have reminded us once again that insulating economic decision-makers too much from popular concerns tends to erode their legitimacy—and thus undermine the credibility that they seek so jealously to protect.

In order to understand how we got into this present dilemma, and to ascertain the risks of future crisis, we need to look at three key moments in the recent history of monetary policymaking: the rise of the rule, the proliferation of exceptions, and the erosion of legitimacy.

One rule to bind them all

Rule-based monetary policy and central bank independence have not always held the kind of near-divine authority that they do today. After the failure of the gold standard and its disruptive influence in the lead up to the Second World War, the task of managing the value of money was seen as a central responsibility of elected governments, to be pursued with an ever-changing mix of fiscal, wage and price control and monetary policies.

Yet, by the mid-1970s, as economic policy fell into a stop-go cycle of stimulus and restraint and inflation continued to surge, monetarism, one of the first and most influential economic theories to advocate a strict rule-based approach to managing inflation, began to gain influence.

The logic of rule-governed monetary policy was straightforward: policymakers would identify and publish their commitment to a particular monetary rule or target (today, the golden rule seems to be a 2 per cent inflation target). Market actors and the general public would then adapt their actions according to this target. Central bank independence was seen as crucial because it was believed that technocrats were more likely to stick to the rule than elected officials who might be too influenced by popular concerns (since monetary policy always produces winners and losers) (Kydland and Prescott, 1977).

After the inflationary instability of the 1960s and 1970s, this rule-governed approach to policy was designed to be both politically and economically stabilizing: to do away with the problem of political uncertainty by removing not only governments' but even central bankers' discretion: just stick to the rule, and everything will work out. A tidy, efficient, depoliticized (although certainly not apolitical) approach to monetary policy.

In practice, of course, the initial effectiveness of the monetarist turn was far from universal: although the painfully high interest rates imposed by the US Federal Reserve Chairman, Paul Volcker, in the early 1980s were generally effective in bringing down inflation, in the UK, Thatcher's governments ultimately gave up on their experiment with a monetary rule and used deflationary fiscal policy and the resulting mass unemployment to bring down the inflation level (Elgie and Thompson, 1998).

Over time, however, the rule-based approach gained traction on a global level, as market actors and politicians came to understand and expect that monetary rules would maintain price stability. Mainstream economists came to love rule-based monetary policy as did politicians. In the 1980s and 1990s, most central banks moved towards an increasingly rule-based approach to monetary policy, with inflation targeting becoming the norm in many countries in recent years.

Although even former US Federal Reserve Chairman, Alan Greenspan, has admitted that the remarkable price stability of the 1980s and 1990s cannot be fully attributed to the effectiveness of rules-based monetary policy, the victory of simple rules became an extremely powerful narrative (Greenspan, 2004).

The exceptions start piling up

Since the 2008 financial crisis, however, those rules came under increasing strain as central bankers experimented with a whole range of unconventional monetary policies in their efforts to respond.

There has been more attention of late to central bankers' increasing power and influence on the global stage, as they were given primary responsibility for responding to the crisis. However, there has been less attention to a key paradox underlying central bankers' new roles on the world stage: they are being forced to govern through exceptions in an era in which rule-following has become the ultimate source of policy credibility. Where central bankers are supposed to stick to the rules, they have found themselves endlessly making exceptions, promising that one day things will return to normal.

Governing through exceptional policies is always a politically-fraught undertaking, particularly over the long-term, but it is even more difficult in a context in which the dominant convention is one of strict rule-following.

Today we are faced with a situation in which the rules no longer apply but are still being invoked as if they did. A recent Buttonwood column notes that the Bank of England has missed its inflation target "almost exactly half the time" since 2008 (Buttonwood, 2016). The European Central Bank (ECB) has effectively expanded its narrow mandate, which formally requires it to make price stability its top priority, by arguing that employment and other issues are crucial to achieving it. Yet the ECB and the Bank of England continue to act as if the old rules still apply.

If we look beyond the narrow rules that are supposed to be governing central bank actions and examine the wider changes in their recent policies, we find similar patterns. Scratch an unconventional monetary policy and you will find a kind of economic exceptionalism: an argument that the instability that we continue to face is extreme enough that it requires a radical but temporary suspension of economic rules and norms.

Most of the unconventional monetary policies that have been tried to date, and just about all of those that have been proposed as future possibilities if we face a renewed global recession, break quite radically with existing norms. Negative interest rates weren't even supposed to be economically possible (until they were tried), while quantitative easing (a central bank's buying up bonds by massively increasing the size of its balance sheet) still carries a whiff of irresponsibility linked to its past as a way for governments to avoid fiscal retrenchment by “printing money.”

More recent proposals include ‘helicoptering’ money into the government’s or the public’s accounts, abolishing cash to make low interest rates effective, and even introducing a reverse incomes policy—a government-enforced increase in wages (as opposed to the wage controls of the 1970s) to try to get inflation going.
All of these existing and potential policies break with current economic norms, and all are being pitched as temporary, exceptional measures that are (or may be) necessary in the face of an extreme future crisis.

Ironically, rule-following was designed precisely to avoid any reliance on ad hoc monetary policies of the kind that had proliferated in the 1960s and 1970s. Yet rules only seem great until they don’t apply anymore. A rule that pretends it can always apply inevitably runs into serious problems when an exception becomes necessary.

The erosion of legitimacy

As the exceptions have started to pile up, market actors, politicians, and the general public have begun to ask questions about the legitimacy of central bankers’ considerable powers (Fleming, 2015; Buttonwood, 2015).

Yet, to fully understand how the legitimacy of central banks became contested, we need to go back further, to the height of the rule-based order. It is true that central bankers like Greenspan were invested with almost mythic authority during the Great Moderation (an era of unusual macroeconomic stability dating roughly from the mid-1980s to the onset of the 2008 financial crisis); yet, the low-inflation order that they sought to maintain through their monetary rules ultimately benefited some far more than others.

Central bankers made an explicit decision to focus narrowly on price stability at the expense of other potential objectives, including fostering employment and encouraging growth. Although the goal of this narrow approach was to get politics out of the mix by aiming for less contestable policy outcomes, this rule-based strategy nonetheless had political consequences.

While the rule-based approach assumes that low inflation will benefit everyone, the evidence on the issue generally points in a different direction, suggesting that growth and equality are best served with moderate rather than very low levels of inflation (Kirshner, 2000; Monin, 2014; Bulir, 2001). There will also be winners and losers for any given interest-rate level: for example, young families with big mortgages will generally benefit from low interest rates, while seniors living on their savings will be penalized by them. There is simply no way to avoid the distributive consequences of monetary policy.

At the same time, the very fact of excluding broader economic targets from their calculations made monetary policy blind to some of the signs of economic instability and limited their ability to predict and prepare for the 2007-2008 crisis. As late as August of 2007, for example, the Federal Reserve was still more preoccupied with the possibility of inflation than with the looming threat of financial instability (Telegraph, 2013).

Of course, once the crisis hit, central bankers underwent a rapid about-face, shifting from a narrow reliance on monetary rules to an unprecedented experiment with exceptional measures. Yet, even as monetary policy shifted from rule to exception, the same dynamic was at work, as policies designed to avoid political conflicts ultimately end up exacerbating them.

Why did central banks play such a massive and extended role in responding to the financial crisis? In large measure, because elected leaders wanted them to play that role. Particularly as the immediate crisis receded, and politicians decided to switch gears from fiscal stimulus to austerity, they came to rely increasingly on central banks' exceptionalist measures (like very low interest rates and quantitative easing) to keep the economy moving. By refusing to take political responsibility for the need for further stimulus, they passed the buck to central banks.

Yet, once again, by trying to avoid political conflict, these governments ultimately created a different kind of political problem: granting central banks more authority than they could legitimately sustain over the longer-term.

As central banks' legitimacy has come into question, so has their policies' long-term credibility, putting them in a very difficult place indeed. After all, how does monetary credibility work? It depends, at the end of the day, on faith. Even orthodox economists agree on this: the credibility of a central bank's monetary rules hinges on public expectations that a policy commitment will be followed through in practice—that the rule will be followed.

As the exceptions pile up, it is becoming increasingly difficult for central bankers to convince the public of the credibility of their rules. If employers, investors, and wage earners don't believe that policymakers can or will stick to the rule, then they will begin to change their monetary practices, eroding the virtuous circle of monetary credibility as, for example, wage-earners start asking for higher future increases to hedge against future inflation. While the habitual nature of low inflation expectations, and the practices that they inform, will continue for some time, if central banks' legitimacy continues to erode, there is a growing risk that they will come unstuck in the context of a future shock.

Whereas central banks provided some of the most effective responses to the last crisis, it is therefore unlikely that they will have the legitimacy and the effectiveness needed to fight the next crisis. In remarkably short order, central bankers have gone from the heroes to the villains in many political narratives. The Governor of the Bank of England, Mark Carney, has faced unprecedented attacks for the Bank's grim predictions of the likely economic fallout of a positive Brexit vote, while Congressional Republicans' post-crisis calls to "Audit the Fed" in the United States have now been joined by President Trump's repeated criticisms of the Federal Reserve Board. It will be far more difficult for politicians to call on those same monetary institutions to help fight the next economic crisis if their credibility is in tatters.

Where should we go from here? In the short-term, with authoritarian exceptionalism on the rise in the United States and elsewhere, we may be glad that there are at least a few institutions, like central banks, that are at least somewhat insulated from direct political control. Yet, the lessons of the past decade should make us think rather carefully over the longer-term, as we try to understand how things could have gone so very wrong, and how to prevent them happening in the future.

The lesson to be drawn here is a simple one: while too much politics may make for poor monetary policy, too little politics can be just as dangerous over the longer-term. When monetary institutions seek to insulate themselves from political pressures and concerns in order to ensure their policies' credibility, they may actually become vulnerable to more dramatic erosions to their legitimacy -and thus to their credibility.

And as recent events have reminded us once again, when our institutions lose their legitimacy, bad things often start to happen.

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